Software Source Code Escrow Agreements: Drafting and Negotiating the Agreement

A Practical Guidance® Practice Note by Sonia Baldia, Kilpatrick Townsend & Stockton LLP

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This practice note addresses key issues in drafting and negotiating a software source code escrow agreement involving an independent third-party escrow agent. A software source code escrow agreement is a contract that governs the deposit and storage of the source code, documentation, and other essential materials (Deposit Materials) of a specific software application in escrow. This tri-party agreement usually refers to a customer as the beneficiary, a software provider or developer as the depositor, and a neutral third party storing the Deposit Materials as the escrow agent.

The agreement typically accompanies a contract for:

- The development of custom software, to protect a customer in the event the developer is unable to or unwilling to finish the project
- A software license arrangement involving the use of a mission critical application, to protect a licensee's business interests against the risk of the licensor abandoning its obligations to support, update or provide access to the software

When negotiating a source code escrow agreement, it is important to bear in mind the differing perspectives of the parties involved. The developer's or software provider's key concern with releasing the source code to the customer is that the customer may not keep the source code secure and confidential or it may misuse the code beyond the authorized purpose. On the other hand, the customer's key concern is that if, upon developer's default, the customer does not get access to the source code to maintain and update the software on which the customer's business is reliant, then the customer's business would suffer immensely. The escrow agent is a neutral party that typically resists any liability under the agreement for the source code release.

For a more detailed discussion on software development agreements, see Software Development Agreement Negotiating and Drafting. For more information on software license agreements, see Software License Agreements: Drafting and Negotiating the Agreement.

Escrow Agreement Basics

A software source code escrow agreement requires the depositor to deliver the Deposit Materials to the third-party escrow agent directly. The escrow agent holds the Deposit Materials for the benefit of the beneficiary. The agent then releases the materials to the beneficiary on occurrence of specific events triggered by the delinquent actions of the depositor that put the beneficiary's ability to access or to use the software as intended at risk.

Many disputes arise over the course of this agreement because the parties fail to address:

- The materials that the developer will deposit with the escrow agent
- Whether the developer is obligated to update the materials periodically during the project
- The procedure for verifying whether the materials are complete and accurate

- Ownership and use rights to the materials between the parties
- The scope of the release conditions triggering the release of the materials and the procedure for release

Supplying the Deposit Materials

The Deposit Materials should consist of all information and resources on which a reasonably technical person can rely to run, maintain, and modify the software independently. Specify the Deposit Materials that the depositor must deliver to the escrow agent, either in the body of the agreement or as an exhibit. Examples include:

- Software source code
- Software object code
- Compilation instructions
- Build scripts
- Maintenance documentation
- Interfaces
- Specifications
- Third-party software and documentation

In addition, ensure that the agreement sets out the procedure for delivering the Deposit Materials to the escrow agent. While the escrow agent usually determines the manner in which the developer delivers the Deposit Materials, the parties should include any special precautions that the depositor must follow, for example, to comply with:

- Applicable law or regulatory obligations
- Confidentiality restrictions
- Privacy or data security requirements

Include a time frame for the depositor to deliver the Deposit Materials to the escrow agent. Most agreements require the depositor to make the initial deposit either:

- After the beneficiary pays the first installment of fees for the development or licensing of the software
- Within a certain number of days after execution of the escrow agreement
- At a mutually agreed date and time

Updating the Deposit Materials

Beneficiaries typically require the depositor to make subsequent deposits to escrow of the most current materials on:

- A recurring basis for custom software development projects (e.g., every 60 days)
- Any new release, upgrade, or version of existing software that a depositor licenses to a beneficiary

Subsequent deposits are especially critical in situations where the depositor is developing software for the beneficiary because the software typically is an incomplete and inoperable product during the development process. Doing so ensures that the escrow agent consistently has the most up-to-date materials available to the beneficiary if necessary.

Verifying the Deposit Materials

Beneficiaries often negotiate for the ability to verify the completeness and accuracy of the Deposit Materials when the depositor delivers new or updated materials to the escrow agent. The escrow agent typically provides verification services if it is capable of doing so at its facility. If the escrow agent does not offer verification services, the process should be undertaken by the party best equipped to verify the Deposit Materials efficiently and properly.

When negotiating a verification clause, determine:

- Whether a representative of the beneficiary must be present to supervise the verification process
- The extent to which the depositor and beneficiary must cooperate with the escrow agent during in the verification process (e.g., responding to information requests, giving the escrow agent a right to use the Deposit Materials, and providing access to key technical personnel)
- Which party is responsible for the costs of performing the verification services
- The amount of time to allow the depositor to cure any deficiency in the Deposit Materials discovered during the verification process
- Whether the depositor can supervise any verification test to confirm the integrity of the testing
- If the escrow agent can use subcontractors to perform the verification services

Ownership and Use of Deposit Materials

Beneficiaries often negotiate for a license specific to the Deposit Materials that

- Grants the beneficiary all the necessary rights to modify, maintain, and support the Deposit Materials if a condition for releasing the materials occurs
- Includes the right for the beneficiary to use, display, distribute, reproduce, and create derivative works from the Deposit Materials if they are released from escrow

In addition, beneficiaries should include language to protect their ability to exercise their rights under the license when a depositor files for bankruptcy. For more information on enforcing your rights as a beneficiary when the depositor is bankrupt, see Software License Agreements: Drafting and Negotiating the Agreement — Source Code and Escrow.

