

Dispute Perspectives

Dispute Management of Software Escrow Agreements

May 2013





From the Editor's desk

Dear Friends,

Welcome to our fifth issue of ***Dispute Perspectives*** – a periodic newsletter that will provide you with a focused analysis of ongoing trends in dispute resolution in India.

In this issue we will look at software escrow agreements and how disputes can be effectively managed or mitigated in such agreements.

We, of course, look forward to hearing from you. I believe that we should be able to assist you or at least guide you in your pursuit of finding the most efficient and effective way to resolve disputes.

Should you have any questions, concerns or suggestions for future topics, please feel free to write to us.

Warm Regards,

Vidya Rajarao

National Leader, Forensic Services
vidya.rajarao@in.pwc.com

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Business continuity is paramount in a dynamic business environment with intense competition. Businesses, big or small, have at least one software license agreement which needs a source code escrow agreement to ensure business continuity in the event of default or bankruptcy of the software developer. To cite an example, one thing common between nationalised banks such as United Bank of India, Andhra Bank, Allahabad Bank, Bank of Maharashtra, and Punjab & Sind Bank is that their recent tenders for customised software have insisted that the software developer place the source code in escrow.

The Reserve Bank of India in 1998 appointed a 'Committee on Technology Upgradation in the Banking Sector' to examine and suggest steps to facilitate implementation of the spirit of the recommendations of the Narasimham Committee-II. The Committee report, Chapter 4, brought out in 1999, relating to outsourcing of technology and services by banks, says that there exists ***“the need to get the entire source code for the software that is outsourced. An escrow arrangement***

for the software outsourced may prove to be an ideal solution.” In Chapter 9, the Committee explicitly recommends that, ***“the entire source code should be obtained, if need be under an escrow arrangement.”***¹

Software development constitutes a substantial investment for a business which it will naturally want to protect. It will want to ensure that its investment will not vanish overnight, either by the developer neglecting its contractual obligations or being subject to liquidation / bankruptcy proceedings. Source code escrow alleviates these concerns and offers a reliable assurance and business security with adequate protection in respect of its investment in software.

A developer or software publisher on the other hand deploys a team and will have invested considerable time and effort in the creation of source code and will often want to use parts of it in other projects, so as to minimise the amount of time and effort it needs to expend in the future. Source code escrow acts as a strong motivating force for it to abide by the terms of a contract by securing its ability to use parts of the code in other projects.

1. The Reserve Bank of India, accessible at <http://www.rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=22>

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There are various types of escrow which we will briefly look at –

- **Data Escrow**

Data escrow is where one party to an agreement deposits information with an escrow agent, pending the performance of an obligation by the other party. If the obligation is not performed then the data will revert to the party that deposited it with the escrow agent. This type of escrow has traditionally been used in relation to databases but has become prevalent in its own right recently with the emergence and widespread proliferation of software as a service (“SaaS”), also known as “cloud computing”. SaaS is where the software used to create, access and store data is hosted on a central server by a service provider, together with the data itself, on behalf of several companies. This differs from the traditional model of hosting data on a hard drive in a computer situated in a company’s premises. Data is often interacted through a web browser when SaaS is deployed, removing the need for a business to invest heavily in the hosting and maintenance of its own data and instead delegating this to a third party provider in return for payment of a fee.

Data escrow acts to mitigate the risks associated with outsourcing critical data, particularly because the benefits received as costs savings can easily evaporate by the data being unlawfully accessed, corrupted or otherwise deleted. The escrow agreement will also provide for a quick remedy in the event of the hosting company becoming insolvent or for service outages

or data losses that harm a business. In such an event, the companies will be entitled to recover their data and in some cases, may be entitled to the underlying data behind the SaaS framework. This will motivate the provider to proactively protect their network.

Risks in Data Escrow

The risks of information protection from other companies and the server space shared by several users may pose a high risk if the data stored is sensitive and require compliance under Regulatory requirements such as HIPAA or Privacy Acts. Further forensic investigation of data maintained in escrow may not yield desirable result due to lack of maintenance of trails.

- **Database Escrow**

Database escrow is where a database developer deposits the code that makes up a computer database with an escrow agent, in accordance with an escrow agreement. A database escrow agreement will usually state that this code will pass to the business that commissioned its creation, should the developer be unable or unwilling to meet its contractual obligations. Investing in a database is a large investment for a business which it will naturally want to protect. It will want to ensure that its investment will not evaporate overnight, either by the developer neglecting its contractual obligations or becoming subject to liquidation/bankruptcy proceedings. Database escrow alleviates these concerns and offers a business security and peace of mind in respect of its investment in a database.

