



# SOURCE CODE ESCROW AND ACCESS AGREEMENTS

Richard Austin  
February 12, 2010



I. INTRODUCTION

II. SOURCE CODE ESCROW AGREEMENTS

III. IP LICENSES UNDER CANADIAN BANKRUPTCY LAW



# I. Introduction

*“Mobile-software company UIQ files for bankruptcy”*<sup>1</sup>

*“Software vendor Cassatt in rough shape, bankruptcy possible, report says”*<sup>2</sup>

*“Security software maker files for bankruptcy, lost \$7M in '08”*<sup>3</sup>

*“SCO Blames Linux For Bankruptcy Filing”*<sup>4</sup>

*“Clone-maker Psystar Files for Bankruptcy”*<sup>5</sup>

→ Faced with the risks of not being able to use or maintain software, Licensees are seeking access to source code and related documentation to safeguard their ability to use and maintain the software



# I. Introduction cont'd

## Competing Interests:

### Software Developer / Licensor

### Software Licensee

Control of scope and costs	Compliant / functional software
Time and materials	Fixed price development
Standardized (Licensor) terms	Standardized (Licensee) terms
Time – limited obligations	Long term relationship
Defined ongoing maintenance and support obligations	Leveraged maintenance and support
Sustainable revenue stream	Controllable costs
Ownership of IP	Access to source code
➤ Escrows can represent an acceptable compromise	



# I. Introduction cont'd

## Definition:

**Source code escrow** is the deposit of the source code of software with a third party escrow agent. Escrow is typically requested by a party licensing software (the licensee), to ensure maintenance of the software. The software source code is released to the licensee if the licensor files for bankruptcy or otherwise fails to maintain and update the software as promised in the software license agreement.

Wikipedia, *Source Code Escrows*

[http://en.wikipedia.org/wiki/Source\\_code\\_escrow](http://en.wikipedia.org/wiki/Source_code_escrow)



# I. Introduction cont'd

## Summary:

- Source code escrow agreements:
  - Protect against specific supplier viability and performance obligations
  - Do not address all issues around insolvency/bankruptcy
  - Should be identified as a requirement as early as possible, preferably in any RFP
  - Licensees should pay attention to:
    - Definition of Escrowed Materials
    - Verification Procedures
    - List of Release Events
  - Should be completed at same time as the license agreement

## II. Source Code Escrow Agreements

### A. Types of Escrow Agreements:

#### Three-Party Agreements

Parties:

- Licensor
- Escrow Agent
- Licensee

Escrow Agreement negotiated amongst all three parties

Terms are generally customized

All three parties sign the Escrow Agreement

#### Two-Party Agreements

Parties:

- Licensor
- Escrow Agent

Escrow Agreement terms prepared by Licensor

Standardized Terms

Licensor and Escrow Agent sign the Escrow Agreement

Software Licensees sign “User Enrolment Schedule”

## ❖❖ II.A Types of Escrow Agreements cont'd

For sample single- and multi-user source code escrow agreements:

<https://www.innovasafe.com/agreements.html>

Protection depends upon terms and conditions:

- Definition of Escrowed Materials
- Licensee's Verification rights
- List of Release Conditions
- Release process
- Licensee's rights to use following release
- Other terms and conditions



## II.B Escrowed Materials

Escrow Agreement should specify:

- the Escrowed Materials (what is to be deposited in escrow):
  - What
  - When
  - How
  - Where

## II.B Escrowed Materials cont'd

### Escrowed Materials - What:

- Should include more than source code
- Define in consultation with technical personnel – may include
  - Executable object code
  - Supporting intellectual property including all third party tools
  - Application programming interfaces
  - Schematics of software components
  - Detailed documentation
  - Instructions and procedures for set up, compilation and execution
  - Encryption keys and passwords
  - Contact information for technical support personnel
- Electronic and hard copy versions

## ❖❖ II.B Escrowed Materials cont'd

### Escrowed Materials - When:

- Timing of initial and subsequent deposits:
  - For development agreements, connect deposits to payment/achievement of milestones/implementation
  - For upgrades, always have Escrowed Materials for current execution version of the software in escrow

