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Podcast

Tech Talks

Proactive Contracting for Tech Startups: Will Your Commercial & IP Agreements Help or Hinder an Exit?

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Announcer
Welcome to Mayer Brown's Tech Talks Podcast. Each podcast is designed to provide insights on legal issues relating to Technology & IP Transactions, and keep you up to date on the latest trends in growth & innovation, digital transformation, IP & data monetization and operational improvement by drawing on the perspectives of practitioners who have executed technology and IP transactions around the world. You can subscribe to the show on all major podcasting platforms. We hope you enjoy the program.

Julian Dibbell
Hello and welcome to Tech Talks. Our focus today is on startup companies, tech startups, and the steps that they can take now with respect to their IP and commercial agreements to avoid future friction in an investment or acquisition. I'm your host, Julian Dibbell. I am a senior associate in Mayer Brown's Technology & IP Transactions practice. I'm excited to have here with me today two partners from our Salt Lake City office, which opened just over a year ago in Utah's booming tech hub. Spencer Glende and Scott Young are both partners in the Technology & IP Transactions practice and the Emerging Companies & Venture Capital practices. Our EC/VC Group is a cornerstone practice of the Salt Lake City office.

Spencer and Scott, welcome to the podcast.

Scott Young
Thanks Julian. Grateful to be here.

Spencer Glende
It's great to be here. Thanks, Julian.

Julian Dibbell
Well, we're glad to have you.

Spencer can why don't you give us some background on this topic and why it's important for startup tech companies?

Spencer Glende
Happy to. Scott and I both deal a lot with these tech startups and typically with the focus on their IP agreements, licensing agreements and commercial contracts.

And we also have the chance to see and be involved in investments and acquisitions, M&A transactions involving startups. And from that perspective, we've had a chance to see where these IP and commercial agreements sometimes can bog things down or even kill off a deal. So we wanted to share some ideas for tech startups to use that they should not postpone so that they're ready for a clean exit when the time comes.

Scott Young
Well, Julian, I have to jump in and say when I told my kids that I'd be doing the Tech Talks podcast, they said, OK dad, we got one line of advice for you: Whatever you do, don't be boring. And I said, wait a minute, it's a legal podcast, how am I supposed to do that? And they said, OK, Dad, here's what you do, you use a Top Gun Maverick analogy. So I'm going to give you my best one here to start us off, and that is, if you remember the movie, the Top Gun Maverick movie, they spend most of that movie, in fact, preparing, getting ready for running through scenarios, getting ready for their big event, for their battle scene at the end. And the point I think that that makes is, you just can't ignore the preparation. You have to think through every scenario, you have to be prepared for what's coming, and that's the way you find success. And the same really is true if you're an entrepreneur and you get a tech company, you've got to take steps now to be prepared for that exit.

Julian Dibbell
Now, and this sounds like it's going to be a really helpful discussion particularly for tech startups, which is the focus of your practice, but I'm also getting the sense here that the questions that become complications in an investment or acquisition are going to be the same questions for the more established companies that are doing the acquisitions, right?

So in some sense we're focusing on startups, but this isn't really just a podcast episode for Startup Companies, right? We can ask our more established listeners to hang on and you might learn something useful as well.

Scott Young
Don't hang up yet. That's exactly right.

Spencer Glende
These are things that the acquiring company should be thinking about as well from the opposite view. And, for that matter, even we see some of these mistakes happen in the context of pretty well established companies that are merging or being acquired. So it's never too early or too late to be thinking about these.

Julian Dibbell
Alright, let's get into it then, Spencer. What are the particular issues? I imagine for startups, a lot of them are going to have to do with intellectual property concerns. Is that right?

Spencer Glende
That's right. In fact, probably the bulk of what we'll talk about relate in one way or the other to IP ownership and rights. A little later on we can focus on some more strictly commercial contracting issues to be mindful of but on the IP ownership side, probably the first thing that comes to mind is just making sure you document your IP ownership well, and the 1st place that usually comes up is in dealings with employees and independent contractors. In the US there's this notion of work made for hire in copyright law, but a lot of companies misunderstand that, and they might even think that as long as I'm paying for development, I will own the IP. That's only true in limited circumstances, like when it's copyright authored by a true employee, as opposed to a contractor. And although there are some instances where you can contract for work made for hire with the contractor. But, again, those are limited. And so the best practice is to have, with anybody who contributes to your IP, a written invention, an IP assignment agreement.

Scott, you’ve probably seen instances where the company says, “We don’t get everybody to sign those but the people who really matter signed it”.

Scott Young
Absolutely. You probably don't need the janitor or the cleaning crew to sign, but you know it's best practice to try and get that for anybody who's developing IP to get to sign that.

