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Surviving the Escrow of Your Source Code

by Janet Langjahr

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Janet Langjahr

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Sooner or later, most IT consulting companies that develop software will encounter a customer who insists on an escrow of the software. The purpose of source code escrows is to protect business software user groups, which depend on the reliability and adaptability of mission-critical software, from the possibility of the consulting company going bust and vanishing.

Many software user groups that seek the protection of an escrow are deep-pocketed, lawyer-staffed Fortune 1000 companies that will gladly bear all of the associated expenses of an escrow. By contrast, software consulting companies are often small, independent IT shops consisting of a handful of talented developers and other technical professionals - but no lawyers.

Typically, professional escrow agents each use their own standard forms for escrow agreements. Not surprisingly, these standard forms generally fail to adequately protect consulting companies from premature and insufficiently constrained release of proprietary intellectual capital.

Unfortunately, once the source code cat is out of the bag, there is no satisfactory way to contain all the possible harm to the consulting firm (or its successors). Furthermore, because of the way that sophisticated consulting companies leverage and reuse the proprietary source code libraries they develop, the harm could extend to consultants' past and existing customers. It's even conceivable that consulting companies might find themselves liable to such customers for setting in motion events that brought about the disclosure of their trade secrets.

Such disclosures could also harm a consulting company by effectively voiding covenants made to the consulting company by past and present employees, contractors, and business affiliates. Clearly, a consulting firm must ensure that its source code is not released prematurely or without appropriate restrictions.

I recently negotiated an escrow arrangement on behalf of a company that developed software. Here, I'll discuss a few notable points that I found lurking in the software escrow agreement. Some of these issues may not jump out at a consulting company's management or project team, but they can be critically important.

Ample Notice
First and foremost, a consulting company must insist on an early notice that affords it adequate time to defeat (or at least prepare for) release of the software.

Most escrow agents' standard agreements provide that all notices "shall be conclusively presumed to have been given and received when made" by the sender by various means, including regular mail. This means that if the escrow agent's notice to the consultant gets lost in regular mail, the escrow agent may release the source code to the user. If the consulting company doesn't learn that the user group has invoked the release provisions, the consulting company can't very well challenge (or prepare for) the invocation.

Agents' Liability
Consultants should beware of liability limitations with regard to the duties of the escrow agent.

An escrow agent's standard agreement generally precludes liability of the agent except for "grossly or deliberately negligent conduct." However, deliberate negligence is a contradiction in terms. According to such an agreement, the escrow agent may be accountable to the consulting company only for gross negligence. This is unacceptable. The consulting company is entrusting its most valuable assets to the escrow agent, so the escrow agent should have a duty to exercise good faith and reasonable care. The agent should be liable for ordinary negligence.

"Destroyed" Materials
Standard escrow agents' agreements include provisions that give the escrow agent the right to destroy the software under a number of circumstances, including the user group's failure to pay the escrow agent's fees. In such a scenario, the consulting firm is penalized for the user group's misconduct. But how many consulting companies would be satisfied with an escrow agent's simple assurance that the escrowed source code has been destroyed?

A consulting company has a legitimate interest in insisting that escrowed materials are returned to the consulting company in their original condition. The consultant should not have to rely on the escrow agent's assurance.

Terms of Release
Consulting companies should pay special attention to the wording of an escrow contract in the section that defines the conditions that may cause the release of the software. A typical agreement defines the release triggers to include "cessation of normal business operations" and "failure or refusal to provide maintenance and support services required" for 30 days after written notice of default. Let's consider each of these terms.

First, what does "cessation of normal business operations" mean? I know of some small IT shops that shut down for a week or more during the winter holiday season. Could some sharp user group successfully argue that such a situation satisfies the terms of the contract?

What about the second item? Should a single instance of default (even after notice) under an ordinary license or maintenance agreement justify the extraordinary measure of release of the source code? In a perfect world, consulting firms would never lag in providing support. But in the real world, events such as hurricanes and persistent bouts of flu can impact delivery of support.

The point is that the definitions of legitimate release triggers are typically too weak and vague to protect consultants. So consultants must take measures in this area to protect themselves.

Defining "Software"
Consulting teams entering an escrow arrangement may need to belabor the

definition of software. Standard escrow agents' agreements define software to include documentation "necessary for a reasonably competent programmer to routinely maintain and modify such programs." But under this definition, how many consulting companies developing custom software would be required to create such documentation solely for the purpose of the escrow? Escrow agreements may also contain over-reaching provisions for verification and inspection of software.

When presented with such conditions, a consulting firm should cry out that they provide user groups and agents an undue pretense with which they may jump the gun to release the software.

Escrow Deposits Consulting firms must scrutinize the fine print concerning when the escrow deposit must be updated. An escrow agent's agreement typically requires the consultant to update the escrow deposit with each "release of a new revision" of the software. What does this mean?

Let's face it. With a new custom software product, changes can be pretty frequent - even after the software has been implemented in a production environment. Some changes may be as trivial as correcting a spelling error in a message in a dialog box. It is one thing for a consulting company to whip up a new installation utility and e-mail or upload it to a customer's server. That's business as usual. It is another thing entirely to have to undertake all the formalities of a deposit into escrow.

From the consulting company's perspective, the obligation to update the escrow deposit should be limited to major releases incorporating major enhancements or bug fixes.

An Escape Route
Just as escrow agents and user groups focus on the release of code to protect the user groups, consulting companies must protect themselves by spelling out all of the circumstances under which they should be allowed to terminate an escrow arrangement and retrieve their source code.

A consulting firm should be entitled to terminate an escrow upon any breach or default by the user group of any agreements with the consulting company. In a standard escrow agent's agreement, the agent has no obligation to release the source code to the consulting company unless the user group signed off on a termination notice - even if the event triggering the release was the termination or expiration of the user group's license or maintenance agreement. User groups that violate ancillary agreements probably won't cooperate in signing termination notices. So a consulting company shouldn't agree to be dependent upon such cooperation.

Remaining Issues
Also important to a consulting company are provisions that an escrow agent may completely omit from its standard form and which the consulting firm might not think to raise.

For example, a small consulting company in a dispute with a large user group will probably be served best by a requirement that disputes must be resolved by arbitration in the consultant's locality and at the expense of the user group. Such proceedings should be subject to secrecy to protect the consulting company's proprietary information. Also, the escrow agent should be prohibited from seeking recourse against the consulting company under the agreement; let the agent look solely to the user group.

Similarly, the user group's obligations should survive termination of the escrow

agreement. The agreement should clearly state that the consulting company retains exclusive rights to its intellectual property even after a release of the source code. The release under the escrow must be strictly limited in nature and purpose.

The escrow agreement should also impose nondisclosure and related covenants on the user group and its agents and employees, as well as on the escrow agent and its agents and employees. The (smaller, non-institutional) escrow agent should also be required to notify the consulting company of (at least) material changes in the ownership or corporate status of the escrow agent.

Watch Your Step
Clearly, IT consulting companies considering entering into a software escrow arrangement should approach it very cautiously. Such agreements demand vigorous negotiation and careful, diligent drafting and review. Otherwise, an escrow agreement may eventually have a greater impact on the software development segment of consultant's business than any other contract the consultant may ever enter.

-- Janet Langjahr is an attorney with a private practice focusing on business law and litigation, especially IT law. She has also developed software for mainframes, PCs, and the Web. You can reach her at mailto:AttorneyJL@mindspring.com.