KTI
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KTI Practical Guide
to Spin-out Company Agreements

Foreword

The KTI Practical Guide to Spin-Out Company Agreements and its Companion Guide have been produced as resources for those approaching transactions between Irish research performing organisations (RPOs)[1] and commercial companies. The Practical Guide together with the Companion Guide, explains common terms in the agreements and describes the considerations that might apply. The Guides are offered as a starting point for drafting and discussion.

The Companion Guide to this Practical Guide contains a suite of template Model Agreements and associated documents suitable for use in the early stages of spin-out company formation. These take account of the legal constraints upon RPOs when entering into contracts, as well as the unique nature of RPOs, whose primary purpose is not-for-profit rather than commercial. At the same time, the terms of the agreements seek to address the typical commercial priorities of companies. The Guides are based on European best practice. The Model Agreements contain detailed drafting notes to aid consideration of the issues involved. Neither companies nor RPOs are mandated to use the Model Agreements.

The Model Agreements, without drafting notes, are available in Word format on the KTI website to download and use directly.

Disclaimer

Parties should take their own legal advice on the suitability of any model agreement for their individual circumstances and on associated legal and commercial issues. Neither Knowledge Transfer Ireland, Enterprise Ireland nor any of the individuals or organisations who have produced or commented on these documents assumes any legal responsibility or liability to any user of any of these model agreements or commentaries.

1 RPOs are considered to be Higher Education Institutes (Universities and Institutes of Technology) or State research organisations

Contents

Chapter One
Introduction to Spin-Out Company Agreements

Introduction to spin-out companies and agreements

What is a spin-out company?

The term spin-out refers to the fact that the RPO's intellectual property (IP) is 'spun out' from an academic environment into the commercial arena. The term *spin-out company* is a convenient label for a company that, typically:

- is incorporated by a 'founder' (i.e. an academic and/or an external person associated with the business proposition) or an RPO;
- acquires IP from an RPO with a view to developing and commercialising that IP;
- acquires funding from outside investors, usually in return for shares in the company;
- has several shareholders who (by the time outside investment has been obtained) may include the RPO, the founders (e.g. the key academics and/or possibly any senior managers), and the investor(s); and
- is (at least in its early days) a small-to medium-sized enterprise whose assets, other than IP, may be limited.

Why are spin-out companies formed?

Forming a spin-out company is one of the ways in which an academic or an RPO can arrange for the further development and commercialisation of technology. Other routes to commercialisation include licensing an established company or making the technology freely available, e.g. through scientific publications, in the hope that commercial enterprises will use the technology in commercial products and services.

Who forms the spin-out company?

This question arises at both a technical level (i.e. who incorporates the company at the Companies Registration Office Ireland) and at a more strategic level (i.e. who is responsible for managing the spin-out process). Who incorporates the company may raise tax considerations and tax issues are discussed in Chapter 5 of this Practical Guide.

The larger question is the extent to which the RPO (as well as the lead academics) should be involved in developing the spin-out proposition, finding investors and management of the company, appointing solicitors and negotiating the formation agreements, etc. In other words, should the RPO invest large amounts of efforts in, and be responsible for, managing some or all of the spin-out process, or at the other extreme should their role be limited to ensuring that the terms of any agreements do not adversely affect the RPO's interests?

Some RPOs take a relatively 'hands-on' approach to the formation of spin-out companies. However, other RPOs may take a more 'hands-off' approach, where the academics have primary responsibility for developing the spin-out proposition and the RPO's role is more reactive – to support the academics in an advisory capacity (if and when advice is sought), to give permission where needed and to ensure that the terms of the transaction do not expose the RPO to unnecessary liabilities. The degree of RPO input may depend, in part, on the local business environment in and around the RPO.

Typical process for setting up a spin-out company

Setting up and running a spin-out company typically involves a number of stages, which may include the following stages (not always in this order, and some of these stages may be simultaneous):

- **Start-up phase**
  - Initial discussions between the RPO and the academics, including initial due diligence on the IP and investigation of possible routes to commercialisation
  - Execution of confirmatory assignments by the academics in favour of the RPO
  - Preparation of a business proposition or business plan for the company
  - Incorporation of the company
  - Execution of an option agreement, or a standstill letter, by the RPO in favour of the founders or the company
  - RPO approval of the proposal to spin-out IP into the company

- **Structuring the deal**
  - Finding any investors and/or external management team that may be required for the company at this early stage
  - Agreement in principle between the RPO, the founding academics and any other stakeholders (e.g. investors and/or external management team) about the relative shareholdings, the scope of the IP to be put into the company, the business plan, the role of the academics and the RPO in the company, etc.

- **Detailed negotiations and formalities**
  - Negotiation of detailed agreements between the RPO, the foundering academics and any other stakeholders (e.g. investors and/or external management team), including any IP licence agreement, shareholders' agreement, director's appointment letters, consultancy agreements, etc.
  - 'Completion', which may include the licensing of the IP rights into the company, the receipt of investment by the company, the issuing of shares in the company, the appointment of directors and company secretary, etc.

- **Ongoing management of the company, including**
  - Employment of key staff, acquisition of premises, trading, etc.
  - Rounds of financing
  - 'Exit' strategy

What types of agreements are signed when a spin-out company is set-up and financed?

Setting up spin-out companies typically involves the negotiation and preparation of a large number of commercial documents that together can form a ‘bible’ of documents, several inches thick. The bible may include some or all of the following:

- Company formation documents
- Business plan
- Due diligence documents, including questionnaires, disclosure letters, etc.
- Documents recording the internal approval of the RPO to spin-out IP into the company
- Agreements over the allocation of shares between the RPO and the founders, etc.
- Preliminary agreements with investors, e.g. confidentiality agreement and term sheet
- Investment/shareholders’ agreement
- Constitution
- Confirmatory assignments of the IP from the academics to the RPO
- IP licence agreement
- Letters of appointment of the directors
- Consultancy agreements with key academics
- Employment contracts with key employees
- Share option schemes
- Property rental agreements, etc.

Why is there such a complex set of agreements?

Establishing a spin-out company involves a more complex set of agreements and documents than licensing to an established company. The spin-out company is at the centre of a web of relationships - with the RPO, founding academics, investors, directors, employees, landlords, insurers and others. Put another way, as well as licensing IP into the spin-out company, it is usually necessary to prepare and agree documentation in the following areas:

- Forming the company and providing it with a constitution, officers, etc.
- Establishing the corporate relationships
- Dealing with the intellectual property assets
- Running the company

It is important to separate the various aspects of the transaction into its component parts and to treat each as a separate (albeit simultaneous) transaction. There are several reasons for this, namely:

- It can simplify the negotiation by breaking it down into 'bite-sized' parts
- The parties to each agreement may be different and, where the RPO is a party, different parts of the RPO may need to be involved (e.g. Estates, HR)
- In most cases, each agreement should be capable of standing alone – the IP licence agreement is likely to outlive all the others
- Some of the agreements or documentation may need to be publicly disclosed (e.g. under the Freedom of Information Act 2014)

Which agreements are discussed in this Practical Guide?

This Practical Guide will discuss, at least briefly, the full range of agreements mentioned above. In view of the breadth of subject-matter of these agreements, and the limited space available, some topics are covered only in outline. The main focus of this Practical Guide will be on the corporate aspects, including the respective rights and roles of the RPO, any investors, the founders and the company.

Where are licences, options, consultancies and CDAs discussed?

Spin-out transactions usually include an agreement under which IP is licensed into the spin-out company. The detailed issues that arise in licence agreements are discussed in a separate KTI Practical Guide to Licence Agreements. The detailed terms of confidentiality agreements, consultancies and option agreements (all of which may feature in spin-out transactions) are discussed in other KTI Practical Guides as well.

Deciding whether to form a spin-out company

Spin-out company or traditional licence agreement?

The RPO will wish to consider, on a case-by-case basis, which is the best route to commercialise a package of IP. The role of the founding academics in this decision-making process will vary from RPO to RPO, but in any event they will usually be a good source of information. In many cases, the main alternatives will be (i) licensing the IP to an established company, or (ii) licensing the IP into a spin-out company.