Spencer Glende
And erring on the side of having everybody do it makes it even easier when the time comes to be acquired, and the acquirer said, “Make me comfortable that everyone who matters signed it”. Well, every single person did so there's nothing to worry about. A couple of things that we flag in these assignments is, you have to get the wording right. Sometimes you see them written as the company will own the technology I developed, and that a lot of courts say is not enough, or, I will assign to the company the IP I developed. What we really want to see to make sure it's effective as a present assignment, the individual or the contractor hereby assigns its rights, current and future, in the development that it will provide.

Scott Young
Often we'll tell our clients there's no magic language, but this time there really is magic language, Spencer, you're absolutely right on that.

Spencer Glende
And we've seen that slow deals down where the investor will say, hey, your invention assignment agreements aren't really assignment agreements, go out, fix some, get amendments, which can be really tough if people have left the company or maybe even become hostile since they've worked at the company.

Scott Young
Speaking of mistake, I'll tell you, you're talking about getting all the employees to sign, and sometimes the clients and companies would be great about that but they'll forget about getting the founders themselves to sign those - the founders would be so focused on let's get everybody else taken care of they forget their own. And especially when there are multiple founders and one of them leaves, or one of them isn't cooperative, then you get yourself…

Spencer Glende
That would never happen, Scott.

Scott Young
You have to be so careful on those too. And sometimes those are a little bit unique too, Spencer, because the founders sometimes have prepared their IP before the company was formed, and so you have to have their invention assignments looking back, to predate the company…

Spencer Glende
Which isn’t always the case, most forms you see companies using focus on development made while the individual is with, or the consultant is with, the company. And in this case, you have to look back before that engagement and maybe even before the formation.

Scott Young
I have to tell you a quick war story I had. I was representing a company that was getting at the time, a prepaid license in a sense, so it's kind of an investment in this tech company and fortunately got a lot of reps and warranties about that the company that they were essentially investing in owned the IP. Well, it turns out the founder didn't ever do a proper intellectual property assignment, and so as sometimes

things do, things go wrong and the IP wasn't delivered. And so the company wanted to foreclose essentially on that loan, and wanted to take the IP. Well, when the IP's not in that company, it was a real problem, and so to your point, Julian, you have to be aware of these issues if you're on the investor side or the formation side. But it turned into some real nasty litigation because that founder never took care of, and that company never took care of, getting that IP assigned.

Spencer Glende
I think your story illustrates another important point that when you are bringing in technology, or IP, whether it's something that you are getting ownership of, you think are getting ownership of, or maybe a key inbound tech license that you're going to rely on, make sure that the party you're dealing with has the rights to give you, or a license to give you. And it's great that in that contract you mentioned you had the representations and warranties of the company saying, hey, don't worry, we own this and that...

Scott Young
They were successful in the litigation, but you wouldn't have had the litigation if you'd had done the proper due diligence.

Spencer Glende
Even better to kick the tires, ask for those, if it's important technology, ask to see the paper trail showing that they own it. And this can be particularly complicated when you're dealing with folks who are overseas.

Scott Young
Absolutely. You've got different rules, you've got different laws. We're so used to dealing with U.S. law, but if you've got employees or contractors or developers overseas, you can sometimes run into problems. You had a situation like that recently, didn't you, Spencer?

Spencer Glende
A company that was getting acquired had some of its key software developed by a company using developers in Vietnam. And when the acquirer looked at that contract, said, well in Vietnam, they don't have work made for hire the way they do in the U.S., and even if those individuals were bona fide employees of the consulting firm, there needs to be separate documentation to give the consulting firm ownership in the copyright and the software that the company being acquired ultimately needed to own. That was a good reminder of the fact that you've got to be mindful of the local jurisdiction where the development is being done because the rules may be very different.

Julian Dibbell
Now, in all of this discussion so far, it sounds like we're focusing on the kind of rights you can assign a transfer and so forth. Copyrights. Patents.

What about those more less fungible types of rights, like trade secrets. How do you approach an intellectual property that's protected by trade secret regimes?

Scott Young
Well, Julian, you're absolutely right. You've also got to worry about trade secrets, and one of the best ways, or most important things you can do, and we're talking about contracting here, is making sure you've got a great or an effective nondisclosure agreement, and use that consistently. The way you protect trade secrets is making sure it's always the subject of reasonable efforts to protect its confidentiality, and the way you do that is with an agreement. One of the things that I will do and make sure that my clients have is a good nondisclosure agreement anytime they're entering in discussions that could involve their trade secrets or any of their confidential information, for that matter.

Julian Dibbell
A good NDA? Aren't all NDA's the same? Hey, I signed an NDA. We're done, right?

