# AVOIDING THE HOT SEAT: CLARIFYING OWNERSHIP AND PREVENTING DISPUTES WITH THIRD-PARTY ESCROW

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**Presented at Technology Transfer Society (T2S) 25th National Conference, Austin, Texas, July 20-21, 2000**

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## PURPOSE AND INTRODUCTION

The purpose of this paper is to give an overview of third-party escrow, and to show how it can proactively enforce the ownership and IP rights of the Developer (Depositor) and secure the investment of the Licensee (Beneficiary). This dual-mode of protection helps the Technology Transfer Agent or broker transfer technology and intellectual property via License Agreements, contracts and other methods.

Because of its function and value, third-party escrow should be in the "toolkit" of every technology transfer manager, technology developer, license or contract manager, CTO, risk manager and policy director. The independent nature of escrow helps all of the Parties to technology transfer "avoid the hot seat" proactively, by stipulating the ownership, proprietary contents at the time the technology is licensed.

The Parties to technology transfer (i.e., the Developer, the Licensee and the Technology Transfer Agent) can each gain the following:

1. Third-party escrow is a proven solution for independently authenticating ownership and proof of first-use of technology, trade secrets, proprietary information and other intellectual property. It provides "enforcement by contract", which quickly and efficiently resolves ownership disputes that may arise, whether from a client, competitor, former employee, etc. When compared to internal "backups" and record keeping, third-party authentication will reduce the time and legal expenses necessary to defend a claim of ownership.

2. When licensing software or other technology, the escrow of its source code or other key components will reduce your potential licensee's (or corporate sponsor's or investor's) business risk. Escrow assures potential licensees or corporate partners that the critical "pieces of the puzzle" are kept securely and are available if needed. This added element of security may facilitate a Technology Transfer Agent's matching of the IP with a licensee or sponsor.

3. In conjunction with formal IP protection (patent, trademark), third-party escrow provides actual preservation and administration of the IP for any and all Licensees or Beneficiaries, should specific release conditions, per the Escrow Agreement, occur.

## COMMON RISKS IN TECHNOLOGY TRANSFER

Technology transfer is akin to a business merger or acquisition, where knowledge or due diligence is power and any ambiguity in negotiations can be costly to all of the Parties. When technology or IP is being transferred, the Parties should be aware of the risks of loss, business failure and stalemate.

### Risk of Loss or Business Failure

Over the years, the risks of creating, owning, managing and transferring IP have been largely the same: accidental loss or physical destruction, sabotage, theft by a competitor or an employee, etc. However, a risk that has become increasingly important to Developers, Licensees and Transfer Agents who "broker" the transactions among them is that of market volatility and resulting business failure.

This is largely due to the rapid advances of the high-tech sector. Today's technology market is glutted with startups, dot-coms and sole proprietorships. The relatively low cost of hardware, Internet access and web hosting makes it easy for anyone with "a great idea" to build an online shopping mall or develop very specialized custom software. If cost is an object, there is also a glut of investment money and venture capital to be found. Today's business world not only accommodates this sort of growth and volatility, but encourages it: "Move at 'Internet Speed' or die!"

While this environment cultivates a high-tech "boom town" market and mentality, business failure rates remain proportional, which is to say there are even more technology business failures than ever before.

For the Licensee or the Technology Transfer Agent trying to make a match, this volatility and uncertainty presents a substantial obstacle, as the Licensee, corporate sponsor, investor, etc., must weigh the risk carefully before jumping into a License Agreement. Meanwhile, the Technology Transfer Agent must do whatever possible to minimize this risk.

### Risk of Stalemate in Transfer Negotiations

One obstacle common to software licensing agreements is source code availability. With the large number of "small" Developers as noted above, the Licensee is often a bigger, established company. The easiest way for the Licensee to feel secure in licensing the smaller Developer's software is to simply demand the source code during the licensing negotiations, and try to have that provision written in the License Agreement.

However, most Developers who have spent as much time, money and energy developing a

technology are not willing to just slide the CDs across the table in exchange for the signed License Agreement and a big check. The code and other proprietary components, e.g., documentation, encryption notes, etc., are the Developer's bread-and-butter.

You can see, when the (potential) Licensee says "Gimme the source code" and the Developer says "Gimme the money", stalemate occurs. In some cases, the whole deal is jeopardized.

