

# The Keys to a Reliable Escrow Agreement

*Richard Sheffield*  
3539 A Church St.  
Clarkston, GA 30021-1717  
1-800-875-5669  
[escrow@mindspring.com](mailto:escrow@mindspring.com)

*"Forethought in any part of life is seldom regretted and always rewarded."*

Perhaps one of the most admired industries in the world is that of computer software. Most companies who comprise this industry are looked upon as rapidly growing, innovative enterprises. These companies are often admired as smaller operations that must fight to stay on top in a highly competitive industry. Yet these are the very characteristics that scare so many of the clients of these developers. An end-user of the software often wonders, and rightly so, that if the software developer fails to prevail in this competitive industry, if bankruptcy is only a few months away. *The Economist*<sup>1</sup> has reported that as many as 60% of all newly created high-technology companies will disappear within five years. The recognition of the corporate mortality of technology developers extends beyond this industry. This concern has also alarmed business partners of technology companies who might be involved in co-development projects. Lastly, investors, such as venture capitalist, are looking for ways to secure their interest in proprietary information.

## **Background**

These are the concerns that gave birth in the late 1970s to *software escrow services*. These arrangements require the developer of a software product to place proprietary materials necessary to maintain the product in escrow with a neutral party known as the *escrow agent*. Should the software

vendor, or *licensor*, fail to support the product, the escrow agent agrees to release the proprietary materials (such as source code) to the end-user. The end-user, or *licensee* is then allowed to employ the deposit materials to support the licensed product. In theory, the service seems reliable and should allow the licensor and its client to proceed with their business relationship. However, does the software escrow service really protect the licensee or does it only provide an erroneous sense of security?

The opponents of these arrangements turn to the examples of failed escrow agreements as evidence that the concept is a flawed one. All too often, the parties involved in licensing negotiations rush through the establishment of the escrow and neglect the issues that distinguish an effective escrow from a valueless service. Todd Volyn, an attorney with Shell Oil Company notes, "Raising the point [of escrow] threatens to considerably lengthen the negotiation process - an outcome that nobody desires. Thus, the parties come to a raw compromise without considering the cause of the concerns, whether an escrow is even capable of meeting those concerns, and alternative solutions."<sup>2</sup> In particular, the conditions upon which the escrowed materials may be released are often so restrictive, that it is not possible for the licensee to retrieve the escrow documentation, even if the developer has clearly failed in its responsibilities. Moreover, if the licensee is successful in acquiring the source code and other materials, it may have been so poorly prepared that it is useless in the efforts of licensee to assume the responsibility for the maintenance of the licensed program.

While these criticisms are fair ones, they do not indict the entire escrow process but rather point to the lack of foresight in the creation and execution of many escrow agreements and services. When properly prepared and executed, an escrow arrangement will provide a safety net under the relationship between the parties involved in technology transfers.

## **A Prepared Escrow Policy**

Most companies have no established escrow policy, leading to uncertainties within an organization of when to request an escrow from software vendors and what type of service should be required. Many licensees go to the trouble to demand an escrow from their vendor, but the decision of who to escrow the materials with is left up to the vendor. Not surprisingly, the vendor usually opts for the least expensive service, such as the vendor's own attorney. While an arrangement of this nature may provide a quick solution, it often sacrifices the security of the escrow. Many contracts of this kind include insurmountable obstacles to the licensee's acquisition of the deposit materials. For example, the only condition that the material may be released will be "complete corporate dissolution" of the software vendor, a condition that omits service faults, reorganization or the transfer of ownership of the vendor.

For the company that licenses software and is unable to acquire the proprietary information central to the product, a standardized policy of when to ask for an escrow and what type of service is required will often ensure a successful escrow arrangement. The licensee's counsel or legal department should coordinate such a policy with the purchasing and Information Technology (IT) group within the company. This strategy must offer the purchasing agent criteria for evaluating if the developer is likely to fail in support of the product. The escrow requirement should be submitted before the license agreement is executed. This provides the licensee with significantly more leverage in its request and allows portions of the escrow agreement to be referenced in the license agreement.

