Protect Yourself

ARE YOU PREPARED if one of your major suppliers or customers is forced to scale back operations or go out of business? How would you handle such a situation? Resultant problems could include interruptions in the supply of proprietary components for original equipment manufacturer (OEM) systems, canceled purchase orders, delays in contracted development projects, or failures in outsourced support services.

While there are no perfect solutions, if you pay careful attention you might be able to anticipate sticky situations and ease potential damage to your business. The key is being alert for signs of possible problems. Keep an eye on your suppliers' delivery timing and performance reports, and take action at the first sign something is amiss. In addition, keep on top of available sources of information so you can stay fully informed about the financial health of your business associates.

REVIEW YOUR CONTRACTS

The first step is to review your contracts to gauge your rights. This means all of your ongoing contracts—such as OEM supply, maintenance, outsourcing, development, or license agreements—that you haven't paid much attention to because everything was going well. Focus on rights and remedies contained in your contract that could be of practical use if you anticipate financial problems affecting the other party's performance. Contract provisions that you should examine carefully include termination rights, penalties on default, rights to gain access to and use software source code or hardware manufacturing information, rights regarding data, rights regarding work-in-process under development contracts, and survival of license rights.

If you believe that the rights and remedies contained in a contract aren't adequate, attempt to renegotiate. Threats to terminate a contract or enforce penalty provisions can give you the power to renegotiate terms such as regular data delivery and intellectual property escrows that may improve your position in the event your supplier goes out of business. This approach can make it possible to gain the advantage of contractual protections that weren't included in your original contract.

If the affected party is in good financial condition, he/she won't object. If he isn't, that will tell you that you should look elsewhere. In addition, keep in mind that bankruptcy can alter the rights and obligations between the parties to a contract, so you might want to review your contract structure to minimize the impact that a bankruptcy can have on your business.

Here are some proactive steps you can take to limit the impact on your business if one of your vendors can't fulfill its obligations.

By Milton Zall

TWO IMPORTANT STEPS

The next two areas—protection of your data and escrow arrangements—should have been covered in your original contract. If they weren't, perhaps you can renegotiate them now. They are critical.

Getting your data. Get your hands on proprietary data or work under development that belongs to you. If you have a service provider who is collecting or processing data for you, access to that data can be critical for quickly transitioning to a new vendor if your current provider goes belly up. The same advice applies to work-in-process under a development contract. If there's a risk your developer may go out of business, do what you can to get an immediate download of your data or delivery of your work-in-process, and establish procedures to keep it up to date. Make sure that the contract establishes your exclusive ownership of the data or developed work to prevent possible attempts by the service provider or its bankruptcy trustee to recognize value from it.

Escrow arrangements. Use escrow arrangements effectively. They are common arrangements whereby the payment for a technical product is held by a third party until the buyer is fully satisfied that he didn't buy a pig in a poke. At that time, money is turned over to seller.

The creation of a technology escrow agreement usually occurs during negotiations for a license or other proprietary rights agreement. As a result, the negotiators often enter the escrow-negotiating phase in adversarial roles, which may cause them to perceive escrow, and the escrow process, in the same aggressive-defensive manner in which they view each other. Approaching an escrow contract this way can result in a misuse of time and money or even lead to a "successful" negotiation that can backfire. For example, in one case, a licensee's attorney insisted that he draft the technology escrow agreement. When he did so, he zealously protected the licensee on every issue he could imagine. He resisted the counteroffers requested by the licensor's attorney, and he ignored the suggestions of the proposed escrow company. At the end of the negotiations, he was probably very proud of the contract he had created. The problem, this lawyer later learned, was that he didn't really understand the administrative processes and procedures of a technology escrow company. Inadvertently, the lawyer had contractually taken the escrow company out of its time-tested procedures. As a result, his client lost some important benefits it would have ordinarily received from the escrow agent's process. For example, the escrow company might have tested the functionality of the technical product to make sure it worked. Or the client might have had earlier access to the product, perhaps giving the buyer a competitive edge (first to market with new product).

The focus during the escrow phase of negotiations should be on the substantive, not the administrative, aspects of the escrow arrangement. Examples of *substantive* issues include the identification and format of the specific materials to be deposited into escrow, whether the content of the deposit should be verified, the definition of release conditions, and the right of use following a release of materials from escrow. These substantive issues go to the essence of the escrow relationship between the depositor and the beneficiary of the deposit. *Administrative* issues involve the processing of the escrow transaction. This begins with the initial deposit and continues through the deposit updates, term renewals, annual reports, audits, releases, and terminations. A good technology escrow company has the ability and experience to handle these processes without diminishing the rights of the parties to the escrow.

