IMPORTANT CONSIDERATIONS FOR PORTFOLIO COMPANY COMMERCIAL CONTRACTS

Commercial contracts are critically important for every business, especially for private equity-backed portfolio companies that have unique characteristics. This article provides a summary of some commercial contract provisions that are important for PortCos to "get right" to ensure all stakeholders receive maximum value at exit.

A business may experience significant change when it receives an investment from a private equity firm and becomes a private equity-backed portfolio company ("PortCo"). Many private equity investors use their industry expertise and execution skills to professionalize the PortCo and create operational value for the PortCo and its stakeholders. For example, the private equity firm may have a 100-day plan to implement changes with goals to increase revenue, improve gross margins, reduce overhead, and leverage shared services with other PortCos. These goals may be achieved through a digital transformation of the PortCo's operating systems, a "lift and shift" of various operations to the cloud, or implementation of more sophisticated pricing strategies, to name just a few.

An increased attention to the PortCo's commercial contracts will be a part of the PortCo's professionalization and change. PortCos have three particularly unique characteristics that need to be considered when reviewing commercial contracts:

- they will likely experience significant growth, both organically and through add-on acquisitions of other similar companies or those in adjacent verticals;
- they will undergo a change of control in the short-term or medium-term future; and
- they are owned by firms or funds that may own other PortCos that have little or no operational relationship to them.

These characteristics require reviewing the PortCo's commercial agreements through a new lens while paying particular attention to: (i) the PortCo's current business operations; (ii) organic growth of the PortCo; (iii) growth of the PortCo via add-on acquisitions; and (iv) value of the PortCo at exit. Some of the most important commercial contract provisions that will receive new or enhanced scrutiny are described below.

Basic Commercial Terms of Customer Contracts

PortCo leadership will have a set of specific financial metrics that will be used to measure operational value creation and, ultimately, maximize the PortCo value at exit. The PortCo's legal counsel and sales team should collaborate to ensure the commercial terms in the PortCo's customer contracts are consistent with the private equity and PortCo management's financial objectives. A focus on alignment between management, on one hand, and legal counsel and sales

team, on the other, may be even more important if there are new PortCo sales leaders or combined sales teams after add-on acquisitions.

A simple example can illustrate the importance of alignment between the PortCo's management, sales team and legal counsel. Annual recurring revenue ("ARR") and cash flow are typically very important metrics for PortCos in the software-as-a-service industry. The commercial terms of a customer agreement may start at $1,000,000 for a two-year term paid in equal installments of $500,000 at the start of each contract year. After negotiation, the commercial terms may evolve to $2,000,000 for a four-year term, paid in installments of $200,000, $200,000, $200,000, and $1,400,000 at the start of each respective contract year. These two deals could have materially different impacts on ARR and cash flow, so the sales team and legal counsel negotiating the deal should confirm that PortCo management approves of the new deal structure.

<u>Key takeaway</u>: **The PortCo's sales team and legal team need to be aligned with the PortCo's management team on key financial metrics to ensure commercial terms in customer contracts are consistent with such key financial metrics.**

Most Favored Nation Pricing

Most favored nation, or "MFN", provisions in customer contracts are another potential pitfall for PortCos. While formulations vary widely, a basic MFN provision promises the customer that the price charged to the customer for the goods, services, or technology being provided will never be higher than the lowest price charged to any other customer for the same or similar goods, services, or technology.

An MFN provision can create issues for a PortCo in a number of ways. First, with accelerated organic growth, a PortCo is at greater risk of violating an MFN provision with the additional volume of customer contracts that results from such growth. Second, the PortCo may inadvertently breach an MFN provision if it assumes new customer contracts as part of an add-on acquisition because those contracts may contain lower prices than prices in the PortCo's existing customer contracts. Third, at exit, an MFN provision could create serious concerns for a strategic acquirer with a similar customer base as the PortCo. The strategic acquirer may inadvertently breach an existing MFN provision if it assumes new customer contracts as part of the acquisition. Moreover, if the contract is material, an MFN provision may reduce value of the PortCo at exit if the acquirer will need to adjust prices of its own goods, services or technology in order to comply with such MFN provision.

