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9 Contractual Issues Tech Startups Should Be Wary Of

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Technology startup companies have limited resources.

Given these limitations, together with the many priorities competing for management's time and attention, all too often startup companies make critical contracting mistakes that inadvertently weaken their commercial position.

Similarly, they often overlook relatively simple but crucial steps that are essential to owning and protecting their intellectual property. The consequences of these mistakes are often not seen or felt immediately, but they will almost always surface at some point, typically in connection with a key investment or other significant transaction involving the business.

Buyers or investors and the company are left to dispute the relative importance of these deficiencies — only some of which may be remedied — and any of which can lead to significant diminution in the value of the company, or even kill a deal altogether.

While there are numerous contracting mistakes early-stage companies can make, there are nine common contractual provisions and issues that need to be handled with care and foresight in order to avoid problems in future transactions.

1. Exclusivity Provisions

Exclusivity rights may be granted in many forms to customers, resellers and suppliers alike, and may even be demanded by those parties, particularly if they perceive significant negotiating leverage over a smaller technology startup. In some cases, these provisions may seem harmless at the time — for example, the startup may only be operating in limited markets, or it might not have other prospective commercial partners standing by.

But an exclusivity provision that is otherwise benign for a small startup may create a pitfall for an acquiring entity that is not in a position to comply with the exclusivity commitment, particularly if the agreement is to be assigned to the acquirer — whether as part of an asset purchase or a future roll-up — or if the exclusivity as drafted extends to the startup's affiliates.

Indeed, the acquiring entity may have conflicting commitments to other parties, or may itself be a supplier of the product or service that is the subject of the exclusivity, or its strategy for the acquired business may depend upon expansion into markets that the exclusivity would prohibit.

If a would-be acquirer were to notice a problematic exclusivity provision — which it should be looking for — in its due diligence, that by itself may be enough to derail a transaction. Sometimes those problematic provisions can be modified in a way that will allow the deal to go through, but often only at great cost to the startup.

The bottom line is that startups need to be thinking about the future any time they are asked to consider any sort of exclusivity commitment.

2. Most Favored Nations Clauses

"Most favored nations" or most favored customer provisions — often referred to as MFNs — typically commit a company to giving its best pricing, or best contractual terms, to a certain customer.

If the company were ever to offer better pricing or terms to a different customer, the customer with the MFN protection would be entitled to the better pricing or other terms. As with exclusivity provisions, if this sort of commitment were to be assumed by an acquiring entity, or if it extends to the startup's affiliates, it may impose an unwelcome or simply unworkable obligation on the acquirer.

When negotiating an MFN, a startup may be able to limit its impact in some ways — for example, by making it apply only to sales of the same product, in comparable quantities, to similarly situated customers. But the MFN will still be, at the very least, a point of concern to most acquirers, and in some cases it could dramatically impair the value or viability of the exit transaction.

3. Assignment Provisions

Assignment, or anti-assignment, provisions are often buried at the end of a contract along with other miscellaneous provisions. Despite being perceived as "boilerplate," assignment provisions often play a significant role in acquisition transactions.

It is quite common for contracts to require a party to obtain prior consent from the other party before it can assign or transfer the contract to a third party. In those instances, the target company would need each counterparty's consent in order to convey those contracts as part of an asset purchase or if the acquirer later desires to roll the acquired subsidiary up into the parent or another affiliated entity.

Some anti-assignment clauses are more comprehensive — and therefore more troublesome. For example, a clause might also specifically provide that any merger, stock purchase or other sale or change of control of the company is deemed to be an assignment. In that case, the startup may need to get consent to complete the acquisition transaction regardless of how it is structured.

Accordingly, if a company is not careful, a poorly drafted assignment provision could stifle an exit, and a company may unwittingly give its critical customers or suppliers the equivalent of a veto right over any potential acquisition.

4. Affiliate Issues

Technology startups should always carefully consider how the issue of affiliates is dealt with in their contracts, being mindful of how broadly that term is defined and also how it is used.

For example, if a company agrees to license all patents owned by the company and its affiliates, and if that company were to later merge with or be acquired by another entity, then the acquirer's patents — and possibly the patents of the acquirer's other affiliates — may also be subject to the license.

Similar problems can also occur if the term "affiliate" is used in connection with exclusivity or MFN clauses, as described above, or when a company has granted distribution rights for all products of the company and its affiliates.

5. Perpetual Obligations

Any contractual provision that has no end can be problematic and can hinder an acquisition or investment transaction.

A contract with no expiration and no termination rights — or with continual automatic renewals that can be avoided only by the other party — may leave companies without the ability to get out of a bad situation, or a situation that was fine at first but is incompatible with an investor's or acquirer's longer-term vision for the company.