Some RPOs have the following factors (amongst others) in mind when deciding whether to form a spin-out company or to license an established company:

- What opportunities have presented themselves for the particular package of IP? Are there potential or existing licensees for the technology?
- For some, the 'default' route may be a licence to an established company unless there is no natural 'home' for such a licence
- Licensing may not be the best way to reap the value in a product with potential that is at a very early stage of development – it may be better to find ways of 'adding value' prior to licensing or selling the IP (or any business that owns the IP)
- Where IP has multiple applications (e.g. where the IP is a 'platform' technology), forming a spin-out company is sometimes seen as a better route for the RPO than granting numerous non-exclusive licences
- The character, personality and commitment of the lead academics are usually important factors: is he or she suited to being involved in a spin-out company and committed to devoting sufficient time on the spin-out, and (if a full-time commitment is required) does he or she want to move away from an academic career?

Establishing a spin-out company is not a quick or simple process. The academics, in particular, must be fully committed, and be willing to devote the necessary time involved. If they are not, the spin-out is unlikely to be successfully established.

Formation of the spin-out company

Tax considerations on company formation

At an early stage in the spin-out process, the spin-out company will be incorporated. There are various types of company that can be incorporated under the Companies Act 2014, including private companies limited by shares, designated activity companies, companies limited by guarantee, unlimited companies, public limited companies, etc. Typically, an RPO spin-out company will be a private company limited by shares.

The issue of shares in a spin-out company to an academic founder may create complex tax issues for the academic. Tax issues are discussed further in Chapter 5 of this Practical Guide. At this stage, it may be worth mentioning that sometimes, the spin-out company is formed by the academic at his or her own expense and without the involvement of the RPO. Initially, the academic is the sole shareholder. At a later point, the RPO and any other founders and investors subscribe for shares at the same time at which any IP is licensed and any investment is made into the company.

Tax issues also influence the terms of the spin-out agreements, the equity structure, and the allocation of shares, which will be discussed later in this Practical Guide.

Initial constitution

The constitution is a formal document required by the Companies Act 2014. Under the Companies Act 2014, private companies limited by shares have a one-document constitution. Other company types, such as designated activity companies, have constitutions comprising a memorandum of association and articles of association.

The Companies Act 2014 provides template constitutions for each of the different types of companies that can be incorporated in Ireland. The company can choose to adopt the appropriate statutory constitution or to draft a bespoke constitution specific for the company.

The template constitution included in the Companies Act 2014 for a private company limited by shares is a fairly short and simple document. At a minimum, it requires only the following information to be specified in the correct format:

- The company’s name
- That the company is a private company limited by shares
- That the liability of its members is limited
- Certain details about its share capital, i.e. either (i) if the company has an authorised share capital, what that authorised share capital is and how it is divided, or (ii) if the company does not have an authorised share capital, how its share capital is divided
- The number of shares taken by each subscriber

There is sometimes an overlap between matters covered in the constitution and matters covered in any investment/shareholders' agreement that may be drawn up for the company. This is discussed further below.

Business plan

A draft business plan will typically evolve in the course of discussions and may not be finalised until shortly before the formal agreements (e.g. the IP licence agreement and the shareholders' agreement) are signed. Some RPOs take the view that they will not even consider whether to approve the spin-out proposition until they have seen a proper business plan. However, in other cases, the RPO may be initially satisfied with a written business proposition on the assumption that a detailed business plan will be prepared at the time of any external investment.

When investors are involved – reaching agreement in principle

Are the interests of the investors, the founders and the RPO aligned?

If there are to be any investors in the spin-out company, at an early stage in the negotiations, the founders and the RPO should try to establish, through discussion with the investors and other due diligence, whether the investors' objectives for the spin-out company are aligned with those of the RPO and the founders. For example, are the investors' required timescales for 'exit' from the company consistent with the anticipated funding requirements of the company? Do they understand the technology and how it is likely to be commercialised? Aspects of the investors' general approach may be gleaned from the draft agreements that they present, e.g. in the areas of warranties, preferential rights, etc.

Due diligence and presenting a clean IP package

Any investors will usually wish to do extensive 'due diligence' investigations on both the IP and the business proposition. As part of this process, they will likely ask detailed questions of the RPO and the founding academics concerning such matters as who created the IP, the terms of any research contracts or other obligations (e.g. grant conditions) affecting that IP, whether any third-party infringements are known to them, etc.

The investors may also ask the RPO to give warranties about the state of the IP, against which the RPO may make disclosures of any problems or issues known to it. The extent to which the RPO may be willing to give warranties is discussed further below. In practice, on many issues the RPO will be reliant on information provided to it by the founding academics, as RPO employees. There may be other matters that the academics (as founders) may be asked to warrant in a personal capacity.

The investors will almost always seek to impose a financial penalty should any of the warranties be breached. The existence of the penalty should focus the mind of the founders and the RPO alike and help to ensure that they conduct their own due diligence with care, especially in relation to encumbrances on the IP that is to be licensed.

The RPO may already have conducted some due diligence at an early stage in the spin-out process, e.g. by asking the founding academics to complete a detailed questionnaire. The RPO may also have information provided by its patent agents, e.g. on the progress of patent applications through national patent offices. Usually, the RPO will not have invested in infringement searches.

As part of the RPO's due diligence activities, the RPO should obtain any necessary assignments of the IP from the relevant academics and others (e.g. collaborating institutions that contributed to the IP in question). Depending on the terms of any funding of the research that led to the IP being generated, it may be necessary to obtain consents from funding bodies to the licensing of the IP into the spin-out company.

The RPO should consider preparing, at an early stage in the spin-out discussions, a due diligence 'pack', both for its own purposes in deciding whether to go ahead with the spin-out company and which could also be handed to any investors. The due diligence pack may include, amongst other things:

- How and by whom the IP was developed, and whether the developers were employees of the RPO
- Copies of any contracts or grant terms under which the IP was developed
- Whether the academics are aware of having used any third-party IP or materials in the development of the IP to be licensed to the spin-out company
- What specific IP has been created, including details of any patents, design rights, etc. and the names of the academics or other contributors to that IP
- Copies of any assignments or contracts under which the RPO has acquired title to such IP (e.g. from the academics) and any other relevant documents (e.g. consents from funding bodies to the licensing of the IP to the spin-out company).

A good quality due diligence pack should assist the RPO and any investors to understand what IP the spin-out company will have. It may also reassure any investors about the state of the IP, so that they will be persuaded not to spend time in demanding onerous warranties from the RPO or the academics.

Ideally, the RPO should also consider whether the IP package can be bolstered prior to licensing to the spin-out company, e.g. by applying for further patents, but resource issues may limit the RPO's ability to do this in all cases.

Key terms of the deal

Before negotiating the detailed terms of spin-out agreements, the parties will usually wish to discuss and agree the general structure of the deal, including key terms.

The key terms will vary from deal to deal, but may include:

- A brief statement of what the company will do
- A description of the IP to be licensed into the company
- A summary of the main warranties that may be required
- The amount of any investment
- The relative shareholdings of the parties and any special rights (e.g. liquidation preferences) or restrictions (e.g. vesting periods) attaching to any shares
- The composition of the board
- The role of the academics in the company
- 'Exit' strategy (i.e. how any investors will realise their investment)

Signing a term sheet

Sometimes, the parties wish to sign a preliminary document to record their agreement in principle to the key terms of the deal. These preliminary documents have a variety of names – MOUs, letters of intent, heads of agreement, heads of terms, term sheet, etc. For convenience, they will be referred to in this Practical Guide as term sheets. The name is less important than being clear as to whether the document is intended to be legally binding. This is discussed further in Chapter 2.

Negotiation of the detailed agreements

Who should draft the spin-out agreements?

Investors usually require that their solicitors prepare the first drafts of the agreements, using the investors' standard templates. If the founding academics are required to sign any agreement in a personal capacity, they should seek their own independent legal advice before doing so.