### How – Deposit Method:

- Physical or Electronic

### Where - Storage of Escrowed Materials

- Location
- Responsibilities of Escrow Agent for safekeeping
- Conditions of Storage Area (security, humidity, etc. of storage area)

## II.C Verification

*“Statistics show that 77% of all deposits sent in for analysis were determined to be incomplete and 88% of examined deposits required additional input from the developer in order to be compiled.”<sup>6</sup>*

Verification provides assurance that:

- Escrowed Materials are complete
- Licensee will be able to implement, use and maintain Licensor’s technology
- Implementation can be completed quickly and effectively

## II.C Verification cont'd

### Single User Escrow Agreement:

#### “3. Verification

- (1) Licensee may, at any time, request the Licensor to verify that the Materials are consistent with the most current version of the Software by giving 5 business days prior written notice to Licensor and SCEC. Such notice shall specify (a) the date and time (on a business day and during normal business hours) when the verification is to be conducted and (b) the location where the verification is to take place. Subject to section 3(2), at the date, time and location specified in the notice or as may be agreed to by the parties, SCEC shall deliver the Materials to Licensee. In the presence of Licensor, Licensee may perform (or at its option require the Licensor to perform) such tasks and verification procedures as Licensee may deem necessary to enable Licensee to determine that the Source Code when compiled and executed performs consistently with the most current version of the Software. Upon completion of the verification, Licensor and Licensee shall return the Materials to SCEC and ensure that all physical and computer copies of the Materials which were created pursuant to the verification are destroyed and purged.
- (2) All SCEC's fees, expenses and disbursements related to such verification shall be borne by Licensee and, at the option of SCEC, may be required to be paid in advance of such verification.”

The Source Code Escrow Company, Single-User Model Agreement at  
[http://www.source-code-escrow.com/model\\_agreements.html](http://www.source-code-escrow.com/model_agreements.html)

## ❖❖ II.C Verification cont'd

### Licensee Verification:

- Typically for Single-User Escrow Agreements
- Tests conducted on notice to Licensor
- Escrow Agent delivers materials to Licensee
- Tests conducted by Licensee or Licensor under Licensee control
- All materials returned/destroyed at conclusion of the tests

## ❖❖ II.C Verification cont'd

### Escrow Agent Verification:

- Escrow Agent verification services becoming best practice
- Verification services range from:
  - None
  - Limited verification of Escrowed Materials
  - Comprehensive Verification of Escrowed Materials:
    - Compilation
    - Execution
    - Functionality Testing
- Should be determined in conjunction with technical personnel

## II.D Release Conditions

- Key to an effective Escrow Agreement
- More than just bankruptcy:
  - Loss of support
  - Ceasing to carry on business (in respect of maintaining and supporting the software)
  - Force Majeure event rendering Licensor unable to carry on business in normal course or fulfill material obligations under the License Agreement
  - Breach of obligations
  - Change of control/sale of assets



## II.D Release Conditions cont'd

Release conditions should be

- Comprehensive
- Detailed
- Specific
- Use “industrial strength” drafting

**Licensor becomes bankrupt, insolvent or the subject of receivership**

**if Licensor makes an assignment for the benefit of creditors or if a petition in bankruptcy is filed against Licensor and such petition is not dismissed within • days, or if a receiver is appointed for Licensor whose appointment is not vacated within • days, and as a result of any of the above, the personnel of Licensor are unable or unwilling to execute their normal business routines or Licensor is unable or unwilling to fulfill its material obligations under the License Agreement;**

## II.E Release Procedures

### Standard Release Process:

- The Licensee notifies Escrow Agent and Licensor that Release Event has occurred
  - Affidavit with specifics of the Release Event
- The Licensor has specified number of days to respond
  - If the Licensor agrees Release Event has occurred, Escrow Agent delivers copy of the Escrowed Materials to the Licensee
  - If the Licensor does not respond, Escrow Agent delivers copy of the Escrowed Materials to the Licensee
  - If the Licensor in good faith disputes the occurrence of the Release Event
    - Affidavit with specifics of good faith dispute
    - Dispute submitted to [expedited] dispute resolution
    - Escrow Agent retains Escrowed Materials until final decision
- If Release Event cured:
  - The Licensee returns Escrowed Materials and all copies to Escrow Agent or the Licensor