Scott Young
You think they're all the same. In fact, a lot of our clients think they're all the same, but they're really not. You've got at least a couple of different categories. You've got mutual nondisclosure agreements when both parties are disclosing their confidential information, both parties are disclosing their trade certificates. You've also got one-way nondisclosure agreements that are very appropriate when you're dealing with your contractors, your developers, someone like that, where the confidential information is only going one way.

Spencer Glende
And I've seen that bumbled, unfortunately, in an acquisition it came up that the company our client was looking to acquire had for some unknown reason put mutual agreements, mutual nondisclosure agreements in place with each of its individual overseas developers, independent contractors, and if you read the agreement, basically it was saying that the software code that they had hired these folks to create because it was being disclosed by the developer to the company was treated as the developer's confidential information. And so that we had to have that company go back and amend each of those. We were lucky, I guess, that each of those individuals was still around and was willing to replace that improper NDA with the appropriate one.

Scott Young
That's really fortunate, because that could really give your developers an opportunity to really hold you hostages in a sense, if they didn't sign this contract, so it's not just the type, it's also the language that's included in those non-disclosure agreements that can be so important.

Julian Dibbell
Sounds like we've covered a lot of topics under the heading of IP here, and it sounds like there could be a lot more, but moving along, what about other types of considerations with respect to agreements that startups are entering into, commercial agreements, for example with suppliers or with major customers?

Scott Young
You're absolutely right, Julian, and just like there are a lot of different topics you could be discussing on the IP side, there are lots of different things to be looking for on the commercial contract side. I'm just going to sort of give you the takeaway right now. I mean, the takeaway really is, you've got to be thinking about your exit. Have that in the back of your mind when you're reviewing a commercial contract, especially when you're a startup dealing with, oftentimes, a larger, more well established contracting partner and you've got to be thinking about that goal, have that end in mind when you review the topic. But let us maybe give you our top four, five or six, or whatever provisions or issues to look out for when reviewing.

Spencer Glende
These are the kind of things that could almost turn into poison pills. As Scott said, they might seem fine when you're contracting in the present, but they don't fit anymore when the acquirer comes to town or when you become an affiliate of a larger company, and probably number one is exclusivities. It might not seem like a big deal, for instance, to grant an exclusive license to somebody else in Europe, or to say to someone in South America, "You're going to be our only manufacturer for our product". Because who knows, the company that might want to acquire you may have their own relationships in Europe or South America, or they may want to exploit those markets in ways that you didn't have the ability to do as the startup. And so those exclusivities can really alter the going-forward business case for the acquisition. So

exclusivities is one. Number two is similar. Most-favored nation clauses MFN pricing terms where again those might conflict with commitments your acquirer has already made to others. Minimum purchase commitments is another flavor of those kinds of constraints that might fit now, but are not good when the acquirer comes into the scene. And one thing that really exacerbates all of these is any time that the other party asks for these clauses to apply to affiliates. And so maybe as a fourth example, distribution rights, sometimes you see the scope of distribution rights, like if you're authorizing someone to resell or distribute your product, it might say that you authorize them to resell all of the products of the company and its affiliates. Might be fine if you don't have affiliates or if you only have three products right now, but if you're going to get acquired by the 800 pound gorilla, all of a sudden they're an affiliate and all of a sudden that distributor has rights to represent them, which may not fit the needs of the acquirer.

Scott Young
Yeah, you've got to be, like I said, you've got to be keeping that in the back of your mind anytime you're negotiating these commercial contracts. In fact, just throwing in, you know, that example I gave earlier of having the appropriate Rep and Warranty, so often startup companies can get into the mode of they're dealing with friends, they're small, small groups. “Hey, we don't need the documentation. We don't need the formalities of the contract”, but you know, time goes on. Founders leave, you need the basic reps and warranties to protect you from the very situation, so make sure you have appropriate representations and warranties. Make sure you've appropriately documented transactions so that when the acquisition happens, those can flow through. And the other things to think about, Spencer, as you've got change of control provisions anytime you see a change of control provision in your contract, you have to be mindful of the future. What does that change to control look like? What happens when that triggers? And then of course the big one of the big ones for me is that assignment provision.

You will often see in these commercial contracts of prohibition on assignment and sometimes it can be worded in such a way that it would prohibit that contract from being assigned in connection with an acquisition.

Spencer Glende
Or it might even say an acquisition is deemed to be an abbreviated assignment.

Scott Young
And so all of a sudden you've given and let's say it's a big customer, right? A big customer represents so much of the value of the company, and if that customer all of a sudden has a veto over the assignment, it effectively gives them a veto over the acquisition. And so you could be beholden to any one of a couple of large customers for your whole acquisition, which is not a situation you want to be in. So be really careful of those assignment provisions.