## **The Escrow Agreement**

The foundation of any escrow service is the agreement. Although many escrow agents will offer their own form contract, the vendor and licensee may

both profit by having their own terms to present to one another when beginning the escrow discussions. Counsel for either side should be all too familiar with what they and the opposing side require of the escrow, particularly the release conditions which are at the heart of the contract. An attorney representing the licensee is likely to offer liberal release conditions that allow the licensee to receive the deposit materials immediately upon any request. Conversely, as mentioned above, the developer's counsel will insist upon a release only in the event of the vendor's dissolution as a corporate entity and require the licensee to pay all fees associated with the service. While a truly neutral escrow agent is unlikely to take a position on such issues, one may expect the agent to offer suggestions based on their experience and present their own requirements of the contract. The agent is likely to insist on the clarity of such instructions that dictate the terms of release. Vague release requirements benefit no one and often invite extended court battles.

The effectiveness of the service is determined by a number of other sections of the agreement. First, the contract should establish a date by which the vendor is required to deliver the deposit materials to the agent. Often an agreement is reached to escrow the materials with an agent, but none of the parties are responsible for ensuring the materials are actually delivered. Second, the developer may want to consider placing restrictions on the licensee's use of the deposit materials should they ever be released. Such conditions usually correspond to the constraints found in the license agreement. Finally, there is the question of the indemnification and liability of the agent holding the materials. It is in these sections that the escrow agent is likely to offer its strongest opinion, insisting on reasonable limits to its liability.

## **The Deposit Materials**

The escrow agent is likely to offer great insight in how to prepare an effective escrow deposit. The deposit should be made within a reasonable period following the execution of the escrow agreement. A

period of 15 to 30 business days is typically agreeable to both sides. Should there be a delay in this deposit, the escrow agent should notify the licensee of the developer's failure to comply with the agreement. This delay may be due to a number of factors, including the developer's intentional noncompliance with the agreement or something as innocent as a delay in the scheduled development of the product. However, even if the product is not fully developed at the time the deposit is required, a partial deposit likely benefits the licensee more than a hollow arrangement with no deposit. If the delay is due to the developer's oversight or disregard for the arrangement, the licensee is usually the only party with enough leverage to influence the developer to make the deposit. Ultimately, the developer should work to make both the initial and update deposits in a timely manner. All parties might find it helpful to agree upon an established schedule, such as quarterly updates, to ensure the escrow deposit remains up to date.

While some critics of an escrow cite incomplete deposits as evidence of the ineffectiveness of an escrow, it is not an inherent problem of the service. In fact, deposits that are of no ultimate use to the licensee are often the result of failed communications between the parties as to what materials would constitute a usable escrow deposit. It is common for the parties to hurry through this discussion and to disregard the advice of the agent who likely has some valuable background as to what materials have historically made up a reliable deposit. In any event, communication on this matter between the agent, a programmer for the developer, and the ultimate end-user for the licensee will go a long way towards the creation of a reliable escrow deposit. Many larger corporations have found it useful to create a standardized list of escrow materials that are required from all developers. This policy insures that all escrows created will have a comprehensive deposit. It also prevents key materials from being omitted on account of an accidental oversight by a hurried developer, or the negligent action of a careless employee on either side. A partial list of recommended deposit materials includes:

- Two copies of the Source Code for each version of the licensed software on magnetic media
- All manuals not provided to the licensee (technical, operator/user, installation)
- Maintenance tools and necessary third party system utilities
- Detailed descriptions of necessary non-liscenser proprietary software, descriptions of the programs required for use and/or support that the developer does not have the right to offer to the licensee
- Names and addresses of key technical employees that a licensee may hire as a subcontractor in the event the developer ceases to exist
- File listings generated from any magnetic media
- Compilation instructions in written format or recorded on video format.

When the materials have been prepared by the developer, they should be shipped to the escrow agent through a traceable courier. Included in this shipment should be a complete set of the materials, a letter from the developer certifying the accuracy of the materials, and an inventory list of each item of the escrow deposit. Upon receipt its receipt of the materials, the agent should contact both the developer and the licensee to verify the material's arrival. This notification should be sent to an individual determined to be the primary contact for all activity relating to the escrow account.