The Licensee feels he/she cannot afford the risk of relying on the Developer to support the product a year or two down the road, and the Developer cannot afford the risk of handing over the crown jewels of the business, or, at that moment, losing a sale!

If the request for the source code doesn't work, the Licensee is often in the position of insisting on escrow, and sometimes at the Developer's expense ("Who pays" is an issue that varies by Party and transfer situation.). Although escrow ultimately makes both Parties content and secures the transfer, it can be a less than pleasant surprise detail, especially for the Developer to handle, if it is sprung late in the licensing negotiations by the Licensee.

## THIRD-PARTY ESCROW: DEFINITION & BACKGROUND

Generically speaking, escrow goes back some 400 years by definition, and probably farther back by application.

The original idea could have stemmed from an impasse over a transaction as simple as the purchase of a milk cow. The buyer wouldn't just hand-over the money, and the seller wouldn't just hand-over the lead rope – the "No, you go first" routine. So until they figured out their final terms, both the money and the cow were kept safe by a trusted but disinterested neighbor. This isn't much different from today's common escrow application involving a bank transfer of funds for a deed to a house, or as previously mentioned, a technology transfer from Developer to Licensee.

An important key to its etymology, "escrow" comes from the word meaning "script". So originally, and importantly, the terms of release were written and agreed upon by the Parties to the transaction. This front-end, written agreement is a very basic principle but one that lends credibility to the Escrow Agreement. All of the Parties are in accord at the outset, and none should have cause or reason (contractually speaking) to later dispute the Escrow Agreement or its administration by the escrow agent.

### IP Protection: Third-Party Escrow and Patents or Trademarks

Although the focus of this paper is to "avoid the hot seat" by implementing third-party escrow, the relationship between escrow and formal IP filings merits a brief explanation, as questions often arise regarding the two.

Both escrow and traditional forms of IP protection, e.g., patents, trademarks and copyrights, protect the owner similarly, by substantiating the owner's claim "I was here first".

Simply put, the United States Patent and Trademark Office (USTPO) puts its federal stamp on the IP, authenticating its creation and filing. The Escrow Agent also puts its "stamp" on the technology or IP via the Escrow Agreement, and subsequently administers the contract.

From an IP protection standpoint, one does not necessarily negate the other. Escrow Agents often work with the General or IP Counsel of technology developers (and their Licensees) to implement escrow when a licensing or transfer situation calls for it.

Third-party escrow still applies to patented or trademarked technology *when it is licensed or transferred*. At that point, escrow's primary role shifts from IP rights protection to more of an administrative and support position. The additional third-party authentication provides additional proof of ownership for the Developer.

The USPTO keeps records on ideas and inventions with its own filing and paperwork system, as well as maintaining its "library" of facsimiles or representations of the IP. It is not, however, in the business of administering or maintaining the IP proper. This is where formal filings and third-party escrow differ the most.

The Escrow Agent is authorized by the Agreement to duplicate and distribute exact copies of the IP, whether it is software source code or a file of trade secrets, to a Beneficiary if specific Release Conditions in the Agreement are met (See "The Components of a Basic Escrow Agreement" below.)

If a dispute were to arise over a licensed and patented software or design product, the USPTO would not (nor is it in a position to) duplicate and distribute an exact copy of the IP in question to anyone.

**IP Protection: Time and Cost Issues**

For IP protection, a major benefit of escrow is that it is quicker to implement than a patent filing, for example. An Escrow Agreement can be drafted and executed in days, versus months or even years. This can give a Developer a real jumpstart when preparing to go to market.

Escrow implementation and administration costs are also considerably less, which can help individual inventors, small companies, startups and public entities that might have limited funds or budgets.

## THE COMPONENTS OF A BASIC ESCROW AGREEMENT

Like other contracts, the basic Escrow Agreement comprises several general sections. Although the specifics of any Escrow Agreement may vary due to a wide range of variables that may

pertain to an individual license or transfer agreement, the following basic points will normally apply:

**Identifying the Parties**

As in any contract, this declares who is involved, namely the Depositor, who is usually the owner of the IP; the Beneficiary, whether a licensee, investor or other entity entitled to the agreement; and the Escrow Agent or Company which is responsible for holding the IP and administering the agreement. These Parties are identified in detail with their respective contact information on subsequent Exhibits to the agreement.

