



**ENTREPRENEURIAL  
BUSINESS LAWYERS**

## **SPIN OUTS**

### **INTRODUCTION**

A significant proportion of new companies each year are created as a result of spin-out activity whether it is from a larger company, University or other institute of advanced research and education.

A “spin-out” is the term used to describe a company, which is set up to acquire and commercialise novel technology (and often a technical team) from the “parent” institution/company, ultimately to gain a life of its own.

Taking the step to spin-out and start up a new company requires confidence in your science, research and team. The decision to spin-out may be made due to external pressures such as a lack of funding, insufficient resources to conduct research or a lack of interest in the technology by the current employer. Whatever the reason, it can make good business and scientific sense to take the leap of faith and spin-out.

### **INCORPORATION OF NEWCO**

A new company needs to be incorporated which will ultimately be the spin-out entity (“Newco”). Legal and tax advice should be sought at an early stage to ensure that the founding shareholdings are structured in such a way that they are as tax efficient as possible. Although companies can be incorporated online many of the online incorporation

agents cut corners and you would be wise to instruct a law firm to assist with this.

### **FUNDING**

Funding can pay for protecting intellectual property rights (“IPR”), appointing directors, covering employees’ salaries, securing premises, conducting R&D and so on. Few “spin-out” companies will be able to function effectively without adequate funding and more Universities and parent companies are making it a condition of the spin-out deal that appropriate funding is in place.

There are various sources of funding and choosing the right source can be a critical decision for Newco. It is likely that Newco will need to seek both public sector (such as grant assistance, SMART awards, SPUR etc) and private sector funding to help establish the business. A business plan will be essential for this task.

### **THE TECHNOLOGY**

The technology will be the key asset of Newco and will no doubt be novel, inventive and cutting edge. However, in order for the technology to be considered a valuable asset, the IPR in the technology needs to be secured at the earliest stage possible. The extent of Newco’s rights in the IPR will impact Newco’s value, competitive edge in the marketplace and share price.

## **OBTAINING RIGHTS IN THE IPR**

Since the overriding principle in intellectual property law is that in the absence of an agreement to the contrary, any IPR generated “in the course of one's employment” will belong to the employer, it is more than likely that the parent company will own the IPR in the technology and Newco will need to negotiate with the parent company to purchase rights in the technology/IPR.

Ideally, Newco would be able to purchase the IPR outright from the parent and the IPR would be unconditionally assigned to Newco in return for cash and/or equity in Newco. However, in many deals the parent company will initially only grant a licence of IPR to Newco. The licence agreement will be a critical agreement for Newco as it will set out the extent of Newco's right to use the IPR and the amount Newco will need to pay for the rights. The agreement will be scrutinised by any investors in Newco to ensure that Newco has the means of developing and/or commercialising the technology. Any eventual acquirer of Newco may take a keen interest in this agreement, so it is important to get it right.

## **THE LICENCE AGREEMENT**

From Newco's perspective, the terms of the licence agreement are crucial for Newco's business and will impact Newco's ability to obtain funding from investors. That being said, depending on the nature of the parent company, it may be quite difficult for Newco to negotiate advantageous licence terms as many parent companies have standard licence terms that they are unwilling to move away from.

The following issues will be the most important provisions for Newco to negotiate:

- Exclusivity - the extent of exclusivity granted to Newco will have a direct

impact on the value of Newco's business.

- Scope – Newco will want to ensure that the scope of the licence is wide enough to cover Newco's commercialisation plans. Newco will not want the licence to be limited to a narrow “field of use” or territory.
- Payment terms – Newco may not have access to extensive funds at the outset so the extent of any up-front licence fee or permitted holiday period will need to be considered. Newco will also need to negotiate the extent of any royalty payments, when the royalties will be due and whether the parent company requires an equity stake in Newco.
- Term and termination rights – The term of the licence is key and any exclusive licence will need to have a term that complies with competition law rules. The parent company may seek provisions in the licence agreement that require Newco to introduce its first product to market within an agreed timescale (or else risk termination of the licence). Care should be taken with the wording around this, especially having regard to the resources available to Newco.
- IPR infringement proceedings – Newco will want to ensure that it has the right to take action against any third party that is infringing the IPR.
- Undertakings – Newco needs to obtain assurances from the parent company that it will do all that is required to maintain the IPR in force including paying all renewal fees on time. If the IPR is only at the application stage, the parties will need to determine who will be

responsible for the costs of pursuing the application through to grant.

- IPR trigger event - Newco should try to build an IPR trigger event into the licence agreement so that if Newco achieves certain milestones (i.e. achieving a set level of sales or payment of royalties), then the IPR will be assigned to Newco.
- Option for related technology - Newco may wish to obtain a first option to purchase or licence any related technology from the parent company.

#### **THE ASSIGNATION AGREEMENT**

If Newco is fortunate enough to have negotiated a deal which involves the transfer of IPR to Newco, the terms of the assignation agreement must still be carefully considered.