### **Storage of the Deposit Materials**

Unlike most paper documents, magnetic media requires unique storage conditions. It is critical that

both the developer and the licensee be familiar with the escrow agent's storage facilities before contracting for this service. It is common for the company who agrees to store magnetic media to also store other valuables, such as jewelry or personal collectibles. This practice is problematic for the developer and licensee, because these types of facilities are more susceptible to burglaries and vandalism. If possible, an agent of the licensee and developer should confirm that only magnetic media or technology documentation is being kept at the storage location.

An environment designed to store paper documentation, such as a safety deposit box or safe, differs from the environment required to store magnetic media. Because fluctuating temperatures and humidity can damage the media, the escrow agent should have a *media vault* in which to secure the deposit materials. These vaults avoid dangers to these types of materials. For example, a media vault will not have standard water fire extinguishing systems which, if activated, will destroy magnetic media. An inspection of such facilities should confirm these qualities in an escrow agent's facilities:

- fire retention walls with a minimum four hour fire rating
- Halon or some alternative gas fire extinguishing system
- storage environment that maintains constant temperature and humidity
- extensive security systems shielding the facilities

The escrow agent should be required by the developer to secure the confidentiality of the media. The developer often receives commitments from the agent that the material will be not be available to any party once it is delivered to the agent, except as required by the agreement. To ensure this condition is met, the developer may wish to seal the materials in a package that will remain unopened when the material is

received by the agent. Periodic audits of the facility and condition of the materials should help assure the safe keeping of the escrow deposit. During these audits, one should examine the insurance held by the agent and look for coverage designed for escrow services, such as liability and errors & omissions coverage.

From time to time the product being licensed by the end-user is upgraded. It is critical that major updates to the source code be sent to the escrow agent so that the escrow deposit correctly corresponds to the version being used by the licensee. Otherwise, if the escrow is ever released, the licensee may find the escrow deposit to be antiquated and therefore useless for its purposes. While the primary responsibility for shipping upgrades to the escrow agent lies with the developer, both the agent and licensee may play an active role in updating the escrow deposit. For example, quarterly phone calls may be made by the agent to each party asking if an update has recently been shipped to the licensee and if such an update should be made to the escrow. The involved parties should decide whether the older materials should be returned to the developer or continued to be stored when an update is made. Most escrow agents recommend the continued storage of at least one past version. This practice protects the licensee in the event that there is ever a problem reading or using the newer version and serves the developer by documenting the development date of each update. Finally, because magnetic media degrades over time, the escrow agent should require the developer to ship a new copy of the materials every three years if the materials are never updated.

### **Verification of the Deposit**

Many licensees are understandably concerned about the accuracy and reliability of the escrow deposit. Frequently a licensee will find that when the deposit is released, it was prepared so poorly by the developer that it is useless for supporting the licensee's system. Critics of software escrow point to these cases as the preeminent obstacle to a successful escrow

agreement. However, there are several solutions to this potential shortcoming.

The first step towards securing confidence in the deposit is to be attentive during the period the initial deposit is being prepared. All too often, the escrow deposit is hurriedly compiled and critical components are omitted. By simply showing interest in what materials are shipped by the developer to the escrow agent, the licensee will increase the likelihood that the deposit will be functional. Ideally, the escrow agent should coordinate discussions between each party involved in the matter. Together, each side can contribute their ideas as to what materials will make the escrow effective. A list of materials is then compiled and used by the developer to gather the materials for shipment to the agent. At this point, the escrow agent must visually verify the materials that it receives. This procedure will act as a second line of defense against an incomplete deposit. Lastly, the licensee should reserve the right in the escrow agreement to test any updates.

The option of validating the escrow deposit is the least used but most effective way of ensuring effective escrow protection to the licensee. The more capable escrow agents provide a testing service to their clients, usually through an in-house agent or a professional software testing agency. One such agency is KPMG Peat Marwick's Software Quality Center, based in Boston. John Crawford, Director of the Center, describes the primary goal of a verification test. "We primarily focus on establishing, from a technical perspective, that the escrow deposit is what it purports to be. This is most often accomplished by understanding the terms of the escrow agreement, and then preparing simple and objective tests to verify that the software escrow deposit contains all of the components contemplated by the parties when they entered into the agreement."