## II.F Rights to use Following Release

Include license in License Agreement and Escrow Agreement:

- Current (not future or conditional) grant
- Perpetual license

License should encompass the rights to:

- Use the Escrowed Materials (including to make derivative works)
- Relocate software to other hardware or locations
- Make backup copies
- Provide 3<sup>rd</sup> parties with access to Escrowed Materials (affiliates and contractors including outsourcers)

## ❖❖ II.G Other Escrow Agreement Provisions

- Standard of Care and Liability of Escrow Agent
- Notice Provision
- Force Majeure
- Licensor Concerns:
  - Non-disclosure obligations (other than Verification and Release)
  - Timeframe to cure defaults/breaches
  - Precise Dispute Resolution provisions
  - Return of all complete or partial copies of Escrowed Materials (including derivative works)

## ❖❖❖ II.H Other Escrow Arrangements

- Software-as-a-Service
  - Escrow companies offering Software-as-a-Service escrows:
    - Supplementing traditional source code escrows
    - Includes escrow of executable code in a separate account
      - Focussed on disaster recovery and application continuity
      - Release of executables based on 'demand release' conditions that minimise downtime
    - Include automated data backup and recovery services
    - Verification of Escrowed Materials
- Joint venture and distribution agreements
- Mergers and acquisitions
- Employee/confidentiality agreements
- Preservation of collateral

## III.A IP Licenses - U.S. Situation

Section 365 of the U.S. *Bankruptcy Code* (before amendment):

- Governed right of bankrupt to assume or reject executory contracts
- Where bankrupt had additional obligations, bankrupt could disclaim the executory contract, maintaining any benefits provided and avoiding ongoing obligations

*Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.* <sup>7</sup>:

- Bankruptcy trustee successfully rejected license for use of metal coating technology granted by Richmond to Lubrizol

U.S. *Bankruptcy Code* was amended in 1988 in response to criticism of *Lubrizol Enterprises*

## III.A U.S. Situation cont'd

Post-amendment, under 365(n) of U.S. *Bankruptcy Code*, if the trustee disclaims a license, the Licensee can:

- Treat the license as having been terminated if bankrupt Licensor's rejection of license, absent the bankruptcy, would have been a breach entitling the Licensee to terminate
- Licensee can sue bankrupt Licensor for damages for breach of contract. Claim for damages is unsecured claim.

or

- Retain its rights to use the IP (including a right to enforce exclusivity provisions but excluding right to specific performance) during the term of the license and any "as of right" extensions.
- Licensee must pay all license fees and royalties as if contract had not been rejected.
- Licensee cannot force bankrupt Licensor to provide services set out in the license agreement.

## III.B Canada – Pre-Amendments

Pre-amendment Canadian cases focussed on whether IP licenses were proprietary or contractual:

- *Re Erin Features No. 1 Ltd*<sup>8</sup>:
  - Trustee sought to disclaim agreement under which bankrupt had granted exclusive marketing rights in Canada to a film
  - The Court assumed, without deciding, that a trustee in bankruptcy has the power to disclaim executory contracts.
  - Agreement could not be disclaimed because the grant of exclusive marketing rights to the film conveyed a property interest which could not be reversed.



## III.B Canada - Pre-Amendments cont'd

### ➤ *Re T. Eaton Co.*<sup>9</sup>

- In a restructuring under CCAA, Court permitted Eaton's to disclaim an agreement which granted National Retail Credit Services an exclusive license to supply credit card services to Eaton's customers and to use Eaton's' trade marks in relation to such services.
- Court held that the licenses granted did not transfer any property interest.
- Court also noted that restricting debtor companies from repudiating contracts would constitute an insurmountable obstacle to affecting compromises and reorganizations.