<u>Key takeaway</u>: **A PortCo should rarely, if ever, agree to MFN pricing in a customer contract.**

Termination Rights

In addition to the basic commercial terms of price, payment terms and length of the agreement, provisions that grant the other party the right to terminate the agreement early should also be carefully considered by a PortCo. A classic example is the "termination for convenience" right. These termination rights permit a party to terminate the contract for any reason or no reason, typically with a certain amount of advance notice (ex. 30 days).

Termination for convenience rights can be problematic for many reasons. First, the PortCo may not be able to recognize revenue when and how it needs to if the other party has a termination for convenience right. This inability to recognize revenue could have a damaging effect on the accounting and financial metrics used the measure the PortCo's performance. Second, these termination rights can be harmful from an operational perspective if the PortCo is relying on a commercial arrangement only to have the "rug pulled out from underneath it" midway through the arrangement. For similar reasons, an acquirer of a PortCo will not want to assume a contract under which the other party has a termination for convenience right. Prior to closing a corporate transaction, the acquirer may require assurance that the contract will not be terminated for convenience by the other party, giving the counterparty to the contract significant leverage to ask for concessions in exchange for removing its termination for convenience right.

<u>Key takeaway</u>: **A PortCo can undermine the value of a commercial contract, both from the PortCo's current operational perspective and future value at exit perspective, if it grants the other party broad termination rights.**

Ownership of Intellectual Property Rights

All companies, especially new PortCos, may rely on newly developed technology to create efficiencies, scale, and enhance operational value. Of course, PortCos in the technology space regularly

commercialize new technology on the customer-side of the PortCo business. All of these companies need own all intellectual property rights ("IPR") in and to the newly developed technology. For technology developed "in-house" by employees of the PortCo, the PortCo needs to have a contract with each of its employees that says the PortCo owns all IPR in and to all technology developed by such employee within the scope of the employee's duties, or using the PortCo's resources or confidential information. These agreements are commonly referred to as "proprietary matters agreements." While default law may provide that the PortCo (as the employer) is the owner of all such IPR, no PortCo should rely solely on default law because potential acquirers will request to review signed proprietary matters agreements and default law may have some exceptions, nuance, and ambiguity that may allow the employee to argue he or she is the true owner of the IPR.

It is even more critical to have a written agreement in place for technology developed for the PortCo by third parties (ex. development companies and individual independent contractors) because, generally speaking, default law will provide that the third party, not the PortCo, will own the IPR in and to the developed technology. The written agreement needs to contain certain "magic language" in order to effectuate the assignment of the IPR from the third party to the PortCo. As a result, a contract provision that says "PortCo shall own all intellectual property rights in and to the Developed Technology" would likely not be sufficient to actually transfer the IPR to the PortCo.

Another issue that the PortCo must consider for technology developed by third-party development companies is the existence of "proprietary matters agreements" between the third-party development company and its personnel involved in the creation of the developed technology. A PortCo should think of IPR ownership as a "chain," and the PortCo may not own all IPR that it intends to own if a link in that chain is missing. So, for technology developed by third-party development companies, the PortCo needs to confirm that the individuals working for the third-party development company assign all IPR to the third-party development company, who then assigns all IPR to the PortCo. Without the assignment of IPR from the personnel to the third-party development company, the assignment from the third-party development company to the PortCo may not be effective.

Key takeaway: Unfortunately, ownership of IPR is an area where "form over substance" can still rule the day. Accordingly, a PortCo's legal counsel should carefully review all contract provisions addressing ownership of IPR.