A depositor should ensure that it retains all ownership rights in the Deposit Materials, and that the escrow agent will return these materials to the depositor on any termination not involving the triggering of a release condition. In addition, limit the scope of any license grant to the beneficiary to cover:

- Verification of the accuracy and completeness of the Deposit Materials
- Maintenance of the Deposit Materials for the beneficiary's internal business purposes
- Use of the Deposit Materials on the triggering of a release condition, including the depositor filing for bankruptcy

Escrow Agent Responsibilities

The depositor and beneficiary should ensure that the agreement lists the escrow agent's responsibilities under the agreement, including:

- **Collect and Store the Deposit Materials.** Describe the procedure for collecting and storing the Deposit Materials.
- **Inspect the Deposit Materials.** On receipt of the Deposit Materials, promptly inspect the materials to verify that the deposit is complete and accurate, and confirm the condition of any storage media holding the Deposit Materials.
- **Identify Responsible Individuals.** Designate key personnel who manage and control the collection, storage and release of the Deposit Materials.
- **Recordkeeping.** Maintain current and accurate records that document all activity relating to the handling of the Deposit Materials, and management of the escrow account.
- **Verification Services.** Assist in verifying the Deposit Materials by providing, for example, access to facilities, computer systems, and technical personnel to perform or supervise the verification.
- **Security.** Implement security procedures and exercise the appropriate level of care to protect and safeguard the confidentiality and physical safety of the Deposit Materials.
- **Transition Services.** Assist in the selection and appointment of a successor escrow agent on termination of the agreement, and cooperate in the transfer of the Deposit Materials.

If the escrow agent already entered into a separate confidentiality agreement with the depositor and beneficiary, include a brief provision that references the executed confidentiality agreement and incorporates its terms as part of the software source code escrow agreement. Otherwise, you should include a confidentiality clause that prohibits the escrow agent from using or disclosing to third parties the Deposit Materials. For a more detailed discussion on confidentiality agreements and tips on negotiating confidentiality provisions, see Confidentiality Agreements.

In addition, the party responsible for paying the escrow fees should try to negotiate a right to delay or to withhold payment if the escrow agent breaches the agreement, until the breach is fully cured.

Release of Deposit Materials

The agreement authorizes the escrow agent to release the Deposit Materials to the beneficiary on the occurrence of certain triggering events. Ensure that the agreement describes the events that can trigger the release of the Deposit Materials, and the procedure the parties must follow to determine whether the escrow agent is authorized to make the release.

Conditions of Release

Software source code escrow agreements commonly include the following events that give rise to the beneficiary's right to a release of the Deposit Materials:

- **Failure to Perform.** The depositor materially fails to perform its obligations set out in the underlying software development, license, or support agreement.
- **Abandonment.** The depositor discontinues any sales, licenses or support of the software product.
- **Staffing of Key Personnel.** The depositor lays off a significant portion of its staff responsible for developing or supporting the software.
- **Business Failure.** The depositor ceases doing business, is declared insolvent, files for bankruptcy, or any other circumstance that causes the depositor to stop operating as a going concern.
- **Transfer of Rights.** The depositor sells, assigns, or

transfers to a third party any of the depositor's rights in the Deposit Materials, in whole or in part, and it prevents the depositor from performing its obligations under the agreement.

- **Change of Control.** The depositor undertakes a change in control of its business (e.g., the sale of all or substantially all of its stock or assets).

A depositor should limit the release condition regarding a breach of the underlying software development or license agreement to only uncured "material" breaches of any obligation that impacts the beneficiary's ability to access or to use the software as intended. In addition, a depositor should include a right to cure a triggered release condition before the escrow agent releases the Deposit Materials to the beneficiary (usually 30 days).

Release Procedure

The agreement should clearly describe the steps that the escrow agent takes to release the Deposit Materials. The agreement typically sets out the following procedure for releasing the Deposit Materials in cases where the beneficiary believes a release condition has been triggered:

- The beneficiary submits a written notice to the escrow agent that a release condition has occurred, and instructs the escrow agent to release the Deposit Materials
- The escrow agent notifies the depositor of the beneficiary's request within a specific period of time (usually 5 business days)
- The depositor is provided a specific period of time to rebut the beneficiary's claim by providing the escrow agent with contrary instructions stating that the release condition has not occurred or has been cured (usually 30 days)
- If the depositor provides the escrow agent with contrary instructions, the escrow agent does not release the Deposit Materials to the beneficiary and the parties are instructed to resolve their dispute in accordance with the agreement's dispute resolution clause
- If the depositor does not submit timely contrary instructions, the escrow agent releases the Deposit Materials to the beneficiary

A beneficiary should consider negotiating shorter response times in situations where it requires access to the Deposit Materials to manage or to support mission critical software. In addition, you should distinguish situations where it may need immediate access, for example, when the depositor acts in bad faith or files for bankruptcy protection.

