FEES & BURGESS, P.C.

SUPPLY CHAIN MANAGEMENT MEMO

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Escrowing Source Code

Modern businesses routinely rely on licensed software as part of their day-to-day operations. Some licensed software, like word processing programs, are readily available for a modest price and used by the general public. However, some companies spend thousands, if not millions, of dollars to license complex, highly-specialized software, that is critical to their operations, from software developers. These custom software programs often require updates, troubleshooting, and maintenance, which are typically provided by the developer for an additional fee. Companies licensing this kind of software want some assurances that they will be able to continue using the licensed software and will still be able to have it updated and maintained if something were to happen to the software developer.

One of the most common methods for addressing these concerns is to have the source code for the licensed software put into escrow. Source code is essentially a series of computer instructions, written in a human-readable computer programming language, that controls the processing of data and the functionality of the software. The source code, once complete, can be compiled into machine code that a computer can understand and execute. The theory is that, if the licensee has the source code, it can use that code to create updates for or perform maintenance on the existing software. When parties agree to escrow source code, they are agreeing to put the source code, and perhaps related explanatory documentation, in the hands of a third party to hold. If one of a number of specified events occurs, the party holding the source code, the escrow agent, would release the source code and related documentation to the company paying to license the software. Examples of events that might trigger the release of the source code include things like the developer filing for bankruptcy protection or going out of business. The escrow arrangement should be governed by a contract entered into by the software developer, the licensee, and the escrow agent. Some banks are willing to serve as escrow agents for source code, although a large percentage of source code escrows are done through companies that provide document and electronic data storage services as a core part of their business.

While escrowing source code can be a good option for safeguarding a licensee's ability to continue using critical software applications, it is not a practice that should be adopted for all licensed software. There are usually significant costs associated with setting up a source code escrow. Software developers are normally reluctant to escrow their source code out of fear that it might accidentally get leaked to third parties or end up being misused by the licensee, so escrow agreements tend to be fiercely negotiated. Those negotiations can delay the licensee getting access to the needed software, and, perhaps more importantly, extensive contract negotiations can result in significant legal expenses.

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ESCROWING SOURCE CODE,

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On top of that, the escrow agent expects to receive a fee for its role in holding the source code. Those fees can amount to thousands of dollars depending on the fee arrangement and how long the source code remains in escrow. In some cases, it would be cheaper for the licensee to go out and obtain alternate software if something were to happen to the software developer, rather than pay the costs associated with setting up and maintaining an escrow arrangement.

Before deciding to push for a source code escrow, the licensee should also take into consideration the likelihood of the software developer going out of business or filing for bankruptcy. If the software developer is a fairly small outfit, a newer company, or is on shaky financial ground, a source code escrow makes more sense. But, if the software developer is a sizeable, financially-strong institution that has been around for decades, the need for the added protection a source code escrow provides may not be worth the expense involved in putting the escrow in place.

If, after weighing the costs involved and the risk of something happening to the software developer, a company decides it needs a source code escrow, there are a few things it should keep in mind:

- **Clarity Is Key** - It is important to very clearly articulate in your escrow agreement what constitutes an event that would trigger the release of the escrowed source code. While the vast majority of source code escrows never face a triggering event, when they are triggered, there is often a dispute between the licensee, the software developer, and/or the escrow agent as to whether a particular set of facts constitutes a triggering event under the terms of the escrow agreement. Such a dispute can lead to a long and costly lawsuit, so it is important to be as clear as possible in the escrow agreement when defining what constitutes a triggering event.

- **Monitor What Is Being Escrowed** - The licensee should monitor what is being put in escrow and make sure that it is being updated by the software developer as needed. It is not unheard of for a release event to occur and the licensee to discover that the source code put into escrow is defective, incomplete, or missing key updates. If this happens and the software developer has gone out of business, there may not be anyone left to fill the gaps in the source code.

- **Know How to Use the Source Code** - Escrowed source code might not do a licensee much good if the licensee lacks the expertise to be able to use it. If the licensee does not have the necessary expertise in house, it might have to hire an outside party to assist it in taking advantage of the source code. There could be considerable expense associated with hiring an outside consultant to play that role. So, once again, the licensee should consider whether, on the whole, it would be cheaper and more efficient to simply seek out alternate software if something happens to the original software developer, rather than deal with the costs and delays associated with a source code escrow.

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Fees & Burgess, P.C., Calendar of Events

Contracting with the Customer: What the EMS Manager Needs to Know

Date: February 21, 2013

Location: San Diego, California

Fees & Burgess, P.C. shareholders, Allen Anderson and Jeffrey Roth, will be instructing a class, Contracting with the Customer, at the 2013 IPC APEX EXPO on Thursday, February 21, 2013 in San Diego, California.

Without a doubt, negotiating with OEMs is one of the biggest challenges facing EMS managers. What needs to be covered in the contract? Is your company protected? What should you do if there is a dispute? This comprehensive, two-part course addresses the specific contractual issues faced by EMS companies. Gain a step-by-step understanding of the contracting lifecycle between an EMS provider and its customer, starting with initial engagement and signing of a nondisclosure agreement, through the bid process and formal contract negotiation, to resolution of disputes under the applicable contract(s). Using real-life situations, the contracting process as well as the questions that must be answered before entering into an agreement will be covered. Participants must be representatives of EMS organizations to attend.

The Agenda is:

Part 1 - 9:00 AM - 12:00 PM

Confidentiality agreements, credit and financial risk, letters of credit, and bids (Exercises 1 and 2) ; Letters of intent and preliminary contract documents, purchase order acknowledgment, and "battle of the forms" (Exercises 3 and 4) .

Lunch - 12:00 - 2:00 PM

Part 2 - 2:00 PM - 5:00 PM

Negotiation of contract terms, warranties, limitation of liability, and product liability (Exercise 5) ; Contract guidelines, claim negotiation, and dispute resolution (Exercise 6).

It is recommended that participants attend both Part I (PD-47) and Part II (PD-48) in the afternoon.

For more information or to register for this class, click here

For information regarding other future events, please visit us online at www.feesburgess.com, or contact us at seminars@feesburgess.com.

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To remove your name from our mailing list, please e-mail newsletters@feesburgess.com.

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