## III.B Canada - Pre-Amendments cont'd

- *Royal Bank of Canada v. Body Blue Inc.* <sup>10</sup>
    - Insolvent patent owner had granted Herbal Care exclusive right to manufacture and sell products using certain technology.
    - Vesting order under CCAA allowed receiver to sell assets to a newly formed company (Body Blue 2006) “free and clear of and from any claims and liens”.
    - In response to a claim from Herbal Care for damages and a declaration that Body Blue 2006 acquired the IP subject to Herbal Care’s license, Court found that Body Blue 2006 owned the IP free and clear of any license granted to Herbal Care.
    - Based on common law principle - a license creates no interest in property but, rather, is permission to do something that would otherwise be unlawful to do.
- Pre-amendment cases resemble pre-*Lubrizol* U.S. jurisprudence.

## III.C BIA and CCAA Amendments

Amendments to *Bankruptcy and Insolvency Act* (“BIA”) and *Companies’ Creditors Arrangement Act* (“CCAA”):

- came into effect on September 19, 2009
- expressly permit the disclaimer of executory contracts
- include protections for IP licensees

## III.C BIA and CCAA Amendments cont'd

BIA, section 65.11(7) provides:

(7) If the debtor has granted a right to use intellectual property to a party to an agreement, the disclaimer or resiliation does not affect the party's right to use the intellectual property — including the party's right to enforce an exclusive use — during the term of the agreement, including any period for which the party extends the agreement as of right, as long as the party continues to perform its obligations under the agreement in relation to the use of the intellectual property.

CCAA, section 32(6) is similar.

Licensee is protected in its use of the licensed IP so long as Licensee continues to perform its obligations.

## III.C BIA and CCAA Amendments cont'd

### Amendments:

- Protection under the BIA only applies if notice of intention or proposal is filed – does not extend to licensors in bankruptcy or receivership proceedings.
- Do not define either “intellectual property” or “right to use”
- Provisions do not deal with rights of Licensee in the event of sale of technology (see *Body Blue* decision above)

## III.C BIA and CCAA Amendments cont'd

Licensees should:

- Review the language of existing license agreements relating to Licensor financial difficulties
- Consider taking security or proprietary interests in IP
- Avoid comingling the license fees payable with fees for other services such as maintenance and support
- Enter into source code escrow agreements with licensors.



Questions??

# ⋮⋮⋮ A. U.S. Bankruptcy Code, s. 365(n)

## A. United States Bankruptcy Code, Section 365(n)

“(n)(1) If the trustee rejects an executory contract under which the debtor is a licensor of a right to intellectual property, the licensee under such contract may elect—

- (A) to treat such contract as terminated by such rejection if such rejection by the trustee amounts to such a breach as would entitle the licensee to treat such contract as terminated by virtue of its own terms, applicable nonbankruptcy law, or an agreement made by the licensee with another entity; or
- (B) to retain its rights (including a right to enforce any exclusivity provision of such contract, but excluding any other right under applicable nonbankruptcy law to specific performance of such contract) under such contract and under any agreement supplementary to such contract, to such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law), as such rights existed immediately before the case commenced, for—
  - (i) the duration of such contract; and
  - (ii) any period for which such contract may be extended by the licensee as of right under applicable nonbankruptcy law.”



# ⋮⋮⋮ A. U.S. Bankruptcy Code, s. 365(n) cont'd

“(2) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, under such contract—

(A) the trustee shall allow the licensee to exercise such rights;

(B) the licensee shall make all royalty payments due under such contract for the duration of such contract and for any period described in paragraph (1)(B) of this subsection for which the licensee extends such contract; and

(C) the licensee shall be deemed to waive—

(i) any right of setoff it may have with respect to such contract under this title or applicable nonbankruptcy law; and

(ii) any claim allowable under section 503(b) of this title arising from the performance of such contract.”

## ⋮⋮⋮ A. U.S. Bankruptcy Code, s. 365(n) cont'd

“(3) If the licensee elects to retain its rights, as described in paragraph (1)(B) of this subsection, then on the written request of the licensee the trustee shall—

- (A) to the extent provided in such contract, or any agreement supplementary to such contract, provide to the licensee any intellectual property (including such embodiment) held by the trustee; and
- (B) not interfere with the rights of the licensee as provided in such contract, or any agreement supplementary to such contract, to such intellectual property (including such embodiment) including any right to obtain such intellectual property (or such embodiment) from another entity.”

