Chapter 1

Saying "I Do": Software Escrow Basics

In This Chapter

- Understanding what software escrow is
- Taking the right steps in the software escrow process
- Determining whether you need to escrow your software
- Thinking about your escrow options

Escrowing software is a lot like creating a prenuptial agreement before you get married. You hope you never need it, but if worse comes to worse, you want to be prepared. Escrowing software protects your company in the event that your relationship with your vendor takes a sour turn. It's a smart move.

In this chapter, I tell you the basics of software escrow — what it is, why you need it, and what you need to think about during the process.

Software Escrow: It's Like a Prenuptial Agreement with Your Vendor

So what exactly does it mean when you *escrow software*? Basically, it's a legal contract between you and your software developer that protects your business. Under specified release conditions in which the developer becomes incapable of supporting its software, you're given access to the software developer's *source code* and other proprietary materials. A neutral third party, such as Iron Mountain, typically serves as the *escrow agent*, providing secure storage of the source code and other materials, and producing the contents of an escrow account for its beneficiary(ies) when a release event occurs.

TIP

Throughout this book, I use several terms interchangeably to describe the various parties in a software escrow agreement, depending on the context. A *software vendor* is typically the *developer, depositor,* or *licensor* in a software escrow agreement. The *client* (you) is typically the *beneficiary* or the *licensee*. It's important to note that a "licensee" in this context refers to an authorized end-user, whereas a licensee in many other types of intellectual property agreements is granted exclusive rights to modify and resell a product or service.

When you escrow software, you're basically protecting yourself against a potential risk, such as the software company going bankrupt, breaching your contract, or not providing support. If any of these (or other) predetermined events occurs, the source code is then released to the beneficiary(ies). For more on the release process, see Chapter 4.

Some of the numerous benefits derived from escrowing software include

- Serving as a safety net for investment in software, technology, services, and other intellectual property.
- Providing controlled access to a vendor's proprietary source code under specific release conditions with limited use rights.
- Helping to build trust with your software vendors.

Table 1-1 outlines additional benefits of using a professionally managed escrow from the perspectives of both the beneficiary (licensee) and the vendor (licensor).

Table 1-1 Benefits of a Professionally Managed Escrow Relationship

For the Beneficiary	*For the Vendor*
Gives you leverage and influence with the vendor	Establishes credibility within the marketplace
Provides timely access to current source code and maintenance materials when needed	Eliminates objections and shortens selling cycles
Builds confidence in the viability of a software application independent of the software vendor — particularly important in today's challenging business environment	Levels the playing field with larger, more established competitors that are perceived as less likely to "go belly up" or be the target of an acquisition or leveraged buyout
Satisfies legal and/or regulatory compliance	Satisfies a "best practice" client requirement
Minimizes risk of loss	Protects intellectual property rights
Avoids litigation and courts	Avoids litigation and courts

You can escrow more than just software. Many companies escrow items as varied as electronic hardware, semiconductor manufacturing processes, jet engines, lab notebooks, and other intellectual property.

The Software Escrow Process in a Nutshell

No matter what type of intellectual property you'd like to escrow, the steps in the process are essentially the same. It's the details — for example, what you want deposited — that vary. To help ensure that you don't overlook anything, see Chapter 2.

Although some steps in the software escrow process are fairly obvious — for example, determining what you need deposited — others, such as verifying and managing the agreement, are often overlooked.

Decipher the talk: Types of code

What's the difference between source code, object code, and executable code? It's more than just poh-tay-toes and poh-tah-toes!

Source code is like a secret recipe. It is code that is written in a programming language that is readable (and modifiable) by humans. Without source code, programmers can't debug or upgrade software applications. So if the software vendor goes out of business, without the source code, your software is effectively dead-ended. Depending on how critical the software is to your business, the effects can be devastating.

Object (or machine) code is the translation of source code into a language that only computers can read. Consisting of a series of ones and zeros, object code is generally created by taking proprietary source code and running it through a software program (a compiler) that transforms the source code into object code. Object code is then "bound" with other object code modules (which may be from a third party) to create executable code.