Newco should seek to obtain the following provisions in the assignation agreement:

- Warranties – Newco will want to obtain warranty protection that the registered IPR being transferred is in force, has been maintained and all renewal fees have been paid. Newco may also want to seek warranties that the IPR has not been licensed to any third parties and the IPR will not infringe any third party IPR. However, the parent company may either refuse to grant the warranties or restrict the warranties to the parent company's knowledge on the grounds that the founders of Newco have more knowledge about the state of the IPR than the parent company.
- Undertakings – Newco should ensure that the assignation agreement includes a "Further Assurances" provision whereby the parent company agrees to execute all

documents and do all things necessary in order for Newco to receive the full benefit of the assigned IPR. If Newco wishes to obtain a Power of Attorney from the parent company to enable Newco to sign documents on behalf of the parent company, the assignation agreement should be executed as a deed and signed by two directors or one director with a witness.

- Waiver of Moral Rights – Where the IPR being assigned to Newco includes written works covered by copyright, Newco should ensure it obtains a waiver of moral rights so that Newco will not be restricted in its use of any such documentation in the future.

#### **PROTECTING THE IPR**

Once Newco has obtained either ownership of or a licence to use the IPR, Newco should do all it can to protect such IPR so the value of Newco is not jeopardised. If any of the IPR is registered, Newco should ensure it registers its interest with the appropriate intellectual property office as soon as possible. For example, the assignation or licence of a patent must be registered with the Intellectual Property Office to give notice of Newco's interest in the IPR to third parties so that such third parties are bound by the transfer and to obtain costs and expenses in any IPR infringement claim.

The IPR should also be protected by the diligent use of confidentiality undertakings and agreements whenever Newco is disclosing any confidential information. The principal areas of risk are disclosures to employees or consultants, during technology/knowledge transfers and whenever information is disclosed to investors and advisers.

Newco should ensure that it seeks legal advice to obtain properly drafted

employment contracts, consultancy contracts and non-disclosure agreements from the outset. Although budgets are always tight for any start-up venture, Newco needs to take great care with its contracts because these will be scrutinised by the lawyers of funders and acquirers. “We were only a start-up with no resources” is no excuse for poorly prepared and ill-thought out contracts. Investors and acquirers are only likely to be interested in professionally run operations that can exhibit contracts which provide a strong foundation and platform for a business.

#### **THE TEAM**

Obviously, Newco will only be successful if it has the expertise required to develop and commercialise the IPR. The founding individuals at Newco are crucial for that task and ideally the founding individuals will not only have strong scientific credentials, expertise and know-how but they will all share the same vision for Newco and be able to work together.

Investors will also be keen to ensure that the founding individuals are tied into Newco for the long term (through employment or consultancy contracts or financial penalties) and are prohibited from doing anything that would damage the interests of Newco (through restrictive covenants).

Newco will also need to hire someone with business and financial expertise. The scientists should be left to the science and a finance director (even if initially part time) should be brought in to manage Newco’s finances, write Newco’s business plans and raise funding.

Newco should also identify and engage the help of professional advisers such as lawyers and patent attorneys who are able to assist Newco with negotiating terms with the parent company, assisting with fundraising and protecting and commercialising the IPR.

Newco should only use advisers who have expertise in these areas.

#### **ADDITIONAL CONTRACTS**

In addition to the licence agreement between the parent company and Newco, Newco may need to enter into the following additional contracts:

- Secondment Agreement – the founders of Newco may wish to remain employees of the parent company (as is often the case with University employees) while offering their services to Newco. In this scenario, the parent company pays the founders’ salaries and Newco reimburses the parent company. The IPR provision in these agreements is often critical.
- Consultancy Agreement – if the founder does not intend to work full-time for Newco, a consultancy contract may be used between the founder and Newco. In this case, care needs to be taken that any IPR created by the founder, vests in Newco.
- Facilities Agreement - Newco may wish to enter an agreement with the parent company to enable Newco to have access to and use of the parent company’s facilities and/or equipment.
- Other Contracts – There may be other contracts that Newco requires depending on the relevant deal and the key thing is to reflect on what useful things could help Newco in the short and long term.

#### **EQUITY DEALS**

If the consideration for a “spin-out” deal involves equity being given to the parent company then you should take care to ensure that the articles of association of the

company cover key issues, including:

- Drag along rights – the ability to drag the parent into an exit deal on the same terms and conditions;
- Pre-emption rights – the ability to restrict share transfers by the parent and ensure that where the parent can and does wish to transfer its shares, then these shares are first offered up to sale to the other shareholders and/or bought back by the company;
- Forced transfer scenarios – in some cases if the parent company goes bust, is sold, terminates its licence of technology to the company or is otherwise in material breach of contract, then it may be appropriate that shares of the parent on the occurrence of such an event are offered up for sale.
- Many parent companies will try and insist on a number of rights being imposed on Newco, including:
  - Director and / or observer rights;
  - Extensive information rights;
  - Certain veto rights;
  - Tag along rights (for an exit); and
  - Options or warrants to avoid future dilution.

It may be appropriate that such rights are given although advice should be taken to ensure that they “fly off” at the appropriate time and are not going to unduly hold the company back.

## **CONCLUSION**

Spin-outs are a useful and popular way of making sure potentially significant IPR is developed and commercialised. They provide an excellent commercial opportunity for the founders, the parent company and investors

but the contractual documentation for spin-outs will require negotiation as the three parties involved have competing interests.

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**For further details, please contact:**

**Stuart Hendry**

**Kenny Mumford**

**Tracey Ginn**

**Tel:** 0131 226 8200

**E-Mail:**

stuart.hendry@mbmcommercial.co.uk

kenny.mumford@mbmcommercial.co.uk

tracey.ginn@mbmcommercial.co.uk