Spinning out before investors are involved - reaching agreement in principle

Many of the considerations set out in the previous section headed "When investors are involved - reaching agreement in principle" will also apply when a company is being spun-out of an RPO before investors are involved. However, before investors are involved, it may be that the same level of detailed due diligence and documentation are not required at this early pre-investment stage. As a general guide, though, the following should be taken into consideration:

Are the interests of the RPO and founders aligned?

The founders may be the lead academic(s) and any external business managers(s) who have been involved in developing the spin-out company proposition and who will remain involved with the company post-formation. The RPO should try to establish, through discussion, whether the founders' objectives for the spin-out company are aligned with those of the RPO. For example, are the founders' plans for company development and investment and their timescales for 'exit' from the company realistic? Are they clear about the pathway for development and commercialisation of the technology and the funding (and funding rounds) likely to be required? Do they understand the time they will need to devote to the company, and do they have that capacity? Do they understand their respective roles? Are there any conflicts of interest and, if so, how do they need to be notified within the RPO, etc.?

Due diligence and presenting a clean IP package

As investors will usually wish to do extensive 'due diligence' investigations on both the IP and the business proposition, it makes sense to start to develop the IP due diligence pack at an early stage. This may include documentation evidencing such matters as who created the IP, the terms of any research contracts or other obligations (e.g. grant conditions) affecting that IP, whether any third-party infringements are known to the founders, etc. A properly used Innovation Disclosure Form (IDF) is a good starting point for this. A KTI Model IDF is available on the KTI website. The RPO may also have information provided by its patent agents relevant for the IP in question, e.g. on the progress of patent applications through national patent offices. Usually, the RPO will not have invested in infringement searches.

As part of the RPO's due diligence activities, the RPO should obtain any necessary assignments of the IP from the relevant academics and others (e.g. collaborating institutions that contributed to the IP in question). Depending on the terms of any funding of the research that led to the IP being generated, it may be necessary to obtain consents from funding bodies to the licensing of the IP into the spin-out company.

Key terms of the deal

Before negotiating the detailed terms of spin-out agreements, the parties will usually wish to discuss and agree the general structure of the deal pre-investment, including key terms.

The key terms will vary from deal to deal, but may include:

- A brief statement of what the company will do
- A description of the IP to be licensed into the company
- A summary of the main warranties that may be required
- The relative shareholdings of the parties and any special rights (e.g. liquidation preferences) or restrictions (e.g. vesting periods) attaching to any shares
- Maintenance of the RPO's shareholding in the company until the company has reached a certain minimum level of investment
- The composition of the board
- How certain decisions are to be taken for the company
- The role of the founding academics in the company

Signing a term sheet

Sometimes the parties wish to sign a preliminary document to record their agreement in principle to the key terms of the deal, and this preliminary document is referred to in this Practical Guide as the term sheet. This is discussed further in Chapter 2.

Negotiation of the detailed agreements

Who should draft the spin-out agreements?

Where a company is being formed without external investment, RPOs generally require that their standard templates be used. Founders should seek their own independent legal advice before signing.

Chapter 2
Key Negotiating Issues in Spin-Out Company Agreements

This chapter will focus on the core provisions of certain types of spin-out agreement. Given the variety and complexity of some spin-out transactions, the following text is not meant to be comprehensive. Some further issues are discussed in Chapter 4.

Term sheets

Are they legally-binding?

Once the key terms of the deal have been agreed in principle, the parties sometimes prepare a document recording these key terms. The document may be called a memorandum of understanding (MOU), letter of intent, heads of agreement, heads of terms, or term sheet. For convenience, such documents are referred to as term sheets in this Practical Guide.

There is no automatic assumption that term sheets are binding, or not binding, under Irish law. If the term sheet does not state whether it is intended to be binding, it is necessary to go back to first principles on what makes a legally-binding contract under Irish law (as to which, see the KTI Practical Guide to Legal Issues on Contracts with RPOs).

To avoid uncertainty, the term sheet should state clearly whether or not it is intended to be legally binding. Usually, the parties will not intend the term sheet to be legally binding, except that sometimes the parties intend one or two provisions to be legally binding (e.g. confidentiality and an exclusive negotiation period) and the rest of the document not. Sometimes, terms sheets also set out a process and a timetable for agreeing the terms of the spin-out agreements.

Exclusivity

The key issue in term sheets (leaving aside the commercial terms of the proposed deal that are summarised in the term sheet) tends to be whether the RPO is bound to a period of exclusivity with any of the other parties, and the duration of any such period. Arguably, if none of the other parties are contractually committed in some material respect to the company, nor should the RPO be committed to negotiate exclusively with that company. However, limited periods of exclusivity may be justified where a party (such as a founder or an investor) intends to devote substantial resource e.g. in business planning or in due diligence as part of the pre-investment process.

Where exclusive periods are agreed, it is suggested that they should be for limited periods, and not subject to extension at the discretion of another party (such as an investor) or if negotiations are continuing at the end of the specified period.

Sometimes, it may be more appropriate:

- To state that the negotiations are non-exclusive
- To declare the RPO's intention to negotiate, but state that this is non-binding and that the RPO may withdraw from the negotiations at any time without liability
- To agree that the negotiations will be exclusive until such time as the RPO informs the other parties that it intends to hold discussions with other persons (in addition to, or instead of, those parties)

IP agreements

An important part of any spin-out transaction is to define precisely what IP is to be licensed into the spin-out company and on what terms.

General practice is that an RPOs will license their IP to spin-out companies on commercial terms, which would usually include royalty and other payments. However, some investors argue that:

- The company needs to own the IP (rather than licence it) in order to increase the value of the company and attract further investment; and
- The RPO is receiving shares in the company in return for transferring IP into the company, and it is inappropriate that the RPO should also be entitled to royalties and other payments for that IP.

Counter arguments to the above points are as follows:

- The transfer of IP should be by means of a licence rather than an assignment, because the RPO requires a degree of control over IP generated at the RPO. The RPO would not assign the IP to an established company but would license it, and similar considerations apply to spin-out companies, or more so because spin-out companies are high-risk ventures. It may also be worth pointing out that referring to the spin-out company as a high-risk venture is not to doubt the quality of the IP, but companies of this kind tend to be financially fragile, e.g. because they might not raise further money when it is needed, or because it costs more, or takes longer, than anticipated to reach development milestones.
- Some RPOs are willing to allow the licence to convert to an assignment once the spin-out company has satisfied certain conditions, such as raising a pre-defined amount of money, which then gives the company a degree of financial stability.
- The RPO's shareholding does not represent consideration for the transfer of IP, but instead is recognition for:
  - — the RPO's support of the academic's work;
  - — allowing the academic to pursue the spin-out opportunity;
  - — incurred expenses / investment associated with the research and IP, and management time in progressing the spin-out opportunity;

  - the inherent value brought to the company through being associated with the RPO; and
  - the state resources that have underpinned the development of the commercial proposition.
- By the time of any floatation or other 'exit', there may have been several further rounds of investment, which may dilute the RPO's shareholding to a very small percentage, and which may not represent full commercial value for the IP.
- Accordingly, the licence should be on normal commercial terms, such as those that would be agreed with an established company.
- Not all of the academic inventors of the IP receive shares in the spin-out company. In order to "compensate" such non-shareholder academics under the RPO's revenue sharing scheme, and in order to protect their interests, it is necessary to include financial terms in the licence agreement.
- For the reasons outlined above, RPOs consider that negotiations over the shareholding of the RPO and negotiations over the financial terms of the IP licence should not be linked.

For a discussion of the commercial terms that may be included in a licence agreement, please refer to the KTI Practical Guide to Licence Agreements.

Improvements, pipelines, research contracts and consultancies

Investors tend to be risk-averse in the contract terms that they demand from RPOs, usually more so than an established company that takes a licence to the RPO's IP. This may partly reflect the different perspectives of the investor and the established-company licensee. The established company may already be familiar with the general field of the licensed IP and with the development of commercial products and services in that field. It may understand, and be comfortable with, the commercial risks associated with the IP. Certain investors may have a similar familiarity with the technical and commercial aspects, but in many cases the investors' expertise may lie more in financial matters, and it may be relying on cautiously-drafted professional opinions on the IP and markets involved. The investors may also be used to dealing with larger investment propositions with established companies, where detailed warranties are an expected part of the transaction.