Typically, ***executable code*** is licensed and installed in a live operating environment. Software developers feel confident in licensing executable code because reversing the process and discovering the nature of the source code by examining the object code or executable code is extremely difficult. It's kind of like trying to re-create a tree from paper — you can't just run it back through the mill!

Nearly every software development environment includes third-party applications, which you need in order to re-create the developer's executable code. If the software is released and you don't know what additional third-party software you need, you'll have a hard time figuring it out on your own. Fortunately, Iron Mountain's verification process helps to identify third-party applications that are required to build executable code. For more on verification, see Chapter 3.

Here are the steps to follow when escrowing software:

1. **Assess the risk.**

   You first need to assess whether you need an escrow agreement — since you’re reading this book, you probably do. For more on this topic, see the next section, “Figuring Out Whether You Need Escrow.”

2. **Determine what you need to deposit.**

   You need to consider both hardware and software, as well as the types of code, items from a third party, and any relevant documentation. For more on this topic, see Chapter 2.

3. **Budget for escrow.**

   Although software escrow isn’t necessarily expensive, you need to budget appropriately for it. Typical expenses may include legal fees, escrow agent fees, and verification costs.

4. **Select an escrow agent.**

   You need to select a neutral third-party escrow agent to store the escrow deposits and administer the terms of the escrow agreement. See the section “Selecting an Escrow Agent” at the end of this chapter.

5. **Negotiate your escrow contract.**

   The parties involved in contract negotiation are as follows:

   - The *depositor* (typically the software developer or licensor)
   - The *beneficiary* (you, the software licensee)
   - The *escrow agent* (the neutral third party who escrows the software)

TIP

You can head off disputes — and save money — by specifying upfront what items you want to escrow. Why pay later for the creation of important items, such as build instructions, when you can negotiate them as part of the escrow/license agreement?

6. **Execute the agreement.**

   For nonstandard or highly customized software escrow agreements, you should consult legal counsel to ensure the agreement is legally enforceable.

7. **Verify the deposit as soon as possible — preferably within 30 days.**

   A software escrow agreement isn't worth much if you can't verify that all of the essential components have been properly deposited. See Chapter 3 for more details about deposit verification.

   If you agree that certain items will be placed in escrow but then never follow up to verify that these items are actually deposited, your escrow agreement isn't really worth much. That's why you need to *verify* the deposit. Verification is such an important part of software escrow that I devote all of Chapter 3 to this topic.

8. **Manage the agreement.**

   Your work isn't over just because you and the developer have signed the escrow agreement on the dotted line and the agreed-upon items are deposited and verified. You need to designate a point person in your organization to actually manage the agreement down the road. For more on this topic, see Chapter 4.

9. **Create a repeatable process for escrowing future critical software.**

   Why reinvent the wheel the next time around? Utilize what you learn from your initial software escrow to help guide your organization through the acquisition of new technology in the future. After you've completed your own escrow process document, post it on your intranet.

Figuring Out Whether You Need Escrow

Most companies need software escrow and verification to protect their investments and to keep their business operating smoothly and efficiently in the event that a key software vendor fails to perform. If you're unsure whether you even need a software escrow agreement, start by considering the risk. If your software provider goes belly up, what happens to your company's software-dependent critical processes? If it fails to provide support or updates, what is the effect on you, your employees, and your clients? If the consequences are potentially devastating to your company's operations and revenues, you have your answer.

If the technology impacts revenue, productivity, customer service, or safety, for example, you need to escrow. If, on the other hand, you can buy the technology over the counter at your local computer store, you probably don't need escrow.

Most companies arrange software escrow for their most business-critical applications for a number of reasons. Escrow agreements protect your software investment:

- Should the licensing vendor go out of business
- In case the vendor stops or reduces support (the most common reason software is released)
- By demonstrating *due care* (the legal requirement to protect an organization's assets) and *due diligence* (the prudent exercise of due care to avoid negligence) as part of a larger risk management policy

Although it may be tempting to escrow all software, that approach normally isn't feasible (or even necessary) from a cost perspective. That's why it's important to prioritize your applications, escrowing those that are the most business-critical (for example, custom back-office applications used by accounting or sales, third-party software embedded within your own products, and so on). For more on prioritizing, see Chapter 4.