Such tests, usually performed at the point the initial deposit is made, are able to provide detailed inventories of documents, directories of tapes and analysis of electronic materials. The testing plan is

designed following discussions between the testing agent, a programmer representing the developer and a technical representative of the licensee. These verifications often include a combination of the following goals:

- (1) Verify that the appropriate software modules and supporting documentation are present.
- (2) Verify the technical integrity of the materials through the successful execution of a compilation.
- (3) Verify that the assembled system performs its intended function by executing a sample of system transactions or usage scenarios.
- (4) Independently collecting all escrow materials and securing them in the escrow deposit.

Once a verified version is secured, it should not be removed from the escrow deposit unless an updated version is tested. Through these comprehensive tests, the licensee will have the assurance they seek that the deposit is complete and reliable. The most beneficial test will compile the software using the escrow materials and test the yielded product. If any deficiencies are discovered, the escrow agent will report the test results to the licensee and work with the developer to upgrade the deposit. The cost for these services are subject to the complexity of the software product and the test design. Such fees are quoted on a per project or per hour basis and usually range from \$150 to \$250 per hour.

### **Filing For a Release**

Most professional escrow agents report approximately five percent of escrow accounts are released to a beneficiary. Yet this possibility must be considered by any company entering into this arrangement. Most requests for a release are initiated by the licensee because the developer has either ceased operations or failed to support the product. In 1988, the United States Bankruptcy Code (Sec. § 365

N) was modified to provide protection to companies licensing technology. This step excluded escrow agreements from the protection awarded to a technology company when it files for bankruptcy. To initiate most releases, the licensee contacts the agent and provides any documentation that is required by the escrow contract to support the request. The agent then notifies the developer and the developer is given a period of time to object or consent to the request. More often than not, the developer will rectify any problem with its licensee during the period following the request for release. However, the developer may contest the release of the materials and take the matter before a forum designed to resolve such disputes, such as a court or arbitration panel. During this process, the escrow agent should be expected to be responsive and encourage communication between all parties, including counsel. If any questions arise, all parties should look to the agreement for direction.

There is a less common procedure for a release that is referred to by many as a "quick release." This condition is based upon a release process which allows a licensee to request the deposit and immediately receive the materials from the agent. The developer has no power to stop the release, but can appeal to a court or arbitrator to reverse the action. While the developer may eventually reverse the process, the licensee is able to use the materials to support its operations. Most developers object to this arrangement on the grounds that it does not protect their interest in the process and does not guard against unjustified release requests. However, this scenario does allow the licensee to avoid any lengthy delays in support that ensue during a protracted battle between the licensee and developer. One set of conditions that may address this issue is "restrictions on use of the escrow materials."

Restrictions on use of the deposit materials are often placed in the escrow contract and are not necessarily tied to a "quick release". These terms are often similar, if not identical, to confidentiality terms that are found in the license agreement. These restrictions will identify how the materials may be used, such as

limiting their use to only supporting the existing product and not allowing major modifications. Other topics, such as who may have access to the materials within the Licensee's company or at what site the materials must remain, are also addressed. These conditions must reach a balance between the protection of the developer's interest and the ability of the licensee to use the escrow materials effectively if they are released.

### **Conclusion**

The escrow industry is similar to the technology industry from which it was born - it is constantly changing its services in an effort to improve itself. Admittedly, some escrow arrangements fail to benefit a technology licensee. However, to disregard escrow services ignores one of the few options that are open to a licensee to secure long-term support for their licensed programs. There is nothing inherent in the escrow process that prevents it from protecting a company that invests the proper time to the project. The escrow must be analyzed by all involved parties and established under the premise that it will eventually be used. The strong escrow contract forms the necessary foundation to the service. When a professional, impartial agent is employed, the service will provide both assurance and potential benefits to the involved parties.

<sup>1</sup> The Economist, February 18, 1995, pages 63-63.

<sup>2</sup> The Law Works, April 1995, page 13