Licensing of Intellectual Property Rights

Unlike ownership and assignment of IPR, licensing of IPR involves one party (usually the IPR owner) granting another party permission to use the IPR without actually transferring ultimate ownership of the IPR. Licensing of IPR can be thought of in two groups: (i) in-bound licensing (PortCo is receiving permission from another party to use the IPR); and (ii) out-bound licensing (PortCo is granting permission to another party to use the IPR).

In-bound licensing is applicable to every PortCo, whether or not the PortCo is in a technology sector. Every business relies on technology or software to perform, manage, enhance, or outsource various business functions or operations, including ERP, CRM, supply chain management, project management, financial and accounting back-office operations, optimization decisions, and others. In addition, some PortCos need to incorporate certain IPR or technology into their goods or services that are sold or transferred "down stream" to their customers, distributors, or other third parties. For each of these in-bound licensing arrangements, the grant of rights to the PortCo needs to be broad enough to cover the current and potential future needs of the PortCo (whether resulting from organic growth or add-on acquisitions). The PortCo may also consider the potential needs of an acquirer at exit when negotiating in-bound license arrangements to help maximize value at exit.

Out-bound licensing is usually more applicable to PortCos in technology sectors that commercialize IPR as a core revenue generating business operation. For each of these out-bound licensing arrangements, the grant of rights to the other party should be narrowly tailored to the intended use case for which the other party is paying fees. Overly broad license grants may permit other parties to use IPR for additional use cases that should require additional fees, but are unintentionally included in fees for the overly broad license grant. Even worse, an overly broad license grant may permit the other party to use IPR to develop derivative technology to be owned by the other party and, in a worst case scenario, be used to compete with the PortCo.

Key takeaway: A PortCo should analyze all in-bound IPR licenses not only from the perspective of the PortCo's current operations, but also from the perspective of the PortCo's future operations and impact on future acquirers. All PortCo out-bound licensing arrangements should be narrowly tailored for the specific use case to ensure the PortCo is not "leaving revenue on the table" for future, distinct use cases.

Assignment and Change of Control Restrictions

Acquirers of the PortCo will also heavily scrutinize commercial contract provisions addressing assignment and change of control. At a high level, the sale of the PortCo can take the form of an asset sale, stock or membership interest sale, or merger. For a PortCo, the most probable outcome at exit will be a stock or membership interest sale or merger.

Anti-assignment provisions prohibit a contracting party from transferring the agreement to a third party without prior written consent of the other contracting party. If drafted properly, an anti-assignment provision in a PortCo commercial contract should only apply to the unlikely scenario where the PortCo is acquired via an asset sale (requiring the contract itself to be transferred to the acquirer as a transferred asset). For this reason, anti-assignment provisions tend to be less problematic for PortCos than change of control provisions. Nevertheless, these provisions can cause significant issues for PortCos at exit, especially if the provision is poorly drafted or contains change of control concepts in addition to anti-assignment concepts.

Because a stock or membership interest sale or merger is the most likely outcome for a PortCo at exit, provisions addressing change of control are much more likely to create serious issues for PortCos at exit. Change of control provisions, in essence, say that (i) the other contracting party has a right to terminate the agreement if a certain percentage of ownership of the PortCo is transferred, or (ii) the PortCo can't undergo any change of control without the other contracting party's prior consent. This type of provision may permit the other contracting party to terminate the applicable contract at exit or refuse to consent to the change of control transaction. Further, the PortCo may breach the contract if it undergoes a change of control without the other party's consent. If the contract is material to the PortCo's business, the acquirer may require assurance that the contract will remain effective after completion of the corporate transaction, giving the other contracting party significant leverage. The other contracting party could "hold the deal hostage" at exit and attempt to obtain more favorable terms (or additional payment) in exchange for its permission to assign the contract to the acquirer or remove or waive its right to terminate due to the change of control. Software vendors and landlords are examples of parties that may use these provisions as leverage at exit to obtain increased payment or more favorable terms.