Exploring Your Escrow Agreement Options

Most escrow agents offer several options when it comes to escrow agreements, and the choice you make depends on such things as the number of parties and/or products involved, the scope of desired escrow protection and associated services, and the degree of customization of release conditions:

- **Three-party agreement:** This type of agreement, which is the most common, can be implemented by the developer or licensee (see Figure 1-1a). You should use this agreement when there is one depositor and one beneficiary, when there's a need to negotiate the terms of the agreement and/or release conditions, or when escrow verification is desired.
- **Three-party master agreement:** In this agreement, shown in Figure 1-1b, you have multiple developers or licensees, such as when a developer is supplying products to numerous licensees or a licensee is using software from several developers. This type of agreement is similar in structure to a three-party agreement, and is appropriate when you want to escrow software from several sources or when you are one of several beneficiaries licensing software from the same developer.
- **Two-party agreement:** Typically limited to bankruptcy-oriented release conditions, two-party agreements are only signed by the developer and escrow agent, and are used to provide basic escrow protection to a large number of licensees (see Figure 1-1c). You might use this type of agreement when you are one of several beneficiaries working with one particular depositor and you specifically do not plan to verify the escrow deposit.
- **Two-party master agreement:** This agreement, shown in Figure 1-1d, is similar in nature to a two-party agreement, but it provides the ability for a developer to escrow numerous products supplied to numerous licensees. A developer uses this agreement when it has several different types of software that it supplies to different sets of beneficiaries, none of whom will have the option to verify the escrow.

TIP

Ideally, software licensees should seek to enter into a three-party or three-party master escrow agreement with their developers to maximize their rights and to help avoid future disputes. For more on this topic, see Chapter 4.

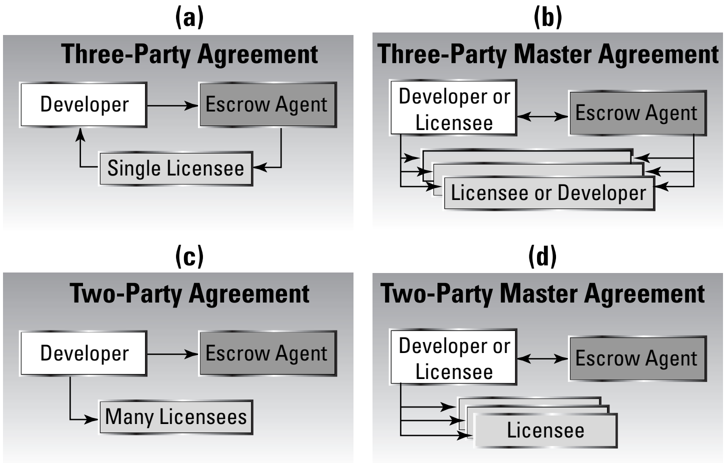

Figure 1-1: The various types of agreements.

Selecting an Escrow Agent

Escrow agents are everywhere. Iron Mountain is the largest with more than 40,000 worldwide clients who collectively rely on Iron Mountain to maintain more than 70,000 active escrow deposit accounts comprising more than 130,000 escrow deposits. As you investigate which escrow agent to use, think about whether the escrow agent:

- Has a stable, long-standing history as an organization with an established customer base
- Operates its own vaults
- Carries levels of errors and omissions insurance
- Has in-house legal counsel to aid in decision making
- Has consistent and verifiable standards in place
- Offers a full set of escrow verification services and has a strong background in administering verification testing

- Offers advanced services to maintain accounts, including electronic delivery of escrow updates
- Has a record to demonstrate that it has successfully administered escrow releases

REMEMBER

All parties should feel confident in their escrow agent's ability to perform its obligations under the escrow agreement and to act in a reasonable and prudent manner with regard to the escrow arrangement. If the parties have any doubt about the agent's trustworthiness, they should select another agent.

TIP

Before you begin your selection process, make a list of the materials you'd like deposited that you can share with your prospective agent. See Chapter 2 for tips on making your deposit wish list as thorough as possible.