# ⋮⋮⋮ A. U.S. Bankruptcy Code, s. 365(n) cont'd

“(4) Unless and until the trustee rejects such contract, on the written request of the licensee the trustee shall—

(A) to the extent provided in such contract or any agreement supplementary to such contract—

(i) perform such contract; or

(ii) provide to the licensee such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law) held by the trustee; and

(B) not interfere with the rights of the licensee as provided in such contract, or any agreement supplementary to such contract, to such intellectual property (including such embodiment), including any right to obtain such intellectual property (or such embodiment) from another entity.”

## B. BIA, s. 65.11

### **B. Bankruptcy and Insolvency Act, s. 65.11 (Disclaimer or Resiliation of Agreements)**

- “(1) Subject to subsections (3) and (4), a debtor in respect of whom a notice of intention was filed under section 50.4 or a proposal was filed under subsection 62(1) may — on notice given in the prescribed form and manner to the other parties to the agreement and the trustee — disclaim or resiliate any agreement to which the debtor is a party on the day on which the notice of intention or proposal was filed. The debtor may not give notice unless the trustee approves the proposed disclaimer or resiliation.
- (2) In the case of an individual,
- (a) they may not disclaim or resiliate an agreement under subsection (1) unless they are carrying on a business; and
  - (b) only an agreement in relation to the business may be disclaimed or resiliated.
- (3) Within 15 days after the day on which the debtor gives notice under subsection (1), a party to the agreement may, on notice to the other parties to the agreement and the trustee, apply to a court for an order that the agreement is not to be disclaimed or resiliated.”



## B. BIA, s. 65.11 cont'd

- “(4) If the trustee does not approve the proposed disclaimer or resiliation, the debtor may, on notice to the other parties to the agreement and the trustee, apply to a court for an order that the agreement be disclaimed or resiliated.
- (5) In deciding whether to make the order, the court is to consider, among other things,
- (a) whether the trustee approved the proposed disclaimer or resiliation;
  - (b) whether the disclaimer or resiliation would enhance the prospects of a viable proposal being made in respect of the debtor; and
  - (c) whether the disclaimer or resiliation would likely cause significant financial hardship to a party to the agreement.
- (6) An agreement is disclaimed or resiliated
- (a) if no application is made under subsection (3), on the day that is 30 days after the day on which the debtor gives notice under subsection (1);
  - (b) if the court dismisses the application made under subsection (3), on the day that is 30 days after the day on which the debtor gives notice under subsection (1) or any later day fixed by the court; or
  - (c) if the court orders that the agreement is disclaimed or resiliated under subsection (4), on the day that is 30 days after the day on which the debtor gives notice or any later day fixed by the court.”

## B. BIA, s. 65.11 cont'd

- “(7) If the debtor has granted a right to use intellectual property to a party to an agreement, the disclaimer or resiliation does not affect the party’s right to use the intellectual property — including the party’s right to enforce an exclusive use — during the term of the agreement, including any period for which the party extends the agreement as of right, as long as the party continues to perform its obligations under the agreement in relation to the use of the intellectual property.**
- (8) If an agreement is disclaimed or resiliated, a party to the agreement who suffers a loss in relation to the disclaimer or resiliation is considered to have a provable claim.
- (9) A debtor shall, on request by a party to the agreement, provide in writing the reasons for the proposed disclaimer or resiliation within five days after the day on which the party requests them.
- (10) This section does not apply in respect of
- (a) an eligible financial contract within the meaning of subsection 65.1(8);
  - (b) a lease referred to in subsection 65.2(1);
  - (c) a collective agreement;
  - (d) a financing agreement if the debtor is the borrower; or
  - (e) a lease of real property or of an immovable if the debtor is the lessor.”