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A developer, on the other hand, will have invested considerable time and effort in the creation of source code that makes up a database and will often want to use parts of it in other projects, so as to minimise the amount of time and effort it needs to expend in the future. Database escrow acts as a strong motivating force for it to abide by the terms of a contract by securing its ability to use parts of the code in other projects. The terms of a database escrow agreement will usually stipulate that any instruction manuals, guides and related materials be placed into escrow, together with the code. The agreement will also set out the specific events triggering release, in addition to dealing with updated versions of the code, the form in which it will be received by the escrow agent and the manner in which it will be held.

The developer will usually pay the escrow costs because it will often have more than one company requesting database escrow. Using the same agent to escrow a database will save the developer time and money by streamlining both contract negotiations and administrative burdens.

- **Website Escrow**

Website escrow is where a third party that has been delegated responsibility for website management on behalf of a business deposits the code that makes up the website with an escrow agent. This ensures that the site will be updated and that new features will be deployed, in accordance with the website management agreement.

A typical website maintenance agreement will require technical work to be undertaken, in addition to ensuring the website is functional and easily navigated. Web design often involves the planning and implementation of a specific architecture and this is not easily passed from one developer to another without access to the work of the original developer.

Website escrow deposits the underlying code which makes up a website with an escrow agent, together with any other information, such as logos, images, sound files and details of interactions with plug-ins required to properly display the information. It will also often require details of any application programming interfaces, or “APIs” to be deposited with an escrow agent.

Website escrow affords a business certainty that its online presence will not be compromised by a developer failing to meet its obligations under a web maintenance agreement. It also ensures that, in the event of a breakdown in the relationship between the business and the developer, a new developer can be commissioned swiftly without having to expend considerable time and resources in understanding the previous developer’s programming methods

In this issue, we have discussed the importance of having software escrow agreements as well as dispute mitigation strategies.

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Businesses often depend on assets they do not own or control, such as software packages, productivity applications or e-commerce solutions. Technology escrow services allow businesses to access these critical assets if the supplier becomes unable or unwilling to provide its services under the terms of a contract, thereby allowing your business to continue without significant disruption. A business seeking to rely on a third party for the supply and maintenance of specialised software will want to protect its investment by ensuring a developer meets its obligations. An escrow agreement gives force to these obligations under a separate contract and sets out clear consequences for a developer's failure or inability to perform its duties.

Under the terms of an escrow agreement, a developer will deposit the source code that makes up a program with the escrow agent, together with any instructions, support manuals and intellectual property rights including copy of applications made thereto for securing the same. Normally the deposit document also includes operation or instruction manual needed for the program to operate. The escrow agreement will set out certain events under which the escrowed material will pass to the licensed user of the software or database.

Typical events that trigger the release of escrowed material are the licensor going bankrupt or undergoing liquidation proceedings brought against it or its failure to perform proper maintenance in accordance with the terms of the licence agreement. The release of source code and other material will allow a licensee to commission another developer to work on the software and to fix issues that the original licensor was either unable or unwilling to deal with or for events such as corporate take-overs.

Through the software escrow arrangement, licensees can protect their interests and rights accruing out of the Software License Agreement; it also provides the licensor with a unique USP to market its software products by addressing the critical issue of business continuity of the licensee. A licensor will also benefit by offering to place its work in escrow, as this will help to market its software and services. Licensees will have confidence in the business and will also a sense of security by knowing their investment will be safe, should an unforeseen event arise.

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More often than not, there are disputes under the following circumstances²-

- The technology vendor becomes bankrupt;
- The technology vendor fails to provide ongoing support or maintenance services. There may be several reasons for such failure. Some of the reasons are cited below -
 - Any natural calamity or terror attack that may affect the technology vendor's ability to provide ongoing support or maintenance services;
 - The vendor ceases trading.
- Sale of technology vendor's business or its products to competitors;
- Leak of confidential information or the source code to competitors either by the escrow agent or the technology vendor;
- The escrow agent many times may go through disputes / legal cases filed by the Code owner or a disputing party alleging any gross negligence and benefiting thereby for a frivolous or false claims;
- Customer service degradation – Companies that license customer facing applications can be especially burdened by any disruption caused by a dispute with the licensor;
- Loss of investment;
- The material is never deposited or only partially deposited into the escrow;
- The occurrence of release conditions is unclear or disputed;
- Occurrence of any unforeseen circumstances including prohibition through any law or court decisions;
- Disputes arising out of the non-disclosure agreement.

2. The circumstances mentioned are only illustrative.

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The core purpose of entering into software escrow agreements is to maintain business continuity and hence while entering into such legal agreements; companies must also have in place dispute mitigation procedures.