Whatever the reason, investors and their lawyers seek to close loopholes and gaps, real or perceived, that may reduce the value of the investment. Much of the documentation presented to the founders and/or the RPO by the investors can be viewed as a series of risk-reduction or risk-management terms for the investors[2]. This partly explains the length and complexity of some of these documents. In the area of IP, these perceived risks may include:

- The risk that the next generation of technology is 'just around the corner' and may 'wipe out' the value of the spin-out company.
- The risk that the RPO may develop that next generation of technology and may not provide it to the spin-out company (e.g. if the academics become disenchanted with the company and seek to license subsequent inventions to another company or even set up another spin-out company).

2 For pre-investment spin-out companies, much of the 'investor' negotiations described in this section will be handled by the company and not the RPO.

- The risk that the RPO's IP may not prevent competitive products from reaching the market, or that the IP is tainted in some way with third-party rights.
- The risk that technical difficulties will prevent the IP from being developed into a commercial product without the involvement of the lead academics.

One way that the investor seeks to assess and manage these risks is through due diligence and warranties, discussed below. Another way is through seeking to obtain both rights to future IP generated at the RPO and ongoing access to the lead academics. The latter way can take a number of forms, for example:

- Asking for automatic rights to any improvements or further developments of the IP that the RPO may make
- Entering into a research collaboration agreement with the RPO under which the company acquires rights to the 'next generation' of IP
- Entering into personal consultancy agreements with the lead academics, under which they provide advice and support to the spin-out company. Usually, by the terms of the consultancy agreement, the spin-out company will own any IP generated in the course of such consultancies

Some of the key negotiating issues for the RPO will be the following:

- Improvements: Is the RPO willing to grant rights to improvements and further developments? Some possible ways in which RPOs address this point are:
  - To grant no automatic rights to improvements or further developments, but to maintain a regular dialogue with the spin-out company so that they know if new improvements or developments are being made. If the lead academic is a consultant to the spin-out company, this is likely to happen without the need for any contractual terms on the subject. The RPO may also suggest that if the spin-out company wants rights over new improvements and developments it should fund a research contract in the department under which those improvements and developments are likely to be made.
  - To grant an option to the spin-out company over very tightly-defined improvements and developments. An example of such an option agreement appears in the KTI Practical Guide to Option Agreements. Typically such options may be limited in time (e.g. no more than 2-3 years from the date of the spin-out transaction), by department (e.g. only work done by the lead academic or under his or her supervision in his or her department, excluding any joint developments with other departments or institutions), and by source of funding (i.e. excluding work that is 'encumbered' by the rights of the sponsor or funder).
  - As an alternative or additional approach to the previous one, to grant rights only to improvements and developments that are 'not severable', i.e. which do not generate any IP that can be used without infringing the original IP that was licensed to the spin-out company.

If the RPO is willing to grant rights to improvements and further developments, whichever route is chosen to give the company access to them, the parties should consider whether the company is providing the RPO with fair market value for the improvements and developments. If not, the access could be a form of unlawful state aid, which topic is discussed in the separate KTI Practical Guide to Understanding EU State Aid Legislation in Research.

- **Research collaboration:** What are the IP terms of any new contract for a research project under which the spin-out company funds work in the lead academic's department? What types of additional payments are to be made for that new IP, e.g. upfront, milestone and royalty payments and/or further issue of shares to the RPO? These results will be new technology and should be subject to arms' length IP terms such as would be applied to any other sponsor of research.
- **Consultancy terms:** What are the terms of any consultancy agreement between the academics and the spin-out company, and might these potentially be detrimental to the RPO's IP interests? Specific concerns include:
  - Some RPOs require all private consultancy agreements to include wording in which the company acknowledges that it will not be gaining access to any IP of the RPO by virtue of the consultancy, and that the consultant is not authorised to make any commitments on behalf of the RPO.
  - Some spin-out companies' standard consultancy agreements have been adapted from employment contracts and include (a) wording stating that the consultant's first duty is to the company, and (b) restrictions on the consultant undertaking any work, or any competing work, for any other organisation. Such provisions need to be modified to make it clear that, as long as the academic remains an employee of the RPO, his or her first duty is to the RPO, and that any restrictions on the academic relate only to his or her activities as a private consultant, and do not restrict the RPO from entering into any agreement in which the academic is to perform research or other services.
  - Generally (and not just in spin-out transactions) consultancies should not be used as a disguised form of research contract, with lower overhead charges and IP terms that tend to be more favourable to the company than would be accepted in a research contract. One way of doing this is to include in the wording of the consultancy agreement a tight description of the consultancy services, i.e. one that is narrower than any services that the spin-out company may ask for across the entire range of the academic's expertise. For example, the consultancy might be limited to assistance with certain aspects of the development of specific products, or attendance at the company's scientific advisory board.

In all the situations described above, the RPO will want to ensure that any conflicts of interest are properly managed and reported according to its own governance requirements.

IP warranties

The negotiation of warranties may reveal significant differences of expectation between an investor and an RPO.

Put simplistically, from the investor's point of view, it is investing in IP assets, and it wants to understand and limit the risks associated with those assets. As a non-specialist in IP, the investor may feel that the creator of the IP should bear some of the risk that the IP doesn't 'do what it says on the tin'. The investor's background may be in acquiring companies and established assets where it is conventional to include very extensive warranties in the sale of business agreement.

From the RPO's point of view, the spin-out company is being set up to take an academic's bright ideas and research results and turn them into commercial products. It is not in the business of taking on commercial risks associated with the IP being licensed, as would be implied by giving extensive IP warranties.

Some RPOs take the position that all they are prepared to warrant is that they have obtained assignments from the academics. Specifically, they are not prepared to warrant:

- The source of the IP
- Whether the IP will 'work'
- Whether any applications for IP will be granted
- Whether any third party, other than the named academics, has any rights in the IP
- Whether the use of the IP will infringe any third-party IP
- Whether the IP will be effective to prevent third parties from competing with the spin-out company, etc, etc.

Sometimes, the investor persuades the RPO that it should warrant that it is not aware of any problems such as those outlined above. In such circumstances, the RPO should be very careful to identify whose awareness is being warranted, e.g. it should be limited to a named individual who is project-managing the IP. Given that patent applications often result in objections from the examiner or third parties, any such warranties will need very careful drafting.

Best practice may suggest that the RPO should not warrant anything that it does not know. But investors sometimes argue that certain facts should be known to the RPO (e.g. an IP ownership position). The RPO should carry out due diligence before agreeing to give any warranties. In the heat and momentum of a deal it is very easy to acquiesce to a warranty in order to 'get the deal done', but an RPO is likely to take an extremely dim view of any individual who is found to have warranted a fact (i.e. made a contractual promise) that was false, especially if the investor brings a claim for breach of the warranty.

A separate set of warranties may be sought as to the circumstances in which the IP was generated, e.g. did it result from an RPO project that was funded by an outside organisation, and what IP terms were associated with the funding. These types of warranties tend to be more factual and may be easier for the RPO to give. But, as with all warranties, the precise wording of the warranty needs to be carefully scrutinised to ensure that it is not asking for something that the RPO cannot, or is not willing to, promise.

Often, in spin-out transactions, the academics who are shareholders in the company, sometimes known as founders, will be asked to give personal warranties. This is obviously a matter on which they should seek their own legal advice and the RPO should take care not to give advice to the academics.

Disclosure letters

Conventionally, a party giving warranties makes 'disclosures against the warranties', i.e. discloses to the other party matters that are exceptions to the warranties. For example, if there is a warranty that all the academics named on a patent application are employees of the RPO, and the RPO is aware that one of the academics was not an employee, it might disclose that fact to the investors. In corporate transactions, disclosures are usually set out in a formal disclosure letter, which is delivered to the investors at the time, or shortly before, the shareholders' agreement is signed. Disclosure letters usually include some important 'boilerplate' language (e.g. that each disclosure is made against all the warranties, even though it may refer only to one or some of the warranties). The wording of disclosure letters is a matter on which legal advice should be sought.

