

Law Office of Stanley B. Kay

303 Wyman Street

Suite 300

Waltham, MA 02452

Telephone: (781) 577-6630 • Fax: (617) 249-1527 • E-Mail: stankay@kaylaw.net

To: Clients and Friends of the Firm

Date: May 16, 2018

Subject: Software Escrow Agreements¹

1. Introduction.

One of the most competitive and innovative industries in the U.S. is that of computer software. These companies are often smaller operations that must fight to stay on top in a highly competitive industry. Yet these are the very characteristics that concern so many of the clients of these companies.

End-users of the software are frequently concerned that their access to the software for maintenance and modifications may be compromised if the supplier becomes financially distressed, and files for bankruptcy. Some analysts have estimated that as many as 60% of all newly created high-technology companies will disappear within five years. This concern has also alarmed business partners of technology companies that may be involved in co-development projects. Lastly, investors, such as venture capitalists are looking for ways to secure their interest in proprietary information.

Many software suppliers have turned to escrow arrangements to allay these concerns. A software escrow agreement allows a software licensee to obtain access to the all-important source code and other materials if the software licensor goes bankrupt or otherwise fails to perform as required.

2. The Escrow Agreement

Escrow requirements should be agreed upon by the parties prior to the execution of the software license agreement. 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. Although many escrow agents will offer their own form contract, the vendor

¹ **This memorandum is not intended to provide legal advice on a particular matter. Its sole purpose is to provide general information and education on the subject. If you are contemplating a public offering, you are encouraged to seek legal advice for your particular transaction. For more information, please call Stanley B. Kay at (781) 577-6630.**

and licensee will frequently agree upon their own terms before it is submitted to the escrow agent..

The release conditions listed in the escrow agreement should cover typical concerns with the product, such as maintenance/support failures, upgrade problems and vendor bankruptcy. While a truly neutral escrow agent is unlikely to take a position on such issues, you should expect the agent to offer suggestions based on its experience and present its own requirements for 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.

3. The Deposit Materials

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. In any event, communication between all parties will go a long way toward the creation of a reliable escrow deposit.

Many larger corporate end-users have found it useful to create a standardized list of escrow materials that are required from all vendors. This policy ensures that all escrows created will have a comprehensive deposit. A partial list of such materials would include the following:

- * Two copies of the source code for each version of the software on magnetic media
- * All manuals not provided to the licensee
- * Maintenance tools and third-party systems
- * Names and addresses of key technical employees that a licensee may hire as a subcontractor in the event the developer ceases to exist
- * Compilation instructions in written format or recorded on video format

4. Storage and Verification of the Deposit Materials

The escrow agent should have a media vault to secure the deposit materials to avoid damage to the media from fluctuating temperatures and humidity. Also, the media vault should have a gas-based fire extinguishing system rather than a water-based system to ensure that magnetic media will not be destroyed if the system is activated.

Some escrow agents take the following precautions to ensure the security of the media:

- * Minimum four-hour fire rated walls
- * FM-200 gas or other fire extinguishing system
- * Controlled storage environment that maintains constant temperature and humidity
- * Extensive security systems within facilities

The escrow agent should be required 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 that the escrowed source code reflect updates, they should be sent to the escrow agent so the escrow deposit correctly corresponds to the version being used by the licensee.

Many licensees are understandably concerned about the accuracy and reliability of the escrow deposit. Verifying the escrow materials may provide additional assurances to the end-user. The more capable escrow agents provide a testing service to their clients, usually through an in-house agent or a professional software-testing agency.

Once a verified version is secured, it should not be removed from the escrow deposit unless an updated version is tested. 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 escrow deposit materials should be shipped to the escrow agent via a traceable courier or electronically. Upon receipt of the materials, the escrow agent should contact both the developer and the licensee to confirm the receipt.

5. Filing a Release

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 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 who 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 court or arbitration panel designed to resolve such disputes.

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 the 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. A strong escrow contract forms the necessary foundation to the service.