

# Helping clients handle disappearing vendors

There is no doubt that vendors of software and technology services will be adversely affected by the current global financial crisis. This is a unique opportunity for lawyers to step up and offer their clients some useful advice on a timely subject.

As businesses suffer or disappear, so too will many vendors. For companies that have outsourced key functions, the collapse or instability of a vendor can be catastrophic.

Even software licences are at risk. Many companies are surprised to learn that if a software licensor declares bankruptcy or goes insolvent, the licensor's trustee can disclaim (effectively terminating) the software licence with no recourse. To deal with this, changes to Canadian law have been enacted, but not yet proclaimed into force, to soften the effects of such disclaimers — but only to a limited extent.

For these reasons, companies are advised to carefully consider their options and review their contracts with their key technology vendors in light of potential financial difficulties or insolvency that these vendors may face. Of particular concern would be agreements with smaller and less-established vendors, which may not have sufficient resources to weather economic turbulence. But as the collapse of some formerly blue chip institutions in the United States have shown, one may need to be vigilant even with larger vendors.



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## Watch for warning signs

It is crucial for clients to watch for warning signs of financial distress from their vendors. By the time a vendor has collapsed or become insolvent, it is likely too late for the client to seamlessly transition to a new vendor on a cost-effective basis.

Insolvency may appear to come out of the blue, but there are often clues that a vendor may be in trouble. Have the vendor's service levels started dropping? Are there any unexplained outages? Have development projects stalled or slowed? These could all be signs that the vendor is distracted or is allocating its resources elsewhere to stave off its creditors.

Many service agreements require vendors to provide financial statements, SAS70 certificates or evidence of their solvency, which may be valuable for evaluating risk. Clients may also have the right to audit their vendors' books for the same reason. Companies can also monitor a vendor's financial health through public documentation and filings, news articles and credit ratings.

## Evaluate rights under existing contracts

Companies should review their

vendor contracts to determine their existing contractual rights and leverage under their current agreements with any distressed vendors.

Most service agreements provide a right to terminate upon the insolvency of a vendor. However, under Canadian law, such rights are stayed upon the vendor filing for court protection. Nonetheless, a company may have the right to terminate an agreement for reasons such as material breach or failure to meet service levels that may be a direct result of the insolvency. Service agreements also typically contain obligations for the vendor, upon or before termination, to assist in creating and implementing a transition plan.

Many contracts also contain special terms that take effect on the occurrence of an "extraordinary event," which usually includes such events as drastic changes to a party's creditworthiness, market conditions or underlying business assumptions of the agreement. An extraordinary event may trigger the right to terminate or to recalibrate or renegotiate key terms such as pricing and volume commitments.

If a licence or service arrangement provides for the escrow of source code, the release conditions for the source code should be reviewed to determine when and how they can be enforced. Most source code escrow agreements also allow the beneficiary to request that an independent third party verify that the escrowed

code is complete and can be compiled. Verification can be expensive but invaluable; if after the fact it turns out that the escrowed code is deficient in some way, it may be too late or too difficult to obtain the appropriate code.

Companies should determine whether there are any restrictions on assignment of the agreement; otherwise, a distressed vendor may seek to simply transfer the agreement to a new service provider that the client has not chosen. Although assignment to a more stable and solvent service provider may be desirable, and could provide the company with the chance to negotiate a more favourable contract, it would still be preferable for a client to have a say in whether the agreement can be assigned.

Companies should also evaluate the effectiveness of any separate performance or financial guarantees that may have been provided by a parent or affiliate of the vendor.

## Planning for the worst

If there are indeed warning signs that a vendor may experience problems, companies should keep in mind that it may take months or even years to transition to a new provider. It can take considerable time to identify replacement vendors, institute a competitive request for proposals process, negotiate an agreement and transition to a new vendor. Therefore, it is important to begin developing a contingency plan as early as possible if there is

any concern about the stability or solvency of a vendor.

A key part of a contingency plan would be to ensure that the vendor has provided the company with any intellectual property or other works developed or in progress and any required intellectual property assignments. Companies should also assiduously claim and collect (or set off from payments owing) any service credits or other amounts owing by the vendor.

If data is generated or stored on a hosted basis, such as in a "cloud computing" model, the collapse of a vendor can be disastrous if the client does not have access to, or copies of, its own data. Where possible, companies should insist on regularly obtaining copies of all data stored off-site, in a readable format.

If a company is entitled to obtain a security interest in any tangible or intangible property of the vendor as part of the services arrangement, the company should take steps to perfect such security to protect its rights or assets.

Finally, if a vendor does file for insolvency or bankruptcy protection, it is essential that the company closely follow and participate in the insolvency proceedings to ensure that its interests and rights are protected. ■

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