Some of the technical aspects of drafting warranties are discussed further in the KTI Practical Guide to Legal Issues in Contracts with Research Performing Organisations.

Limiting liability for breach of warranty

Both the RPO, and any academics who are giving personal warranties, will typically wish to limit their liability for breach of warranty. Sometimes, such limits are linked the value that the RPO and the academics, respectively, are deriving from their shareholdings and should be considered carefully.

The wording of warranties, limitation of liability, and other 'legal' clauses requires particular care and should be reviewed by the RPO's lawyers and the lawyers of any appointed by the founders to advise them personally.

Shareholders' agreement and constitution

Introduction

Shareholders' agreements (sometimes called subscription or investment agreements) tend to be lengthy documents. Together with the company's constitution, they set out a detailed set of rules governing the relationship between the shareholders, any special rights attaching to any of the shares, transfer of shares, decision-making by the board and shareholders, etc. Some of these provisions could be included in either the constitution or the shareholders' agreement or in both documents.

Different classes of shares

Any investors will almost certainly require that they be issued with a special type of share that gives them advantages over other shareholders. A common requirement is that they receive 'preferred ordinary shares' which may carry a right to special dividends and/or enhanced voting rights, whilst other shareholders receive merely 'ordinary shares', which come bottom of the pile in any distribution of assets. Generally, companies with several shareholders may be set up with each shareholder having a different 'class' of shares, which gives the holders of each class certain 'class rights'. However, the complexity of the deal proposed should be weighed against the stage in the company's life-cycle to ensure that things are kept in proportion.

Decision-making

Typically, the shareholders' agreement will include a list of certain matters that cannot be decided without the agreement of certain shareholders, typically the investors or those that own more than a certain percentage shareholding in the company. Sometimes the shareholders' agreement may include two lists, one for shareholder decisions and one for board decisions. Although these lists are fairly standard, they should be checked for practicality in the particular circumstances of the company.

First return of capital

Investors may require that on any sale of the business or winding-up, they will receive a multiple of (e.g. twice) the amount that they invested in the spin-out company, before any remaining proceeds are distributed to the other shareholders.

Issue of new shares; transfer of existing shares

There are several, related issues, some of which have acquired their own catchphrases (see headings below):

- **Pre-emption rights on issue.** In general, pre-emption rights on a share issue provide protection to existing shareholders against dilution of their shareholding by providing them with a right to be issued with further shares (at a certain price) on any new issue of shares by the company. Accordingly, one of the points typically covered in a shareholders' agreement is whether any shareholder (e.g. a minority shareholder) is to be protected from the majority issuing new shares to themselves (or others) that dilute the shareholding of the minority shareholder.
- **Pre-emption rights on transfer.** Similarly, a shareholders' agreement may also provide for pre-emption rights on any transfer of shares, if the existing shareholders want a mechanism to control whether any 'outsider' can become a shareholder in the company. Accordingly, a pre-emption mechanism on a transfer of shares may require an existing shareholder, if they wished to sell their shares, to first offer their shares to the other existing shareholders (at a certain price). If the other existing shareholders declined the opportunity to acquire the shares, the mechanism may also go on to set out whether the shareholder could then sell their shares to a non-shareholder or whether they could force the other shareholders to buy them.
- **Transfer to connected persons.** A 'connected person' in this context may be a family member or a family trust (in the case of an individual shareholder) or an affiliate (in the case of a corporate shareholder). Some shareholders' agreements set out whether a shareholder will have an automatic right, despite the pre-emption provisions, to transfer their shares to 'connected persons'.
- **Drag-along rights.** If the shareholders received an offer to buy all of the shareholding in the company, and a (specified) majority of the shareholders wished to accept the offer, a drag-along right would enable the majority shareholders to force the minority shareholders to sell their shares at the same price and on the same terms as the majority would sell their shares. Accordingly, drag-along rights are considered protection for the majority shareholders. However, they offer some limited protection to the minority in that they must be offered the same sale price and terms for their shares.
- **Tag-along rights.** Conversely, a tag-along right offers protection for the minority shareholders. If a (specified) majority of the shareholders were considering selling their shares, a tag-along right would force the majority shareholders to secure the same sale price and terms for the minority shareholders, so that they are not 'left behind' against their will or disadvantaged by their minority stake.

- **Compulsory transfer of shares by good/bad leavers.** Sometimes shareholders' agreements require certain shareholders (e.g. the founders or employees of the spin-out company) to hand back their shares to the company if they cease to be associated with the company (e.g. if they cease to be a director). Typically, such provisions distinguish between a 'good leaver' and a 'bad leaver'. An example of a good leaver would be someone who retired on grounds of ill-health, and a bad leaver would be someone who is dismissed or who voluntarily leaves before a defined date. Compulsory transfer provisions are sometimes different for managers and for founders.

It has become fairly standard to include provisions along these lines in the shareholders' agreement. Issues that are sometimes the subject of detailed negotiation include:

- The detailed mechanism for offering shares to other shareholders under pre-emption provisions.
- The price mechanism on compulsory sale. Some RPOs and founders take the view that it is desirable to include a provision for the board to try to agree the price mechanism first, rather than automatically going to an external person (such as an auditor) to set the price. This may reduce the company's liability to pay professional fees every time someone is the subject of compulsory sale provisions. Another issue that comes up is whether the price per share should take account of the fact that the selling party is usually a minority shareholder (minority shares are typically treated as worth less than majority shares). Usually, an RPO or a founder will push for the price not to be adjusted downwards to take account of this point.
- Any minimum period of involvement with the company (for good and bad leaver provisions).

Appointment of the board of directors

RPOs and investors often require a right to appoint a director – sometimes for as long as their shareholding remains above a certain threshold (e.g. 5-10% of the issued share capital). RPOs and investors sometimes also require a right to appoint an observer at board meetings, who is not a director. One of the reasons that a shareholder might elect to appoint an observer rather than a director is to avoid legal responsibility for the management of the company. For example, a director may be personally liable for trading if the company is insolvent. There are certain responsibilities that go with being a director and an observer of a company. KTI has produced a separate Practical Guide to the Role of Directors and Observers.

Decision-making

Further protection can be given to a shareholder by requiring that any board meeting, in order to be quorate, must be attended by its appointed director, or that director must waive his or her right to attend. The shareholders' agreement may also provide that certain board decisions can only be taken with the agreement of particular directors. These types of provision are rather 'heavyweight' and might sometimes be resisted by the RPO and other shareholders. In some circumstances, however, the RPO may wish to have its own veto rights, e.g. to prevent the spin-out company from taking decisions with regard to the IP that may negatively impact its value. For example, some RPOs may wish to have a veto over the spin-out company changing in a material way the nature of its business.

Non-compete obligations in shareholders' agreements

Shareholders' agreements sometimes include non-compete obligations on the academic shareholders. If the RPO is asked to accept a non-compete obligation, it may well wish to resist it. RPOs are large organisations and research may be conducted in another part of the RPO that might compete with the spin-out company or which might be spun out into another company. The RPO should not be prevented from conducting such other activities.

Personal non-compete obligations on the academic founders are a matter for the academics to decide (with their own legal advice), but, where the academic will remain working at, or engaged with, the RPO, any non-complete obligations should not interfere with the RPO's research activities involving those academics.

Information flow

It is conventional to include provisions under which each shareholder is entitled to receive management information including management accounts, either from the spin-out company or from 'its' nominated director. In the absence of such a provision, the RPO's nominee director might be in breach of his or her duties of confidentiality to the company if he or she provided such information to the RPO.