> Escrow provisions aren't self-enforcing—they require constant and serious attention to make sure you are getting the protection you bargained for.

Experienced technology escrow companies also have standard escrow contracts designed to operate seamlessly in conjunction with the substantive choices selected. If changes must be made to the substantive issues of the contract, these revisions should be made to the escrow agent's form contracts rather than starting a new contract from scratch. This will preserve the standard operating procedures of the escrow company. Further, as long as the escrow agent's obligations under the standard contract are fair and reasonable to both the depositor and the beneficiary, time and money won't be spent to negotiate changes that aren't really necessary.

If your license or supply agreement includes a requirement to escrow source code or manufacturing information, make sure the licensor or vendor is fully complying with it. Has the escrow actually been established? Have your representatives examined the escrow materials to

verify their completeness? Have the materials been updated with information for the current versions of the products? Escrow provisions aren't self-enforcing—they require constant and serious attention to make sure you are getting the protection you bargained for.

THE NEXT STEP: TERMINATION?

If renegotiation doesn't work, you may want to consider ending the contract because this allows you to transition to a new vendor/service provider. There are many ways to terminate a contract if one of the parties can't or won't fulfill its obligations. For example, contracts may be terminated by reasons of rescission, breach, or impossibility of performance.

Impossibility of performance. Performance means that each party to the contract has fulfilled its obligations; the exchange of promises has been completed, and each side has received what it has bargained for. Once the contract has been completed, neither party owes the other party any further obligation. Impossibility of performance can terminate a contract if an unforeseen contingency—such as financial insolvency—prevents the contract provisions from being fulfilled.

Rescission. Rescission may terminate the obligations of a contract in a variety of circumstances. One party may have the legal right to rescind the contract under certain circumstances that are spelled out in the contract, or the parties together agree to terminate the contract, such as if a product isn't ready on time or doesn't work.

Breach of contract. In this situation, either one party or both parties have failed to perform an obligation as expected under the contract. A breach may occur when a party refuses or is unable to perform the contract, does something that the contract prohibits, or prevents the other party from performing its obligations. The law distinguishes between the two types of breach—material and immaterial—and not all breaches of contract end up in court.

A *material* breach of contract results in court action. A material breach is a serious one because it goes to the heart of the contract. The injured party can seek damages—that is, a monetary payment adequate to cover economic losses resulting from the breach. For example, a violinist who shows up at a concert but doesn't bring his violin has materially breached the contract to perform if he can't play. Similarly, a supplier is in breach of contract if he doesn't ship supplies that you ordered within a reasonable period of time or one that is stipulated in your purchase order and that he accepted.

An *immaterial* breach of contract is a trivial breach of contract and doesn't kill the contract. Say you have a service contract for a heating system under which the service provider agrees to inspect the system each month on Thursday. Contrary to the contract, the service provider makes inspections on Mondays. This act is a technical breach of the contract, but it's immaterial unless, for some reason, the inspections must be done on Thursday as opposed to any other day.

NOTICE OF TERMINATION

A contract may include a right to terminate with specified prior notice. Consider whether you want to give that notice now. Otherwise, termination for breach after a specified cure period is generally available. You can terminate whenever you want, so don't be in a hurry. Give the guy a chance. If you still aren't satisfied, exercise your right to terminate. "Cure period" means time allotted to other party to fix what's wrong or "cure" it. You'll need to assess whether the other party's performance deficiencies may provide grounds for such termination.

A contract also can dictate how it may be terminated. For example, the parties may agree in their initial contract that one party can give the other party written notice that the contract is terminated. Following such termination provisions will ordinarily end the contract.

In addition, if the object of a contract becomes impossible, or if the parties make a new agreement, the original contract is terminated. And the injured party may treat the contract as null and void if the other party refuses to perform.

WATCH YOUR LEGAL POSITION

Dealing with companies in trouble can involve a host of legal issues. Bring in your attorney at the first sign of a potential problem because termination and other remedies must be pursued in strict compliance with legal requirements, or you may face legal counter claims. Agreements may contain tricky provisions that, if not handled carefully, may be used against you by a bankruptcy trustee. Also, dealings with the other side must be handled delicately if you aren't prepared for an immediate breakdown of the relationship. This is a time when it can be especially important to seek and follow sound, practical, experienced legal advice. ■

Milton Zall is a freelance writer who specializes in taxes, investments, and HR/business issues. He is a Certified Internal Auditor and a Registered Investment Advisor. You can reach him at milt.zall@verizon.net.