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Software Escrow – finally coming of age in Europe

by Stephan Peters, first published March 2004 (www.amrecht.com/peters2004.shtml)

The concept of software escrow - maintaining the source code to protect the intellectual property (IP) of developers and offering insurance for IT-investments commissioned by licensees – is recently gaining notable traction here in Europe. In the US, the concept has been discussed and used as an effective tool to enhance business in the software and licensing industry for over twenty years. This article will offer some background on the current shift taking place in Europe and point out the remaining obstacles which stand in the way of escrow evolving to its true potential; it will also state a strong request directed towards the European legislator.

Several factors explain the differing development of escrow in the US and Europe. Firstly, the concept of software made for hire, i.e. the development of specific applications for one company, used to be much more widespread in Europe. As a result, escrow was rarely needed because those deals typically included the handover of the source code. Today, the trend to standardized software applications, which are sold to and used by more than one licensee, has become ubiquitous, one obvious reason for this being the ability to spread development and maintenance costs among several users. Under the newer model, however, it makes sense for the developer to protect its IP and to retain the source code, which potentially leaves the licensee without proper protection in case the licensor can no longer maintain the software.

Secondly, Europe used to have a lot less insolvencies than the US, thus the overall awareness for the business risks associated with software licensing was less developed. A look at recent insolvency statistics shows that this parameter has changed as well.

Thirdly, lawyers in Europe commonly used to be positioned as generalists and clients typically relied on "their" attorney to solve most or all their legal issues; this was analogous to the traditional medical sector and the widespread concept of "general doctors". While offering some advantages, this "universal" approach does no longer account for the current demand and for the increasing depth of know-how accumulated in either industry. Clearly, both systems have been changing towards the more effective concept of specialization. Today, many lawyers concentrate on licensing issues and intellectual property protection, and as a result the knowledge about escrow and its effectiveness is more commonly available among legal advisors.

A fourth explanation for the EU-US gap in escrow usage can be found when looking at the concept of notaries. In most parts of Europe, notaries are highly-qualified professionals who are typically appointed by the state and who – besides offering full-fledged legal advice – take over official functions on behalf of public interest. In consequence, notaries traditionally have also been depositories who stored and administered valuables on behalf of their clients. When the idea and need of handing source code over to a trusted third party arrived in Europe, those notaries understandably were the first ones to be considered. However, since their service encompassed the aspects of basic storage and controlled access only and did not meet the additional needs of the target group - e.g. accounting for continuous developments and updates to the software, varying forms of technical verification to ensure correctness and validity of the deposit materials, highest possible security standards, someone taking over full responsibility for the overall process, or adequate prices - the acceptance of said service was limited and never reached its full potential.

In the US, the concept of the "European" notary does not exist - "public notaries" in the US typically are much less qualified and offer clerical services like confirming equality between an original document and its photocopies. This absence of a "natural" choice for the surfacing idea of escrow sometime around the beginning of the 80s resulted in the evolution of professional escrow

agents who could address best the specific needs of their clients. Today, more and more notaries in Europe are realizing that their service offerings and capabilities are not best suited to serve those requirements; also, many fear the risks and potential liability charges associated with this kind of service. Consequently, now many European notaries happily refer corresponding inquiries to professional escrow agents.

And finally, a look at the legal systems reveals what probably can be considered the most important factor in explaining the dissimilar progress of escrow in Europe and the US. While a potential insolvency of the developer typically is only one reason among several to close an escrow agreement, it is clearly the single most important one. If the effectiveness of said agreements was doubtful - if only the slightest ambiguity was left - the whole validity of the escrow tool would of course be questioned. To a certain extent, this is what has happened in Europe for the longest time.

After more than 10 years of practical experience in using software escrow, the US legislator some 10 years ago confirmed its effectiveness and viability by passing an amendment to the existing law. Now Tit. 11 USC Sec. 365 (n) of the Bankruptcy Code irrevocably manifests the licensee's right to retain and use the source code if it was handed over to him under a properly administered escrow agreement. A trustee, who is typically given all executive power over an insolvent company (in this case the developer), may therefore no longer revoke an escrow agreement in place or its accompanying rights granted to the licensee.

In European law, a trustee's right to potentially revoke an escrow agreement is not explicitly *excluded*, i.e. the equivalent of 365 (n) is not yet found. There is no known case where a trustee has ever tried to revoke an escrow agreement in place; going even further, most insiders agree that trustees would not even have a strong *motivation* to try such act. Still, due to the absence of an explicit clause or an unambiguous ruling, the discussion about this theoretical pitfall has been ongoing for a long time. And this circumstance arguably has contributed strongly to the fact that the mere knowledge about the existence of escrow has not yet reached the same level as in the US, not to mention actual usage of escrow.

Having said the latter, one could start believing that escrow has no factual meaning in Europe. This is not the case at all – European escrow agents have existed for many years. The software industry is becoming increasingly international, and plenty of applications find users on the respective other side of the Atlantic. Together with the software travels the concept of escrow. When looking at the growing number of articles in the relevant press and the increasing public discussion about escrow, it becomes clear that it is only a matter of time before escrow in Europe will enjoy a level of awareness similar to the one in the US. Overall demand is stepping up, in particular right now *after* a prolonged economic downturn (the memory of many bankrupt companies is still fresh) and *on the outset* of a recovery (investments e.g. in licenses are increasing again). The fact that a legal ambiguity remains has only lead to an increased creativeness with respect to the composition of agreements, one remedy – but by far not the only one – involving the usage of foreign entities as escrow agents.

The real issue about the residual legal uncertainty and the related theoretical discussion here in Europe is that it will continue to be an unnecessary burden which uses up resources and energy in an unproductive way. Almost all European experts agree that escrow is an effective tool to protect IP and hedge investments in IT and that it has a fundamental right of existence; no one has yet publicly defended the opposing point of view and argued that escrow should explicitly be banned.

In a situation like this, one must turn to the legislator and ask for the inherent intention of certain laws, whether they are in place (yet) or not. We believe it is about time that Europe too acknowledges the viability of escrow as a tool to protect both sides in a license contract and to support the software industry. We believe that it is about time that software escrow is coming of age in Europe.

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