**The Objectives Statement**

Although specific objectives can vary according to a particular licensing or transfer situation, the general objectives are usually consistent. Normally there is reference to the Parties' License Agreement or other contractual relationship; a statement of confidentiality and disclosure matters; the critical need for Beneficiary's ultimate access to the IP; the establishment of escrow for the protection of the proprietary materials; and a statement of agreement in accordance with U.S. Bankruptcy codes and other agreed-upon conditions that would trigger the release of the Deposit Materials.

**Deposits and Deposit Materials**

This portion of the agreement designates the responsibilities of the Depositor and the Escrow Agent for the deposit, safekeeping, updating and maintenance of the Deposit Materials. Often there is flexibility for the scheduling or frequency of updates to the deposit materials, which are agreed upon by the Depositor and Beneficiary during the drafting of the Escrow Agreement. A detailed description of the deposit materials is supplied in an attached Exhibit to the agreement.

**Beneficiary Enrollment**

In the case of an "open-ended" two-party agreement, the Depositor authorizes the Escrow Agent to enroll and maintain records for any number of subsequent Beneficiary(ies) that may be enrolled to the Escrow Agreement (with the Depositor's prior knowledge and approval, of course). The Escrow Agent may be authorized here to notify licensees or other potential Beneficiaries, on the Depositor's behalf, that the escrow is in place and enrollment is an option.

For static, three-party agreements, other Beneficiaries are not to be subsequently enrolled to the Escrow Agreement. Licensees, for example, who have License Agreements with multiple Developers would have separate Escrow Agreements for each product.

**Confidentiality and Record Keeping**

One of the primary roles and responsibilities of the independent, third-party Escrow Agent is confidentiality. Although it is disclosed on the accompanying Exhibit describing the Deposit Materials, the Escrow Agent is bound to confidentiality with respect to the contents of the

escrow deposit. Similar to an attorney-client privilege, "mum's the word" on the Deposit Materials unless the Escrow Agent is ordered or authorized to disclose the contents by either the Depositor or a court of competent jurisdiction.

**Granting Rights to Escrow Agent**

The usual rights granted to the Escrow Agent by the Parties include the right to duplicate the deposit materials in the administration of the Escrow Agreement, the right to act on reasonable written instructions from the Parties and the right to administer the terms of the agreement in good faith.

**Release of Deposit Materials**

Here's the big one. Obviously this is the most important issue for the Depositor, who has hired an Escrow Agent to protect, preserve and administer the proprietary materials and IP that makes the business money! No Depositor wants some open-ended or vague outline or list of release conditions, and more time is usually spent discussing, negotiating or editing this section than any other in the Escrow Agreement.

The general conditions are usually similar, e.g., bankruptcy, change of ownership, failure to support the product, etc., but the *protocol* for release must be described in detail for the protection of the Parties. The Escrow Agreement would be worthless if the materials could be released upon a phone call from a Beneficiary stating the Customer Support department "didn't return my phone call." So this calls for more detail and a description of *written request for release*, the submission or answer by the Depositor with *contrary instructions*, and the methods for resolving the request, be it a release or denial of release to the Beneficiary.

Timelines are designated by the Escrow Agreement for each Party to act/respond. If the deadlines are not met, either no action is taken in accordance with the terms of the Escrow Agreement or alternative dispute resolution ("ADR" or arbitration) takes place. Regardless, the Escrow Agent will not take action unless written mutual instruction is provided or an order is issued by a trustee in bankruptcy or other court of competent jurisdiction.

**Term and Termination**

Normally the term of an Escrow Agreement is one year, with annual automatic renewal unless the Escrow Agent receives notification to cancel or not renew. Other factors for termination include non-payment of fees, etc.

**Escrow Fees**

Here, either the Depositor or the Beneficiary may be designated as the Party who is responsible for payment of the escrow administration fees. If some arrangement between the Depositor and Beneficiary calls for special fee sharing or splitting, the same can be outlined in this section.

Designating the Party responsible for paying the escrow fees, as well as the inclusion of a fee

schedule, is very important. Despite the Parties' best intentions and any occasional "memory lapse", having the payment terms and fees within the Escrow Agreement will prevent any question or argument when it is time for the agreement to be renewed.

**Liability and Disputes**

When acting in good faith in accordance with the terms of the Escrow Agreement, the Escrow Agent is typically held harmless and indemnified against actions beyond its control in the administration of the agreement. Also, the Escrow Agent is authorized to rely upon and act on reasonable instruction from the Parties. Alternate Dispute Resolution (ADR) terms and procedures are outlined to preclude immediate or "knee-jerk" litigation by any of the Parties.