The technology vendor as well as the company to who services are being provided need to institute such measures so as to resolve dispute expeditiously without jeopardising business process. Some of the critical measures that companies can undertake are outlined below-

- **Bankruptcy of the technology vendor:** technology vendor may fail to provide services completely or there may be an aberration in providing maintenance services because of bankruptcy of the technology vendor. This may trigger the release of the source code which may be contested by the vendor. In such a scenario, there may be potential loss of business if dispute is not handled judiciously. In case, the software in question is very critical to the company, it may result in potential revenue loss for the company and also loss of customer confidence due to unavailability of company's services. A reactive dispute mitigation strategy would be to quantify the potential financial damages. This may help the parties to be dispute ready and also help in building a strong case to win the dispute if the dispute goes to a mediator, court of arbitration or even litigation. Some of the proactive dispute mitigation strategies would include the following -

- The bankruptcy process should be clearly defined with jurisdiction and mechanism for dispute resolution;
- Adequate consideration should be provided to requirements such as bankruptcy requirements under the local law;
- A thorough analysis of the bankruptcy statutes in the country of incorporation of the vendor is required, particularly when the vendor belongs to a neutral country. This could be neither the country of incorporation of the applicant or the escrow agent nor the country of jurisdiction of the escrow agreement.
- **Breach of terms by vendor:** a vendor may breach the terms of the license or support agreement. At the time of disputes a question arises on the agreed level of service and whether any intention (mens rea) exists for any failure below an agreed condition. In order to mitigate disputes with respect to such instances,
 - Clearly articulate what is a 'breach'
 - Redefine the service level and modify the contract and terms at periodic intervals based on prevailing business scenarios
- **Mitigating risk of infringement of intellectual property:** One of the reasons of disputes as discussed in the section above is infringement of intellectual property. This is of grave concern from the point of view of loss of competitive advantage. The escrow agent or the technology vendor may be instrumental in leaking the source code to the company's competitors. This may

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result in intellectual property dispute amounting to financial losses, escalating attorney fees and other expenses. In order to mitigate this risk, some of the practical steps that can be take are -

- Conducting a thorough due diligence on business partners as well on the escrow agents before entering into a legal contract. Due diligence must be conducted on periodic basis.
 - Maintaining an IP audit trail can help expedite intellectual property rights disputes and provide necessary evidence in establishing the owner's right over the intellectual property at dispute.
 - To identify what constitutes a risk sensitive intangible asset;
 - To address new and emerging threats to IP;
 - To properly allocate available risk resources given limited funds; and
 - To achieve compliance within the legal and regulatory environment in which they operate;
 - IP infringement coverage, also known as intellectual property liability coverage, defends from patent infringement claims against the insured and defends the insured's ownership rights in the IP. It also provides insurance to indemnify customers and distributors for allegations that the insured's IP is in violation of another's IP rights and indemnifies against damages the insured is legally liable for as a result of a verdict or settlement
- **Evaluation through identification and performing tests:** Dispute may arise through claiming ownership

of the code. To evaluate and verify the ownership, array of tests to be carried out to understand the underlying issues on ownership. The tests, verifications or evaluations will then need to be performed and an independent and objective report of the results is required to analyse the issues and when required taking it through a mediator, arbitrator or court and provide platform to stand as expert witness.

- **Gross negligence issues:** The escrow agent many times may go through disputes / legal cases filed by the code owner or a disputing party alleging any gross negligence and benefiting thereby for a frivolous or false claims. In such cases, appropriate documentation should be maintained with time records to assist in reactive dispute resolution strategies like analysis of allegations and quantification of damages.
- **Non-disclosure agreements:** In litigation or other disputes involving trade secrets or confidential information, or other challenges to ownership or rights in proprietary technology, it may be critical to establish that certain trade secrets, information, data or technologies were in owner's possession prior to certain dates or events. The escrow service provider can be called to corroborate the date of deposit by the owner, to evidence the owner's claim that it was in possession of the critical trade secrets, information, data or other technologies at least as of the date of deposit. At such times, a background verification of the escrow agent is crucial before carrying out a non-disclosure agreement. In its absence, the credibility of the escrow agent cannot be determined at the time of claims on disputed information.

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Save the date for the launch of our first arbitration survey titled,
“Corporate Attitudes and Practices towards Arbitration in India”

Saturday, June 8 in Delhi

Saturday, June 15 in Mumbai

Monday, June 24 in Bengaluru

Saturday, June 29 in Chennai

Details of the venue and copy of the survey results will be circulated shortly.

To register, kindly email Divya Rishi at divya.rishi@in.pwc.com

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