10 Key Contract Issues for Tech Startups

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Startups move fast and ask questions later. This approach is great for business and necessary in the early days of a company's lifecycle when time, cash and other resources are at a premium. However, tech startups would be wise to - *slightly* - alter this approach when handling certain legal matters. Although startups can't allocate a large percentage of their limited resources to address every legal risk to perfection, it is critical to address key issues in the early days (when it is easier and cheaper to do so) to prevent catastrophic scenarios down the road.

Commercial contracts that receive little or no attention during the startup phase frequently create issues later in the company's lifecycle. These issues can risk the company's intellectual property rights and "put hair on" financing and corporate deals. In the worst case scenarios, these issues can cost the company millions of dollars.

Below is a brief summary of some commercial contract issues that can create material issues for tech startups if not properly addressed at the time of contracting.

1. **Memorialize Commercial Arrangements in Writing**. Every key business arrangement should be in writing. Neither the startup itself, nor potential investors and acquirers, want to rely on oral statements, emails, texts, etc. to determine the terms of the startup's business arrangements. The point here is simple – reduce all important business arrangements to a written contract.
2. **Contracting Parties**. Startups routinely enter into contracts under the wrong party. Sometimes contracts are entered into under an unofficial trade name (or "dba") or by an

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individual. Sloppy contracting practices like this can lead to many unintended consequences, including creating personal liability for the startup founders that legal entity formation is designed to prevent.

3. **NDAs and Confidentiality**. NDAs can seem like unnecessary, standard documents that should never require any attorney review or negotiation. Unfortunately, that is not the case. With limited exceptions, tech startups need to get NDAs in place with every party that receives any confidential information from the startup. Failure to do so can cause the startup to lose trade secret protection on information that it discloses – a potentially disastrous consequence that potential investors and acquirers will consider when evaluating a deal. Further, companies sometimes "sneak in" problematic terms in "standard" NDAs, including broad indemnities, intellectual property licenses, non-competes and non-solicits. A startup should ensure that provisions like these are not in NDAs proposed by other parties.
4. **Intellectual Property**. Intellectual property matters are likely the most critical commercial contract issue for startups and are regularly mishandled by startups. For all parties that contribute or develop intellectual property to be owned by the startup, whether such parties are founders, owners, employees, individual independent contractors or third-party companies, specific "magic language" must be included in the applicable contract to ensure that the startup owns all of the applicable intellectual property rights. In most cases, the startup will not own the intellectual property simply because it paid a party to develop it or the contract contains a provision that says "*Company shall own all intellectual property rights*." If a company fails to insert the required language at the time of contract, the company may find itself in the unenviable position of going back to the other party asking such party to amend the contract– typically in the midst of a corporate deal after the intellectual property has proven to be valuable. Of course, the other party will have leverage to demand payment or other concessions in exchange for "fixing" the contract terms.
5. **Term and Termination**. Every commercial contract should have a defined term and termination rights that are appropriate for the arrangement. There are no "standards" here. On the supplier and in-bound licensing side, a startup should consider whether it needs flexibility to terminate the arrangement at any time and whether it needs a long term commitment from the other party. Investors and acquirers will scrutinize supplier-side agreements to ensure they can rely on such arrangement remaining in place after the deal closes. On the customer and out-bound licensing side, a startup should ensure that its customers do not have termination for convenience rights. An investor or acquirer may exclude from valuations customer contracts that contain termination for convenience rights.
6. **Price and Payment Terms**. Perhaps surprisingly, commercial contracts are often imprecise on price and payment terms. As with every term, clarity is key here. Commercial contracts should be precise on what the payment amounts are, how the payments are calculated (flat fee, time and materials, etc.), when the payment obligations start and end and which payments are applicable to which goods, technology and services provided under the

agreement. Also, startups should think long and hard before agreeing to long term price locks or "most favored nation" pricing in its customer agreements. These terms can reduce value in corporate deals.

7. **Exclusivity.** Granting exclusivity to a customer or other party may not be problematic in the startup phase, but such provisions can create serious issues for investors and acquirers that have plans to grow the startup's business. A tech startup may be tempted to grant a big customer exclusivity within a certain industry or territory to land a big account and receive much needed cash. This deal may be beneficial in the short-term for the startup but cause future investors and acquirers to materially reduce the valuation of the company (or walk away from a deal) if the exclusivity provision prevents the investor or acquirer from implementing a strategy to grow the company's business in the excluded industry or territory.
8. **Non-Competes and Other Restrictive Covenants**. These provisions create similar issues for investors and acquirers that exclusivity provisions create. Non-compete provisions that prevent the startup from competing in certain industries or territories could be in direct conflict with investors' and acquirers' growth plans for the business.
9. **Affiliates.** Commercial contracts can grant rights on behalf a party and its "affiliates." Commercial contracts can also impose obligations on, and grant rights to, a party and its "affiliates." Definitions vary, but "affiliates" typically includes a party's parent companies, subsidiaries and sister companies. Startups should negotiate "affiliate" provisions with the future in mind because the "affiliates" definition may include new parties after a corporate deal closes. For example, a startup may agree to a provision that says, "*Company and all of its Affiliates shall refrain from selling Goods, or any similar goods, to Customers in the Territory*." This may be an acceptable restriction for the startup at the time the contract is entered into, but investors and acquirers that already sell such goods to such customers, or plan to in the future, are or will be in breach of this provision.
10. **Assignment and Change of Control.** Assignment and change of control provisions are classic provisions that are always scrutinized by potential investors and acquirers. Assignment provisions typically prevent a contracting party from transferring the contract to another party. Change of control provisions typically grant a party a right to terminate the contract if more than 50% of the other party's ownership changes hands. Potential investors and acquirers may discount agreements from the startup's valuation if the other party will have the right to terminate upon the deal closing. Further, like intellectual property terms above, the company may find itself in the unenviable position of going back to the other party asking it to amend the contract or consent to the assignment of the contract – giving the other party leverage to ask for payments and other concessions in exchange for such consent.

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The list above is not exhaustive, but it provides startups with basic guidance on some of the commercial contract terms that routinely create issues for companies in the years following the startup phase. Tech startups should have legal counsel pay attention to these issues to prevent spending much more money later on “fixing” these issues.