For example, if an acquirer envisions discontinuing a product line of the target company, that strategy could be foiled by evergreen supply obligations to customers. Perpetual agreements with static pricing terms may be particularly problematic.

What may be a good pricing arrangement at the time the contract is signed will inevitably not be good pricing forever. Ultimately, any time a company considers entering into a contract, it should always know how that contract can be terminated, especially should things not go as expected.

6. Documenting IP Ownership

Another area of concern for any startup is the contracts it may or may not have with its employees and contractors.

One of the most common IP-related misconceptions held by startups is that IP is automatically owned by the party paying for its development. While that may be true in certain circumstances, at least in the U.S., those circumstances are usually too narrow to provide investors or acquirers with the kind of assurances they seek.

For example, the "work made for hire" doctrine under U.S. copyright law automatically gives a company the rights to most copyrightable works created by its actual employees within the scope of employment, but it does not extend to other forms of IP — like patents — and often does not extend to independent contractors, even if the contract says it does.

The reality is that clean IP ownership, with respect to both employees and independent contractors, is relatively simple to achieve and inexpensive when compared to the value of a potential financing transaction or exit. Best practice is to have a written agreement from the beginning of the relationship that assigns relevant IP rights to the company.

Each of the company's founders should also sign one of these agreements, with care given to capturing any pre-founding IP the company should own. Written assignments are particularly important in the case of independent contractors, given the limitations of the work made for hire doctrine noted above.

Under the laws of the U.S. and many other countries, in the absence of an adequate agreement, it is the developing party — often the independent contractor — who will own the IP. Waiting until the eve of a transaction to obtain the necessary assignments can easily delay an investment or acquisition — and it could even result in a key developer holding the deal hostage.

7. License Grants and Assignment Language

Like many provisions of a contract, the specific wording of IP assignments and IP license grants can make a difference. For example, for a license or an assignment to be effective, the operative provision should be written in the present tense.

Stating that a party "will license" or "shall assign" IP may not actually grant the license or transfer the IP — courts have often interpreted this kind of wording as a mere promise to license or assign in the future. This may be a promise that the other party may not be able to keep, especially if it transfers the IP to someone else in the meantime.

Savvy investors and acquirers will expect to see language such as "Contractor hereby assigns its rights ..." or "Licensor grants a license ..." when assessing whether a startup has actual ownership of or license rights to key IP. Anything less will likely be a source of legitimate concern, and could require amending key agreements or obtaining new assignments or licenses before the deal can proceed.

A little attention to detail in how these provisions are worded can make a big difference to the success of any future transaction.

8. Nondisclosure Agreements

A company's protection of its trade secrets and other confidential information can also be critically important for future investors or acquirers. Trade secrets, like product road maps, customer lists, formulas, processes, software or know-how, must always be the subject of reasonable efforts to protect their confidentiality in order to maintain trade secret protection.

Effective nondisclosure agreements are an essential part of those efforts.

Technology startups should be aware, however, that not all NDAs are the same. Given how common they are, the importance and the details of an NDA can often be overlooked. All companies should have effective NDA forms — including at least a mutual NDA and a one-way NDA — and use them consistently.

A mutual NDA is appropriate when both parties are disclosing confidential information to each other, while a unilateral or one-way NDA is appropriate where only one party is providing confidential information to the other, or where information, or IP, created by one party is intended to benefit the other party, but not the other way around.

Using the wrong NDA form could, for example, limit the company's rights to use and commercialize the very software code, formulas or other information that it is engaging another party to develop.

9. Use of Templates

Finally, while not a specific contract provision, there are times when the contract templates used by a startup company can create problems in a future investment or acquisition transaction.

Startup companies can sometimes be so anxious to start selling their product or service, or can be so afraid of legal costs, that they fail to adopt a template that matches their business and includes appropriate IP and liability protections.

It is sometimes easy to find a sample contract online, or to generate one on an artificial intelligence platform, and many companies will assume that any license agreement or other contract, so long as it has the right name attached to it, will fit their business.

However, just as each company, and each product or service offered by a company, can be unique, a good sales contract, terms of service, end user license or other contract template will need to be customized to fit the specifics of the startup technology company and its business, and it will likely need to be updated regularly as the business evolves.

Any errors in a contract template will likely be multiplied across many contracts, and it can therefore become an expensive proposition to negotiate a correction with multiple customers in advance of a potential transaction.

Conclusion

There are several common issues in technology and IP-focused contracts that can have a significant effect on investment or acquisition transactions.

But this list is not exhaustive, and not just for startups. The lesson is that all companies, when entering into commercial and IP-related agreements, should consider not only the present context and objectives of each contract, but also how each contract's language could affect significant investments or acquisitions in the future.

Any company that remains thoughtful and proactive about its IP and commercial contracts will be much better positioned when it comes time to raise funding or sell the company.

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