**General Provisions**

Normal legal provisions include Entire Agreement, Notices, Severability, Successors and Regulations.

**Special Terms and Conditions**

These may be specified in detail on an attached Exhibit, and may include anything outside the basic Escrow Agreement that the Parties agree to.

**Exhibits to the Escrow Agreement**

Exhibits allow the Parties to designate and clarify details such as Depositor's Designated Contact information, descriptions of the Deposit Materials and the Beneficiary's designation and contact information. Exhibits or attachments outlining special terms and conditions give the Parties a lot of flexibility in stating agreed provisions without extensive modification of the basic Escrow Agreement. Attaching a fee schedule is a good idea for establishing charges for escrow administration, updates and other services, whether the fees are fixed or special terms or project pricing is negotiated.

## TWO-PARTY vs. THREE-PARTY ESCROW AGREEMENTS

The Parties to an Escrow Agreement are 1) the Escrow Agent, 2) the Depositor (Owner or Developer) and 3) the Beneficiary (Licensee or Investor). Depending on the status of the technology or the transfer agreement, either of two different Escrow Agreements may be written.

**Two-Party Escrow Agreements**

If there is no immediate Beneficiary, but the Depositor needs the IP rights protection of third-party authentication, a Depositor may take the proactive position in establishing its ownership by entering a two-party Escrow Agreement with the Escrow Agent. These are sometimes referred to as "open-ended" agreements, because the original Escrow Agreement involves only the

Depositor and the Escrow Agent at the outset. The Depositor authorizes the Escrow Agent to enroll future Beneficiaries to the agreement as they become licensees or customers.

One "hidden" advantage of an early-stage two-party agreement, particularly to smaller entities, is the security benefit it offers the smaller Depositor. The fact that the IP is already preserved in escrow may provide extra bargaining power when negotiating a License Agreement with a larger Beneficiary.

### Three-Party Escrow Agreements

As third-party escrow is often used "as needed" by software developers, perhaps the most common Escrow Agreement is the Three-Party Escrow Agreement.

Frequently, the security concern arises when the small Developer wants to do business with the large Licensee. For obvious reasons, the Licensee may insist that the Developer arrange (and in some cases pay for) the escrow before or very shortly after the closing of a License Agreement.

Three-Party, or "static" Escrow Agreements bind only the Escrow Agent, the Depositor and a single Beneficiary to its terms, and typically there is no provision for the addition of future Beneficiaries to the original agreement.

## BENEFITS TO THE TECHNOLOGY TRANSFER AGENT

As the case has been made for the Depositor and the Beneficiary, some distinct advantages exist for the Technology Transfer Agent.

### Security in a Volatile Environment

Escrow can be a big selling point for a Technology Transfer Agent, particularly in an academic environment. Colleges and universities, while "hotbeds" of creativity and the incubator of phenomenal technology developments, are also equally hotbeds of turnover, for lack of a better word.

While the faculties of most schools may be fairly stable, the constant flow of undergraduates and graduate students, which often support the faculty as teaching or research assistants, contributes to a fluid environment that would give any corporate HR manager the shakes.

How many times has a university had to scuffle with a student or former student for capitalizing on IP that was rightfully the university's, after it left the lab or research center, in whole or in part, in a backpack, on a diskette or by e-mail?

Rather than facing a head-butting session or cost-prohibitive litigation, the university can avoid disputes by putting the components of a research or technology project into escrow. The university should also make it known to the students and faculty that the ownership is not only declared by a school policy but also by a binding legal contract.

The escrow *proactively* gives the university the *independent verification* it needs for defending itself and staking its rightful claim in an ownership dispute.

**Security When "Selling" the University**

Obviously, the primary challenge of any Technology Transfer Agent is "selling" the university and its technology or IP to outside firms. Whether it is a License Agreement or if the university is in search of corporate or other private sources of research money, the company or individual who is "investing" in the technology or the research can often use a little extra assurance.

Much like a small software developer who is licensing its product to a Fortune 500 beneficiary, the Technology Transfer Agent can confidently negotiate with a potential corporate research partner when escrow is in place.

The assurance is that the components of the project are *preserved* by the escrow and administered by an independent agent. This "value-added" assurance can open new doors to additional or larger funding sources for special projects.

**Securing Ongoing Development and Research**

Corporate sponsors and research partners, much like investors and venture capitalists in the private business sector, typically do not have a lot of protection for "works in progress".