Spencer Glende
And Speaking of change of control just to flip it around, one of the solutions to some of these instances, like these poison pill terms, if you really are being pressed into agreeing to something you know favorable to a big customer or supplier, you can try it to get in there a protective change of control provision that if we get acquired, we get to renegotiate exclusivity or we get to the MFN no longer applies. Those kinds of things and every now and then can get those as a compromise.

Scott Young
One of the biggest mistakes Spencer, I see is from time to time I'll see provisions that tend to go on forever. Pricing will give you pricing and they don't think about it. Pricing will go on forever because there's not a termination. There's no expiration on the agreement. There's no termination right or the other party controls that right to terminate, not the vendor. And so you're stuck with a bad contract, and

in fact, I just had a client ask me the other day that they just acquired a company that had some of these Evergreen or perpetual contracts saying how do you get out of them because – you've got these customers, now our customers of the acquiring entity - and they've got these perpetual agreements that basically lock the provider into providing the service at a certain fee and it's bad news.

Spencer Glende
Yes, the acquirer might even want to discontinue the service altogether. So be thoughtful about getting out of those contracts.

Scott Young
Always make sure you think about a way to get out of contracts, not just the way to get into it.

Julian Dibbell
Alright, so we've been talking here I think about kind of critical agreements with major suppliers, major customers where they may have a lot more leverage over the startup company. You're dealing with their paper, their terms and obviously that puts you on the alert to how are they taking advantage of us. But then, hopefully there's also a whole category of agreements that are just your standard agreements with customers, day-to-day business ULAS, terms of service, that kind of thing.

Can you just rest easy and not worry about the terms in those or what's the approach?

Scott Young
Well, Julian, I think by asking the question you know the answers. The reality is that so often, startups, of course, are strapped for cash. They're trying to conserve every penny and one of the ways they'll try and cut corners is "Let's just go find a template." You say ULA, Master services agreement, terms of service. These are on the Internet. You can go find them anywhere, but the problem is they don't always fit the business. They don't always have the terms that you need. They don't always have the protections that you need, and so it's one of the things you have to do as a startup, or really a company of any size, frankly, is make sure that your form agreements: (1) match the business; and (2) don't end up giving you one of these poison pills that we're talking about when it comes time for an exit.

Spencer Glende
And you should keep in mind that your business model may change. All too often, companies start doing something different and don't think to go back and update their standard terms of service or master services agreement.

Scott Young
Or laws may change. Things change. You've got to keep them fresh as well. Absolutely.

Spencer Glende
That's right. You mentioned how they could be almost a poison pill, and that's partly a function of the fact that the standard agreements are going to apply to many, many customers usually or business partners which just multiplies even small defects. Those defects could relate to not properly capping liability exposure or ambiguous terms about IP ownership or rights. Again saying that "we shall own it" instead of "you hereby assign" was an example of that. Or fuzzy license grants, even termination provisions that may not be sufficient could leave you kind of locked into this whole class of contracts and so it's always best to reserve the right in your standard agreements. You have some way to modify the terms, modify the pricing and if your customers don't like it their recourse is that they can go elsewhere but you need to have some ability to change and adapt those terms as circumstances change.

Scott Young
I think you made the key point Spencer, which is we might think that any one template agreement may not be a huge deal but the problem can become when you use that as your template and you spread that over a large number of customers or a large number of partners or whatever and then if there's one problem in it you've got to rectify that problem over multiple contracts. It can become a real nightmare when it comes time for the acquisition of the investment.

Spencer Glende
So those templates are not where you want to cut corners because every bit of time you saved by cutting corners, you're going to pay 100 times over when if you have to go back and fix it.

Julian Dibbell
Again, you've touched on a number of topics. I sense this may just be the tip of the iceberg. Lots to talk about here, but time requires that we wrap it up. Any final thoughts on the whole topic?

Spencer Glende
We're glad to have had a chance to talk with you Julian. I guess we just sum up that, going back to the original analogy, preparation and being proactive and having foresight, thinking about your exit from the very earliest stages is important when you're looking at your commercial and IP contracts.

Scott Young
If there's anything that you're going to hear when it comes time for an exit from your client, from the acquiring entity, from the entity to be acquired, especially going back to our original analogy, they will say they feel the need for speed.

Spencer Glende
That's right.

Julian Dibbell
Oh no, Scott.

Scott Young
Well, now I know I'm never going to be invited back to the podcast.

Spencer Glende
It's going to go a lot faster if you've laid the ground work.

Scott Young
That's right – preparation is key, Julian.

Julian Dibbell
That's helpful. Great insights, Scott and Spencer. Thank you also for the major motion picture analogies. Listeners, if you have any questions about today's episode or an idea for an episode you'd like to hear about anything related to technology and IP transactions and the law, please email us at techtransactions@mayerbrown.com. Thanks for listening.

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