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"Software Escrow, a Solution in Germany"

by Christian Kast, Stephan Meyer, and Bea Wray

While in the United States, software escrow, or maintaining the source code as insurance for the licensee, has for many years been commonplace, the situation in Germany differs quite a bit and is only recently starting to change. The reasons for this can easily be seen on three separate levels: First, there had previously been little need for software escrow: Software was usually developed as a work made for hire for an individual customer where the source code was often given. Also German software developers only seldom went out of business. Second, there was a lack of expertise: Lawyers rarely specialized in the law of intellectual property and even then could only with difficulty relate to the specific problems inherent in the licensing of software. Finally, there was a lack of a proper legal framework: A widespread uncertainty about the standing of software escrow agreements in an insolvency situation continues to pervade German publications on this topic. The concern has been that the trustee in an insolvency situation could make existing contracts null and void. This article discusses this last concern.

Yet before we concentrate on this interesting as well as intricate dogmatic issue, it is well worth noting the practical side of the insolvency situation. Firstly, weeks or even months may go by before a trustee for the insolvent software licensor is chosen with legal effect. The power to revoke the escrow agreement is vested only in him. Thus, by the time he is selected, the source code could have already been released to the licensee through a properly managed source code escrow agreement. Secondly, even if the trustee is appointed before the release procedure has been completed he will have a hard time properly surveying the many contracts of the licensor and prioritizes or even finding the escrow agreement, which he might not even know about. Lastly, revoking the escrow agreement is not always in the interest of the trustee since he might rather like the licensee to continue regularly paying license dues.

On signing a software escrow agreement, the licensor of the software (depositor) agrees to entrust an independent third party (escrow agent) with the keeping of a copy of the source code and authorizes it to release this copy to the licensee (beneficiary) when one of a set of specified conditions is met. Usually, the insolvency of the depositor is one of these triggers since it poses a serious danger to the beneficiary of the escrow agreement in that the on-going support for and development of the software is gravely threatened without access to the source code.

At this stage however, the legitimate question arises of whether the trustee charged with liquidating the depositor has the power to revoke the escrow agreement pointing to the interests of the creditors. That is to say they fear losing a great deal of realizable assets in the case of a release of the valuable source code to an external party.

In the United States, law-making bodies had deemed this issue worthy to be decided upon in Tit. 11 USC Sec. 365 (n) of the Bankruptcy Code: "If the trustee rejects an executory contract [...] the licensee [...] may elect [...] to retain its rights [...] to such intellectual property ..." In Germany on the other hand, this need was ignored by politics.

Thus, German academics have been engaging in a contentious debate about how to subsume these cases under the Insolvency Code in a way that would yield equitable results.

The Bankruptcy Code which was in force until it was replaced by the Insolvency Code in 1999 theoretically allowed molding the license agreement into a lease contract which could not be revoked by the trustee (Section 21 I KO). Yet, the cited provision was removed in the Insolvency Code. Other proposed solutions also are not likely to provide satisfactory relief.

It might be helpful though to step back and to ask what criteria the Insolvency Code uses in deciding about the revocability of a contract and why it chooses them. In general, the trustee may revoke a contract where the parties are not obliged to and have not exchanged equivalent contributions. This makes sense since otherwise, the creditors would fear to lose assets in deals that are disadvantageous or even fraudulent towards the company. Now, if one looks at the escrow agreement in isolation, one might find it conclusive to say that the depositor only loses, but does not gain (and vice-versa for the beneficiary). That is precisely the view of the law which ordinarily focuses on individual contracts alone.

But a business-savvy person might add to the dispute that in reality, the escrow agreement is closely related to and would not have been reached without the underlying license agreement. The licensee (beneficiary) most likely tied his consent of the license agreement to whether the licensor (depositor) entered an escrow agreement for the reasons outlined in the second paragraph.

So why not intertwine both agreements on the contractual level as well and make the law see what really is intended? This could easily be done by adding a clause to the license agreement stipulating the duty of the licensor to protect the licensee from harm resulting out of its failure or inability to further support and maintain the software. The licensee would agree to the fulfillment of this obligation through entering an escrow agreement. So you might say, that is all nice and dandy, but suppose the trustee still sees no reason not to revoke the escrow agreement? In that case, the fulfillment would of course be lost, but the obligation would remain, triggering a claim for damages of the licensee against the company in liquidation. With the license agreement not being revocable, this claim will not be neutralized.

This concept capitalizes on the notion of a contract comprising both cardinal (the licensing of the software; the payment of fees) and auxiliary (the reciprocal protection of the parties) obligations. Whereas this way of looking at things might have been disputed and the claim to damages easily been reduced or even negated by the courts only a short while ago, the idea is now widely accepted thanks to a ground-breaking reform of the core provisions of German Civil Law, the Schuldrechtsreform, which was enacted on 1/1/2002. Section 241 II BGB now states: "An obligation may require each party to have regard to the other party' rights, legally protected interests and other interests." And that is precisely what this proposed solution is all about. Its beauty lies in its paying attention to the intent of the law and its consistency with its core principles. With such a tool at hand the escrow industry might very well start to flourish on this side of pond, too.

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