Consultancy / secondment / employment agreements

Spin-out companies do not always have the resources or need to employ a large full-time workforce. Various methods of 'staffing' are seen, including:

- Part-time consultancies with key academics who remain employees of the RPO
- Temporary secondment agreements, under which RPO employees remain employed by the RPO but are seconded to work full- or part-time for the spin-out company
- Service agreements under which individuals are employed full- or part-time by the spin-out company

As has already been mentioned above, the key negotiating issues in these agreements from the perspective of the RPO tend to be:

- Ensuring that the RPO's IP is not transferred to the spin-out company by the back-door route of a consultancy agreement
- Ensuring that the consultancy agreement is not a disguised research contract, and the scope of the consultancy is clearly ring-fenced, i.e. that it is concerned with a specific technical problem or area of activity that is narrower than the general areas of interest of the academic or his or her department
- Ensuring that any non-compete provisions or provisions requiring the academic to give their first loyalty to the spin-out company do not conflict with the RPO's ongoing activities or the academic's duties to the RPO

There may be other matters that would concern the academics, on which they should seek their own legal advice, e.g. liability clauses, financial arrangements, etc.

See further the KTI Practical Guide to Consultancy Agreements.

Property rental / facility / services agreements

Some spin-out companies seek to use the RPO's premises and facilities to conduct their business activities. Where this is available, the RPOs will take an 'arm's length' approach when providing such premises, facilities and services. The RPO should be aware of the RPO's policy on these matters and any written guidance (e.g. in their Financial Regulations).

It is not proposed to discuss property, facility and services agreements further in this Practical Guide, other than to mention that the individual within the RPO who is project-managing the RPO's interests in the spin-out company should be aware of all the relationships that the company has with the RPO, including any key dates such as the expiry date of any property rental agreement.

Chapter 3
Checklist of Preliminary Issues and Provisions Commonly Found in Spin-Out Agreements

Term sheets	• Does the term sheet state whether it (or any term in it) is legally binding? Usually most if not all provisions should be non-binding. • If an exclusive negotiation period is agreed, is the period clearly stated and appropriate?
IP licence agreements	• Has the IP to be licensed into the spin-out company been tightly defined? • Has the RPO obtained all necessary assignments of that IP from the academics? • Has the RPO considered whether the IP can be improved or bolstered by further applications, e.g. for patents? • Has the RPO investigated whether any sponsor or other third party may have rights in the IP, e.g. under the terms of any contract or grant under which the IP was developed? How are any such rights to be dealt with (e.g. by obtaining clearances, consents or assignments from the third party)? • If the RPO is giving any warranties in relation to the IP, has it investigated (e.g. with the academics) whether there are any potential breaches of warranty or matters that need to be disclosed against the warranties to the company / investors? • If assignment of the IP to the company is to take place on a future occasion, has the future occasion been tightly defined? • Does the licence agreement include other conventional provisions to protect the RPO's interests? For example, does the RPO retain a right to use the IP for research and teaching purposes? • Are there to be any continuing obligations on the company to the RPO, with respect to the IP (e.g. obligations to exploit, pay royalties, deal with infringers, etc)? • Are any rights to improvements or further developments to be granted to the company? If so, are these tightly defined in time and scope and are the terms on which the improvements and developments will be licensed clearly defined? • Does the RPO wish to recover the IP from the company in any circumstances (e.g. on insolvency)?

Shareholders' agreement	• Has the academic or any external founder formed a company or does one now need to be formed? Who is dealing with the company secretarial issues, including drafting of resolutions (such as to issue shares, etc)? • Has the academic been told in writing that he/she should seek his/her own legal advice and that the RPO is not advising him/her? • Has advice been obtained on the best way to structure the shareholdings in relation to the tax interests of the RPO and the academic founders, respectively? • Have approvals for the spin-out and for investment been obtained from the RPO authorities? • Has any conflict of interest been identified and notified within the RPO? • Have the relative shareholdings of the RPO and the founders been agreed? • Has the amount of any investment and shares to be issued to any investors been agreed? • What preferential share rights are proposed for any investors? Are these acceptable? • What controls do any investors have over decision-making? Are these acceptable and practical? • What other provisions are any investors seeking to protect their interests, e.g. board appointments, first return of capital, etc.? Are these acceptable? • What provisions should the RPO and the founders include to protect their (perhaps minority) interests (e.g. board appointments)? • Are the pre-emption rights (on an issue of new shares and transfer of shares) understandable and acceptable? • Are the compulsory transfer provisions (e.g. for the founders – good/bad leaver etc.) acceptable to the RPO and the founders? • Are any warranties to be given by the RPO, the founders and/or the company? Are these acceptable? Is liability limited to an acceptable amount? • Are there any non-compete obligations on the RPO and/or the founders? Are these acceptable to the RPO and the founders? • Should a provision be included restricting the company from using the RPO's name without prior consent of the RPO?

Consultancy and employment contracts	• To the extent that these agreements concern RPO employees, do their terms adversely affect the RPO? • Does the agreement state that the consultant's first loyalty is to the company – if so, clarify that first loyalty is to RPO? • Is the extent of the consultant's commitment compatible with any duties he/she may have to the RPO (e.g. is the consultancy limited to the number of days of free time that the academic is entitled to under his or her contract of employment)? • Is the scope of the consultancy limited so that it isn't a disguised form of research contract? • Does the agreement clearly state that no rights to RPO IP are transferred to the company under the agreement?
Other contracts	• Are any other facilities or services to be provided by the RPO to the company (e.g. property rental agreements)? Are there written agreements covering these aspects and has any other relevant RPO department been involved (e.g. Estates)?

Chapter 4
Discussion of Some Commercial Issues in Spin-Out Company Agreements

Introduction

This Chapter will focus on some commercial issues in spin-out transactions. The main topics to be covered are:

- Minority protection provisions
- Shareholdings
- Board of directors
- Academic involvement in the spin-out company
- Conflicts of interest
- Employees
- Share options

The following paragraphs should be read in conjunction with Chapter 2, where some key negotiating issues are discussed.

Minority protection provisions - overview

How can a minority shareholder (e.g. the RPO) protect itself against the majority?

There are several ways in which a minority shareholder can seek to protect its interests from the actions of the majority. The main two ways are:

- By enforcing rights that a shareholder has under company and general law, e.g. to seek a court order:
  - For a remedy in case of oppression (under section 212 of the Companies Act 2014)
  - To have a special resolution passed to alter the company's constitution set aside if the alteration was not for the benefit of the company as a whole
- By including contractual rights in any shareholders' agreement

By company and general law

It should be emphasised that the enforcement of rights under company and general law, although available, is not always a practical remedy in relation to spin-out companies. Court litigation is very expensive and the remedy provided by the Court may be simply that one party must purchase another party's shares, which will not always be in the RPO's interests.

In addition, if the shareholder's percentage shareholding is above certain thresholds (at the time of writing, particularly 10% or 25%), the shareholder has certain rights to veto decisions by the company or to require meetings to be held. For example:

- Under section 89 of the Companies Act 2014, if the share capital of the company is divided into different classes of shares and the rights attached to any such class are varied, shareholders holding at least 10% of the issued shares in that class may apply to the court to have the variation cancelled (where they did not vote for the variation.
- Under section 32 of the Companies Act 2014, a resolution to change the constitution of the company requires the passing of a special resolution (i.e. at least a 75% majority of shareholders as per section 191 of the Companies Act 2014).

By contractual protection

The main contractual provisions that can be agreed to protect a minority shareholder include those summarised below. Some of these (e.g. the right to appoint a director) are regularly included in shareholders' agreements for spin-out companies by both the RPO and any investor, whilst some others tend to be included only by the investor. However, the RPO should not overlook the possibility of including many or all of these provisions with a view to protecting its interests vis-à-vis the other shareholders.

- A right to appoint a member of the board of directors and/or an observer of the board
- Access to information (e.g. management accounts)
- A right of consultation or veto or casting vote over major (shareholder and/or board) decisions
- Protection against dilution of one's shareholding (e.g. pre-emption rights on new issues of shares)
- Provisions on the proper distribution of profits (e.g. dividend policy)
- An ability to 'exit' the company
- By giving each shareholder 'class rights' (e.g. if the RPO's shares are in Class A and the investor's shares in Class B). Certain actions by the majority can be blocked if they vary the class rights of any class of shareholder.

The above list summarises the main areas where contractual provisions can help to protect a minority shareholder. In each of these areas, detailed clauses can be included in the shareholders' agreement. This is a very brief summary of a topic that raises complex issues of company law. Readers should consult their legal advisors as to possible clauses that may be included and the wording of such clauses.