Dispute Resolution

Negotiate, in advance, the appropriate jurisdiction and choice of laws that govern a dispute. If the parties cannot agree on a jurisdiction, as a compromise, the agreement could state that the party bringing suit must submit to the home jurisdiction of the party being sued. In addition, include a dispute resolution clause to address situations where the beneficiary and the depositor disagree on whether a release condition has occurred necessitating the release of the Deposit Material to the beneficiary.

Escrow agents usually seek to engage in alternative dispute resolution, such as binding arbitration, to resolve disagreements. For more information on key issues to consider when negotiation an alternative dispute resolution clause, see Key Provisions in Joint Venture Agreements — Dispute Resolution.

During the dispute resolution process, the escrow agent continues to maintain the Deposit Materials until:

- The depositor and beneficiary jointly direct the escrow agent to release the materials
- An arbitrator or court orders the escrow agent to release the materials
- The escrow agent transfers the materials to an arbitrator or court, or a master, trustee or receiver selected by that court or arbitrator

A dispute resolution provision should carve out exceptions to allow a party to seek injunctive relief, such as when there is an alleged breach of confidentiality, or when the software requires immediate maintenance critical to the beneficiary's operational needs.

Terminating the Escrow Agreement

Escrow agents usually structure their form agreements to terminate on one of the following events:

- **Release of Deposit Materials.** The agreement terminates immediately when the escrow agent releases the Deposit Materials to the beneficiary as required under the terms of the agreement.
- **Termination of the Original Agreement.** The agreement terminates immediately on the termination of the underlying development, license, or maintenance agreement.
- **Mutual Termination for Convenience.** The beneficiary

and depositor can jointly terminate for any reason (or no reason) by providing prior written notice to the escrow agent (usually 30 – 60 days).

- **Escrow Agent Termination for Convenience.** The escrow agent can terminate for any reason (or no reason) by providing prior written notice to the depositor and beneficiary (usually 60 days).
- **Termination for Nonpayment.** The escrow agent can terminate the agreement for nonpayment of fees by the responsible party, if the responsible party does not cure the breach within a specific period of time (usually 30 days).

For any termination that does not involve a release of the Deposit Materials, the escrow agent returns the Deposit Materials to the depositor on the termination date of the agreement, or within a fixed period of time following the termination.

The depositor and beneficiary should include a provision granting them the right to terminate the agreement on any filing by the escrow agent of any petition or action under any bankruptcy, receivership, insolvency, reorganization, dissolution, or liquidation.

In addition, the parties should carefully consider which provisions of the agreement will survive any termination or expiration. For example, the beneficiary should ensure that:

- All warranties, representations, and covenants made by the depositor survive any termination of the agreement
- After termination, the beneficiary retains any rights and licenses granted to it regarding the Deposit Materials

Conversely, the depositor should ensure that:

- The parties' confidentiality obligations regarding the Deposit Materials survives the termination of the agreement
- The escrow agent destroys or returns the Deposit Materials to the depositor on termination (except for any termination that occurs because of the triggering of a release condition)

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Sonia Baldia brings business and technology savvy to her global practice, which encompasses U.S. and international commercial, transactional, and intellectual property (IP) expertise across multiple industries including life sciences, banking and finance, healthcare, energy, information technology (IT), manufacturing, and software. She advises on a wide array of sourcing, technology, and other commercial transactions and helps companies navigate legal issues raised by data, emerging technologies, and digital transformation, both on the buyer and provider side. Sonia routinely advises clients on IP strategy, management, and monetization arrangements, leveraging her technology background and registered patent attorney credentials.

In addition to her U.S. bar admissions, Sonia is also qualified to practice law in India and she leverages that combined experience on behalf of clients in India-related matters.

Prior to rejoining the firm, Sonia was a partner in the Washington, D.C. office of an international law firm where she was part of its technology, IP, international commercial, and India practices. Sonia has also served as a consultant to the U.S. Agency for International Development (USAID) and the U.S. Department of Commerce in Washington, D.C. where she advised foreign governments on IT, telecom and IP-related development projects. She has also served as associate professor of law, teaching courses in IP, technology transfer, and corporate law.

Sonia was ranked in 2022 and prior years by *Chambers USA: America's Leading Lawyers for Business* in Technology & Outsourcing and in 2020, she was recognized for her expertise in outsourcing deals involving India and her broader technology expertise. She has also been consistently recognized by *Legal 500* amongst the leading practitioners in its technology, media, and telecom outsourcing category (2009-2022; and as a "New Generation Partner" in 2020 and a "Leading Lawyer" in 2021-2022). Sonia was recognized in *The Best Lawyers in America®* for Information Technology Law in 2022 and 2023. She is a frequent speaker and writer on digital transformation, global sourcing, IP, and technology topics and she has authored many articles and book chapters.