As research is often lengthy and ongoing, a corporate sponsor can gain some assurance that fruits of its research dollars are best preserved when the entire project, i.e., development notes, prototypes, source code, proprietary databases, etc. are preserved in third-party escrow.

## ALTERNATIVE METHODS OF IP RIGHTS PROTECTION

**Insurance Implies a Loss**

Regarded by some as a "necessary evil", insurance often comes to mind when any discussion or issue of risk or risk management arises. As insurance is used to compensate for losses in property and liability claims, one could surmise that insurance would be adequate protection for technology or IP. But this is not the case.

Imagine that your technology or IP is your home ("and Heaven forbid this ever happens…", as the insurance agent might add), and imagine that your house burns to the ground while you've gone out to dinner. You return to find your home completely destroyed. Nothing but ash and soot remain of your furniture, clothing, décor and structure. You call your insurance agent, file a claim and get a check, right? This cash does not *replace* your original property, but *compensates* you for its "replacement" or the purchase of replacement or substitute property.

On the other hand, if your home (IP) is in escrow when it burns down, you call your Escrow Agent, make your request for release and the trucks start rolling in, bringing in all of the original walls, carpet, furnishings – right down to the family photo album.

With third-party escrow there is no loss, as the IP is actually *preserved* and held safely by the Escrow Agent.

**Throwing Water**
**On Liquidated Damage Provisions**

Some License Agreements and other contracts include Liquidated Damage Provisions (LDP). These basically sketch a projected future cash value of the IP, should a Depositor go out of business, fail to support the product for its Beneficiary or otherwise violate a contract. An LDP stipulates an amount of money that the offending Party will pay as "just compensation" for some *future* breach of contract.

While the law regarding LDP varies by jurisdiction, the provision will usually be enforced only where a court finds both of the following:

- The harm caused by the breach is one that was difficult or impossible to estimate on the front end; and
- The stipulated amount of damages was a reasonable forecast of just compensation at the time the contract was executed.

The fact that LDP drafting is a mere guessing game is enough to give your attorney the shakes, in some cases! Add to that the risk of knowing that a court may find the prediction was an unenforceable penalty because it was "excessive", and it's easy to imagine the injured Party leaving the courtroom empty-handed.

And, no matter how reasonable the forecast might be, if the offending Party cannot be located or is insolvent, the injured Party may only net the proverbial "judgment suitable for framing", i.e., fairly worthless as it is uncollectable.

## TIPS WHEN CONSIDERING A THIRD-PARTY ESCROW AGENT

By Webster's definition, escrow (ca. 1594) is simply

> *"...a piece of property held in trust by a third party to be turned over to the grantee only upon the fulfillment of a condition."*

Accordingly, two important rules of thumb apply when selecting an Escrow Agent:

**Don't Use the "Fire Safe" Approach**

Any trusted third party can serve as an Escrow Agent, but your brother-in-law with a fire safe isn't the best bet.

Select an Agent or Company that specializes in Escrow Agreements, deposit maintenance and contract administration. A number of top-quality, national firms can be found on the Internet, typically by using the key words "software escrow" in an Internet search engine.

Also, don't get the idea that Escrow Agreements are cookie-cutter applications. If you obtain a copy of a draft agreement from an Escrow Agent, know that final Escrow Agreements can vary as much in their terms and language as the technologies they protect.

**If Hire an Attorney,**
**Hire Someone Else's Attorney**

Attorneys are sometimes called upon to administer escrow of cash and other items. However, in a technology transfer situation, neither Party's attorney should attempt to administer the escrow because of the obvious conflict of interest.

If the administering attorney was originally counsel for one of the Parties at the time the contract was executed, he or she may be prohibited from representing that Party if the dispute ends up at the courthouse.

Should a dispute arise, neither Party's counsel will be neutral, so the IP must be kept independent of the Developer and Licensee's individual legal activities.

The unbiased and independent nature of the Escrow Agent is what lends such value to third party escrow.

## CONCLUSION

In a technology licensing or other transfer situation, third-party escrow protects the IP rights of the Developer and the investment of the Licensee.

The Parties net three benefits from implementing escrow: 1) its "Enforcement by contract" helps proactively prevent ownership disputes and establish succession for the Licensee; 2) it reduces the risk of stalemate in transfer negotiations and 3) it secures the investment of the Licensee or Beneficiary.