Where should these provisions be put – in the shareholders' agreement or the constitution?

Some of the above provisions could be included in either the shareholders' agreement or the company's constitution or both. There are some technical, legal issues that may need to be considered when deciding where best to place these provisions, on which the RPO's legal advisors can advise. It may be helpful to mention a couple of practical considerations:

- The constitution is publicly available from the Companies Registration Office Ireland, unlike the shareholders' agreement. For example, it may be important for a purchaser of shares from an existing shareholder to know of any pre-emption provisions that the shareholders have agreed, which would be an argument for including them in the constitution. Other provisions, e.g. warranties or non-compete obligations, might be better kept private, in the shareholders' agreement.
- Usually, a shareholders' agreement can only be amended with the agreement of all shareholders (unless they agree otherwise), whereas the constitution can be amended by a special resolution of (at least 75% of) the shareholders (as per section 32 of the Companies Act 2014). In some situations, particularly if the shareholders hold different classes of shares, it may be more difficult for the majority to make changes at the expense of the minority.

Shareholdings

What percentage shareholding should the RPO get in the spin-out company?

The relative shareholdings of the parties is a matter for commercial negotiation. Some RPOs have developed policies on what they would expect to receive. In any given case, it may depend partly on whether the RPO is expecting to receive royalties and other payments under any IP licence agreement, in addition to a shareholding.

Board of directors

Should the RPO appoint a board member or observer?

Some RPOs wish to appoint a director to the spin-out company. Others take the view that they do not wish to participate in the management of the company and, therefore, would prefer to appoint an observer rather than a director. Some RPOs wish to appoint both a director and an observer. Some may consider the issue on a case-by-case basis.

Usually, under the terms of the shareholders' agreement, any right of appointment ceases once the RPO's shareholding is diluted down below a pre-agreed percentage of the issued share capital of the company. One of the factors that may cause the RPO to appoint an observer rather than a director is that, in some situations, directors may be personally liable for their actions or inactions as a director.

Shadow directors

Whether or not the RPO appoints a director, it (and any observer that it appoints) should be careful not to act as a 'shadow director' (as defined in section 221 of the Companies Act 2014). A shadow director is any person who, although not a director, is a person in accordance with whose instructions the board is accustomed to act. Shadow directors have the same potential liability as directors.

Who should the RPO's director be?

If an RPO is to appoint a board member to a spin-out company, it could choose to appoint an individual from within the RPO (e.g. an employee of its technology transfer office) or from outside of the RPO (e.g. an experienced industrialist). The advantages of appointing someone such as an experienced industrialist as the RPO's representative on the board of directors include:

- Obtaining industry-specific experience
- A clearer delineation of the role of the RPO as a shareholder (and of the RPO as project manager of the RPO's interests as a shareholder) and not as a director or manager of the spin-out company
- A clearer distinction between the spin-out company as a commercial enterprise and the academic department from which the company has sprung (or spun)

If the RPO chooses to appoint an individual from outside of the RPO as its representative on the board of the company, the RPO should ensure that it has in place an appropriate written contract with that individual to set out its expectations of that individual.

Training for directors

RPOs should consider providing training for the directors that they nominate to spin-out companies, on such issues as:

- Directors' legal duties
- Insolvency
- What the RPO expects from the director

Further information can be found in the KTI Practical Guide to the Duties of Directors and Observers.

Academic involvement in the spin-out company

The extent of an academic's involvement in a spin-out company will depend on a number of factors, including:

- How much further research and development is needed to convert the IP into marketable products and services
- How suited is the academic to working in a commercial environment, whether he or she wants to commit time and energy to doing so (and whether he or she can do so in light of his or her other commitments, e.g. as an RPO employee), and whether he or she 'gets on' with the senior management of the company

Conflicts of interest

RPOs have formal policies on the subject of conflicts of interest. In certain situations, it may be inappropriate for an academic to have a relationship with a spin-out company (e.g. as a shareholder, director, or consultant) and also to be involved in contracts between the spin-out company and the RPO. In any case, any involvement in a spin-out company, whether by way of shareholding and other multiple relationships will need to be officially notified within the RPO in accordance with its policy for managing conflicts of interest so that they are 'in the open' and can be monitored.

Conflicts of interest may have other adverse effects, including damage to the reputation of the RPO. The subject of conflicts of interest is discussed further in the KTI Practical Guide to Legal Issues in Contracts with Research Performing Organisations.

Employees

Contracts of employment

Sometimes, an academic will join the spin-out company as a full-time employee. Other founders may also join the company and additional personnel may be recruited from outside the RPO to be employees of the company as well. Typically, senior employees will be asked to sign a detailed contract of employment (sometimes called a 'service agreement'). As well as covering the usual topics of employment contracts, the service agreement may cover areas such as the employee's position as a director of the company, any bonus arrangements, and detailed clauses on issues such as IP, confidentiality and non-competition (non-compete clauses being also known as 'restrictive covenants').

Secondment agreements

Sometimes, the RPO will second employees of the RPO to work at the spin-out company. The seconded employee will remain employed by the RPO, but his or her duties will be to work at the spin-out company. Secondment agreements deal with similar issues to employment contracts, but also address certain obligations of the RPO and the spin-out company to one another.

Share options

Share options can be a relatively low-cost method of providing a financial incentive to employees and other personnel of the spin-out company. They are particularly popular with small- to medium-sized, technology-based companies. Certain types of share option agreement and scheme attract favourable tax treatment (usually, the right to defer payment of income and capital gains tax until a financial return has been realised). Without this favourable tax treatment, the issue of share options to an employee would attract an income tax liability at the time of issue, long before any gain has been realised.

Share option schemes need to be set up and administered carefully in order to comply with tax rules (including tax avoidance rules), and it will usually be appropriate to involve a specialist legal/tax adviser. It should also be borne in mind that the tax rules change frequently, and that arrangements that were suitable in the last transaction may not work in the next, similar transaction.

Chapter 5
Discussion of Some Tax Considerations on Incorporating a Spin-Out Company

Introduction

This chapter provides a high-level overview of some tax issues that are commonly encountered in relation to spin-out transactions in Ireland. It discusses only domestic Irish tax law issues, and does not consider international elements, e.g. where a party to a spin-out transaction is based outside Ireland.

There are several variable factors in any discussion of tax issues, including:

- Various parties, each with their own tax concerns
- Various stages in the life of a spin-out company, each of which raises different tax issues
- Various types of tax

In a little more detail:

Parties: There are typically several parties involved in spin-out transactions, including an RPO, a spin-out company, its founders (some of whom may be employees of the RPO), its investors, and its employees. Each of these parties will have their own tax concerns, which may depend partly on their tax status and other tax-related affairs. For example, if a founder is also an employee of an RPO, the founder will want to ensure that there is no linkage between the issue of shares in the company to the founder and his or her employment status with the RPO. Alternatively, if there is a linkage, the founder will want to ensure that the shares are issued at an early stage, when the value of the shares is low, as the issue of shares to an employee as a reward for services is a taxable benefit of employment. For an employee who receives shares linked to his or her employment, income tax charges and employers' social insurance (PRSI) may be payable on the value of those shares at the time of issue, long before the founder has derived any financial return from the shares.

Activities: Tax issues for some or all of these parties will arise at various stages in the spin-out process, including:

- Company formation
- Company operation
- Issue of shares
- Declaring dividends
- Sale of the business

Taxes: Various types of tax may be relevant to these parties and activities, including:

- Income tax
- Corporation tax
- Capital gains tax
- Stamp duty
- Capital acquisitions tax

In some cases, there may be a few straightforward steps that can be taken to mitigate tax, including availing of tax reliefs. This chapter discusses some commonly-encountered issues. It does not discuss sophisticated tax planning.

As with other legal issues discussed in this guide:

- The information mentioned in this chapter is not legal or taxation advice, and the reader should seek their own tax advice before taking any action in relation to any matter mentioned in this chapter.
- The information in this chapter is not intended to be comprehensive, and as discussed later in this chapter, tax laws or their interpretation may change over time.