**C. Companies' Creditors Arrangement Act, s. 32 (Disclaimer or Resiliation of Agreements)**

- “(1) Subject to subsections (2) and (3), a debtor company may — on notice given in the prescribed form and manner to the other parties to the agreement and the monitor — disclaim or resiliate any agreement to which the company is a party on the day on which proceedings commence under this Act. The company may not give notice unless the monitor approves the proposed disclaimer or resiliation.
- (2) Within 15 days after the day on which the company gives notice under subsection (1), a party to the agreement may, on notice to the other parties to the agreement and the monitor, apply to a court for an order that the agreement is not to be disclaimed or resiliated.
- (3) If the monitor does not approve the proposed disclaimer or resiliation, the company may, on notice to the other parties to the agreement and the monitor, apply to a court for an order that the agreement be disclaimed or resiliated.
- (4) In deciding whether to make the order, the court is to consider, among other things,
- (a) whether the monitor approved the proposed disclaimer or resiliation;
  - (b) whether the disclaimer or resiliation would enhance the prospects of a viable compromise or arrangement being made in respect of the company; and
  - (c) whether the disclaimer or resiliation would likely cause significant financial hardship to a party to the agreement.”



## C. CCAA, s. 32 cont'd

“(5) An agreement is disclaimed or resiliated

(a) if no application is made under subsection (2), on the day that is 30 days after the day on which the company gives notice under subsection (1);

(b) if the court dismisses the application made under subsection (2), on the day that is 30 days after the day on which the company gives notice under subsection (1) or on any later day fixed by the court; or

(c) if the court orders that the agreement is disclaimed or resiliated under subsection (3), on the day that is 30 days after the day on which the company gives notice or on any later day fixed by the court.

**(6) If the company has granted a right to use intellectual property to a party to an agreement, the disclaimer or resiliation does not affect the party’s right to use the intellectual property — including the party’s right to enforce an exclusive use — during the term of the agreement, including any period for which the party extends the agreement as of right, as long as the party continues to perform its obligations under the agreement in relation to the use of the intellectual property.**

(7) If an agreement is disclaimed or resiliated, a party to the agreement who suffers a loss in relation to the disclaimer or resiliation is considered to have a provable claim.

(8) A company shall, on request by a party to the agreement, provide in writing the reasons for the proposed disclaimer or resiliation within five days after the day on which the party requests them.”



## C. CCAA, s. 32 cont'd

“(9) This section does not apply in respect of

- (a) an eligible financial contract;
- (b) a collective agreement;
- (c) a financing agreement if the company is the borrower; or
- (d) a lease of real property or of an immovable if the company is the lessor.”



## D. Notes

### D. Notes

1. David Meyer, January 5, 2009 at <http://www.silicon.com/technology/mobile/2009/01/05/mobile-software-company-uiq-files-for-bankruptcy-39372003/>
2. Jon Brodtkin, Network World, April 27, 2009 04 at <http://www.networkworld.com/news/2009/042709-cassatt-bankruptcy.html>
3. Jean Kwon, Austin Business Journal, February 20, 2009 at <http://austin.bizjournals.com/austin/stories/2009/02/23/story11.html>
4. Paul McDougall, Information Week, September 14, 2007 at <http://www.informationweek.com/news/global-cio/showArticle.jhtml?articleID=201806893>
5. Dan Moren, PCWorld, May 26, 2009 at [http://www.pcworld.com/businesscenter/article/165509/clonemaker\\_psystar\\_files\\_for\\_bankruptcy.html](http://www.pcworld.com/businesscenter/article/165509/clonemaker_psystar_files_for_bankruptcy.html)
6. “Escrow Verification Services”, Iron Mountain, 2009 at <http://www.ironmountain.com/resources/Escrow-Verification-Services.pdf>.
7. 756 F. (2d) 1043 (Fourth Cir. 1985), cert. denied, 475 U.S.C. 1057 (1986)
8. [1991] B.C.J. No. 3330, 8 C.B.R. (3d) 205 (B.C.S.C.)



## D. Notes cont'd

9. [1999] O.J. No. 4216, 14 C.B.R. (4<sup>th</sup>) 288 (Ont. S. C.)
  
10. [2008] O.J. No. 1628, 42 C.B.R. (5<sup>th</sup>) 125, 2008 CanLII 19227 (Ont. S.C.)