Key takeaway: Anti-assignment and change of control provisions will be amongst the most heavily scrutinized provisions of a PortCo's commercial contracts during the due diligence phase of an exit transaction. These provisions require precise drafting because the other contracting party may have the ability to complicate the PortCo's exit transaction if the other contracting party has certain rights under an anti-assignment provision or a change of control provision.

Restrictive Covenants and Exclusivity

Restrictive covenants and exclusivity provisions are contractual tools that prohibit a contracting party from taking certain actions. In their basic sense, restrictive covenants prohibit a contracting party from soliciting the other party's employees, soliciting the other party's customers, or competing with the other party. Exclusivity provisions prohibit one or both contracting parties from entering into a similar (or competitive) contractual arrangement with a third party. Restrictive covenants and exclusivity provisions may apply in a particular geographic area or product vertical and typically last for the term of the contract and for some post-termination/expiration period.

These provisions can be particularly problematic for PortCos. The private equity firm and PortCo management likely have plans for accelerated growth – both organic and through add-on acquisitions. Restrictive covenants and exclusivity provisions in commercial contracts may present significant roadblocks to these growth plans.

For example, let's assume that the PortCo is in the business of selling widgets and that it has a supplier of input goods that wants to "lock up" the PortCo's

business. So, in exchange for the supplier agreeing to discounted pricing, the PortCo enters into a supply agreement with the supplier that says the PortCo will not buy input goods from any other supplier. This contract provision can become a significant hurdle for the PortCo if, as part of its organic growth and focus on operational value creation, it identifies a supplier that can supply the input goods with shorter lead times, better pricing, or other more favorable terms. Even more, this provision could create issues for add-on acquisitions if the target company has an agreement in place with a different supplier that would put the PortCo in breach of its agreement with the current supplier.

Restrictive covenants and exclusivity provisions may also create issues at exit. Every potential acquirer will scrutinize these provisions because they can prevent or complicate certain plans the acquirer may have for the acquired business. Even worse, these provisions may prohibit activities that acquirer is already engaging in prior to the acquisition, potentially putting the acquirer in automatic breach of the PortCo contract if the acquire assumed the contract. So, prior to agreeing to any restrictive covenants or exclusivity provisions, a PortCo should analyze the impact such provision may have at exit.

Key takeaway: **A PortCo should analyze all restrictive covenants and exclusivity provisions not only from the perspective of the PortCo's current operations, but also from the perspective of the PortCo's future operations and impact on future acquirers.**

Affiliate Rights and Restrictions

PortCos also need to be aware of rights and obligations in commercial contracts that are granted to or imposed upon its "affiliates." "Affiliate" definitions vary widely, but they usually include a contracting party's parent, sister, and subsidiary companies. For many companies, this "family of companies" is comprised of different legal entities that are all engaged in the same business enterprise. For PortCos, however, "affiliate" definitions, if not drafted correctly, could be interpreted to include other PortCos that are owned by the same private equity sponsor or fund. This interpretation could lead to many unintended consequences. For example, a PortCo may agree to a customer non-solicitation clause in a commercial contract that applies to it "and its Affiliates." If the Affiliate definition includes other PortCos owned by the same private equity firm or sponsor, the contracting PortCo may breach that non-solicitation clause if one of the other PortCos owned by the same private equity sponsor or fund solicits the other party's customers.

Key takeaway: **A PortCo may have little or no operational relationship to its "Affiliates." A PortCo's legal counsel should carefully review all commercial contracts for "Affiliate" definitions and rights and obligations that are granted to or imposed upon the PortCo's "Affiliates."**

Conclusion

After receiving an investment from a private equity firm, a PortCo should review its commercial contracts with a new or enhanced level of scrutiny. Further, PortCos operate in a unique environment that creates special considerations for PortCo commercial contracts. When reviewing commercial contracts, the PortCo, and its legal counsel, should focus on: (i) the PortCo's current business operations; (ii) organic growth of the PortCo; (iii) growth of the PortCo via add-on acquisitions; and (iv) value of the PortCo at exit.

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