

Play It Safe with a Software Escrow Agreement

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In software escrow, organizations engage an independent escrow agent to store and protect source code and related intellectual assets of a vendor. If a “trigger event” specified in the escrow agreement occurs, organizations can then obtain these assets from the agent.

Escrow generally protects against trigger events like bankruptcy, ceased operations, and competitor takeovers. In these scenarios, the vendor may cease to support applications the customer depends on, so escrow allows the customer access to the source code to facilitate continued use of those applications.

The agent helps the vendor and customer come to an agreement on what materials are held in escrow, and what the trigger events are for materials to be released. The agent also houses materials in a secure location, performs verification testing and offers related services.

Benefits of Software Escrow

Software escrow provides advantages for both customers and vendors. Customers enter into software escrow agreements to gain the following benefits:

- **Business continuity.** If the vendor stops supporting software, the customer can use escrowed material to facilitate maintenance and fixes. These assets provide a better chance of minimizing disruption to key business processes.
- **Risk management and compliance.** Software escrow can help businesses comply with risk management necessitated by Sarbanes-Oxley and other industry-specific regulations. For Sarbanes-Oxley, software escrow reduces the risk of detrimental effects on business caused by failure of a supplier.
- **Inexpensive protection.** Software escrow represents an inexpensive way to obtain a basic level of risk mitigation. Depending on the complexity of the agreement and additional services required from the escrow agent, one time setup fees range from \$1,000 to \$30,000. Ongoing annual fees range from \$500 to \$4,000.

Vendors can use software escrow to establish trust with a new client. Placing code in escrow pledges that the customer will not be left out to dry should a trigger event occur. Moreover, smaller suppliers can use escrow to level the playing field with larger competitors, as some of the risk of going with a less-established player is reduced for the client. Finally, vendors can alleviate nervousness clients may have when exposing business processes to third parties through outsourcing; should trigger events occur, the customer has greater control over those processes.

How Software Escrow Works

- The vendor and customer first choose an agreeable escrow agent to work with. Both parties discuss the escrow requirements with the agent and have an agreement drafted.
- In many cases, if the vendor already has a preferred escrow agent and has established an agreement used with all clients, they may want to continue on this path. This should not be an issue for the customer, provided that they're able to review, discuss, and possibly revise the agreement with the agent and vendor.
- Once all parties agree to and sign the agreement, the assets are deposited into escrow and may undergo verification testing to ensure the integrity and completeness of the source code. Further testing may also occur to determine if the code can be rebuilt into the user's requirements, and that everything needed to do this has been included in the deposit.
- Once the materials have passed verification testing, the escrow agent secures the assets. Updates to the agreement and materials are made at predetermined intervals.

Pitfalls

- **Even with verification, materials in escrow may not be useful.** Understand that even if materials can be rebuilt into customer specifications, further maintenance and updates of the software may be time consuming or impossible. Since the customer or agent cannot thoroughly investigate the code structure itself before deposit into escrow, the customer could wind up with problematic "spaghetti code." Draft a list of technical staff at the vendor to consult if a major trigger event occurs, and be prepared for the possibility of using the software and its source code during transition to new software only.
- **Obtaining materials may be unnecessary.** If the vendor violates the license agreement, problems may be more easily rectified by working with the vendor instead of immediately claiming escrow materials. Moreover, this

can maintain the existing relationship and helps avoid headaches involved in learning the vendor's source code once it is obtained.

- **Don't sign landmark agreements without consulting intellectual property rights experts.** If significant revenues depend on mission-critical software in question, obtain assistance from intellectual property legal counsel to ensure that the agreement, verification process, and arbitration mechanisms are bulletproof and in the best interests of the organization. Critical applications stuck in court battles could spell business continuity disaster.

Recommendations

1. **Evaluate the risks of vendors and applications.** Although software escrow is relatively inexpensive, it may not be necessary. Risk should be weighed against the cost of escrow. Assess the likelihood of an interruption to maintenance and support by examining the size and stability of the vendor, the track record of support, and the possibilities of consolidation, bankruptcy, or ceased business. A large, established vendor often presents none of these dangers, and may not agree to escrow their valuable source code. Moreover, consider the application itself. Does it run mission-critical processes, or will only minor continuity issues arise without access to source code?
2. **Choose a trustworthy escrow agent.** The agent should be fully independent, well-established, and have a full roster of clients and a transparent fee structure. Many previous and current clients mean the agent likely has experience with a range of well-constructed escrow agreements. An agent that offers legal expertise can more deftly handle escrow agreement setup and maintenance; good legal preparation helps minimize headaches down the road. Using a vendor's pre-selected escrow agent is acceptable, as the agent understands the vendor's software and can streamline agreement preparation time. However, judge the agent by the criteria outlined here, and consider auditing the agreement with independent legal counsel before signing.
3. **Ensure proper verification occurs.** Escrow agents offer many services, ranging from simple agreements and storage to full verification and ongoing code audits. Full testing determines if source code can actually be rebuilt, from what the vendor deposits, into the user's requirements. Full verification on the first deposit not only ensures integrity and completeness, but also allows all parties to agree to and understand the scope of escrowed materials. The agent can also provide an audit report that not only verifies contents, but also demonstrates how to rebuild the source code if required.
4. **Verify that the software release clause contains all applicable trigger**

events, and that an arbitration clause exists. These conditions may include bankruptcy, change of ownership, and cessation of product support. In addition, insisting on, and fully understanding an arbitration mechanism is essential if a claim is made and a vendor objects. This mechanism can prevent expensive, time-consuming litigation through open dialogue. If either clause is unclear, seek clarification or have independent legal counsel audit the agreement.

- 5. Understand and document the procedure for obtaining escrowed materials.** Source code may be accessed many years from now. Ensure that successors know what to do. Usually, a customer makes the request to the agent, who checks for an objection from the vendor before releasing material. Document and make available the dispute resolution process, since this mechanism is usually available through the agreement before traditional litigation commences.

Bottom Line

Software escrow is an inexpensive risk mitigation technique that allows businesses to maintain their business-critical applications and processes, even after a major vendor disruption. Learn to build a strong escrow agreement and beware of major limitations.