Deciding whether to form a spin-out company

As indicated in Chapter 1, generally the founder(s) will either be:

- the academic employee(s) of the RPO;
- an external person associated with the business proposition; or
- an RPO.

Generally, the academic employee(s) (and possibly any external person associated with the business proposition) will be the founders of the company, meaning that they will incorporate the company, be the original subscribers for shares and receive the first shares in the company. At this stage, the shares will typically only have minimal value and generally will be issued at nominal value. The founders on company formation will own the company entirely.

Once the company is formed, the founders will then approach the RPO (and possibly any potential investors) to begin the discussions described in Chapter 1. As shares are issued to new shareholders, this will reduce the percentage shareholding of the original founders and should not cause taxation issues for the founders as the company is receiving value (i.e. consideration in the form of cash or non-cash) for the issue of the shares.

If an employer sets up a company and wishes to issue shares to employees, then it would be recommended that taxation advice be sought so that the company can consider the number of options available to it for the issue of shares and decide on the method most suited to its circumstances.

The names of the founding member(s) are inserted into the company formation documents and will appear in the Constitution.

The founders decide the number and type of shares that are to be issued on formation and the shares are issued at par (for their nominal value) on incorporation. No taxation issues arise on shares issued on the company formation. The par value is the value allocated to the shares on the company being formed.

Once incorporated the company must register with the Irish revenue authorities, the Revenue Commissioners, for relevant taxes which may include corporation tax (for tax on its income and profits) and Pay As You Earn (PAYE) if it has employees. The relevant tax numbers will be issued by the Revenue Commissioners.

When deciding who should form the company all available tax reliefs and incentives should be considered. In each case, detailed rules and conditions apply to these tax reliefs and advice should be sought to ensure that the company (and possibly any investors) can meet all of the requirements and avoid any clawback of relief claimed. Some examples of tax reliefs and incentives that may be available are outlined below.

Start Up Capital Incentive (SCI)

SCI is available for small companies (i.e. micro companies with fewer than ten employees and turnover or balance sheet of less than €2 million) who are carrying on a qualifying new venture (i.e. the activities cannot have been carried on previously). The company can raise a lifetime of €500,000 under SCI and it has been designed to incentivise family members to invest in the company.

Start Up Refunds for Entrepreneurs (SURE)

This relief may be suitable for an individual founder who establishes a qualifying company (a new company that is not taking over an existing trade of another business), invests in the company by purchasing new ordinary shares and hold the shares for a four-year period and is a full-time employee or director. The relief is in the form of a refund of income tax paid in previous years. The investor must hold 15% of the ordinary share capital. Special trading relationships with the former employer may disqualify this relief. Extensive conditions apply for this relief.

Start Up Relief

If it is contemplated that the company may make a profit in the first three years of trading, then the founders should consider whether the company will qualify for start-up relief. This relief applies to a new company. The relief gives the company an exemption from corporation tax for the first three years of trading for trading income and certain gains.

To obtain the relief, a number of conditions must be met including that the company has paid sufficient employers' social insurance (PRSI). A company can receive full relief where the corporation tax payable by the company for an accounting period does not exceed €40,000. However, no relief will be available where the corporation tax payable by the company for an accounting period is €60,000 or more.

Issuing further shares in the spin-out company after the company has been formed

At a later point, the RPO and any other founders and investors subscribe for shares either prior to or at the same time at which any IP is licensed to the company and any investment is made into the company.

Shares can be issued for cash, non-cash consideration or a mixture of cash and non-cash consideration. On formation, the company may have little cash and may decide to issue some shares for services provided to the company.

The value to be allocated to the shares will depend on the market value of the company at the time that the shares are allotted. It would be expected that the price of the shares would increase at each stage as the company develops. There may be different valuations pre- and post-intellectual property being acquired by the company, as the acquisition or right to use IP should increase the value of the company for the shareholders and for an investor.

Capital duty/stamp duty

Currently there is no capital duty or stamp duty payable by the company on the issue or allotment of shares to a shareholder.

If shares are issued for non-cash consideration, for example for the transfer of some property to the company then stamp duty at a rate of up to 6% may be payable by the company on the document transferring that property to the company.

There is no stamp duty on the transfer of intellectual property to a company.

Income tax

If shares are issued to an employee or director of the company, the issue of shares may be treated as liable to income tax by the employee if the shares are a reward to the employee or director. This may arise if there is an issue of discounted shares (shares at a favourable price) or free shares.

For example, if the shares are issued by the RPO as a reward to its academic employees then the shares may be treated as employee income and trigger income tax for the employee payable at the employee's marginal (highest) rate of tax on the value of the shares. The issue of shares may also trigger a payment under the universal social charge (USC) and pay related social insurance (PRSI) payments.

Shares received from the company in such circumstances may be within the charge to income tax as taxable pay of the employee and the employee must directly make any income tax, USC and PRSI payment to the Revenue Commissioners.

Issuing share options to employees

An alternative to issuing shares to an employee is to issue share options. The taxation treatment of share options will depend on whether the share scheme is approved or unapproved.

For **unapproved share option schemes** income tax (as well as the universal social charge and pay related social insurance) may arise on the option at the date of grant if the option price is less than market value of the shares. Further income tax (as well as the universal social charge and pay related social insurance) may arise at the time the option is exercised on the difference between the price paid and the market value at the date of exercise.

The USC may also apply to any gain made on the exercise of share options.

For **approved share option schemes** (schemes approved by the Revenue Commissioners), more favourable tax treatment applies. Instead of income tax being charged on the gain arising at the date of exercise capital gains tax is chargeable on the gain upon disposal of the shares. The option price must not be less than the market value of the shares at the date of grant, the shares must be held for 3 years and shares need to be awarded to eligible employees on a similar basis.

Key Employee Engagement Programme (KEEP)

This is a special share option scheme to incentivise employees on share options granted up to 31 December 2023.

The option price at date of grant must not be less than market value. The option must be exercised within 10 years of being granted. The options must be for fully paid ordinary shares.

Qualifying employees and directors must be full time employees/directors while they hold the options. They cannot hold a material interest (more than 15% of the ordinary shares (directly or indirectly through a connected person) in the company. The options must be held for at least 12 months before being exercised. At the date of grant the employment/ office must be capable of being held for 12 months

The special treatment is that instead of income tax treatment for the gain arising on exercise capital gains tax treatment will instead apply on the disposal of the shares.

Prior Revenue approval is not required but annual reporting obligations on options granted must be filed.

There are a number of conditions that must be satisfied. The company must be undertaking a qualifying trade which is any trade except for certain excluded activities.

Capital gains tax

Shares can sometimes be issued by the company for non-cash consideration, for example for services provided or for property or assistance received by the company. Full details of the non-cash consideration must be disclosed in the filings made to the Companies Registration Office (in Form B5).

The person offering the services, property or assistance will need to consider all the tax consequences of doing this.

The transfer of property to the company will constitute a disposal of the assets by the investor or the RPO.

If the person cannot obtain a tax relief or a tax exemption then an income tax, corporation tax or capital gains tax payment may result for the person providing the service or the asset. For example, consider the situation where a shareholder transfers IP to the company as non cash consideration for the allotment of shares. The shareholder would need to check if this transaction would result in it creating a gain (see below for how a gain is calculated) and having to make a capital gains tax payment or corporation tax payment when it gave the IP to the company as consideration for the shares. These tax issues do not arise if cash is paid for the shares.

The RPO should consider all taxation issues and any reliefs that may apply should it wish to transfer IP to the company as payment for shares to be issued to it by the company.

The company will allocate a value to the shares that are being issued to reflect the value of the assets or services that it is obtaining.

Other taxes

Once the company is formed and commences to trade additional taxes will arise.

Corporation tax

Corporation tax is chargeable on the worldwide profits and gains of Irish tax resident companies.

A rate of 12.5% applies to certain trading income and 25% applies to investment income being passive income.

A company that is incorporated in Ireland is automatically deemed to be resident in Ireland for tax purposes.

Corporation tax arises on the trading and passive income of the company as well as any chargeable capital gains arising in the relevant accounting period and based on the company's accounts in that period.

If IP is licensed to the company, the company will seek a deduction for the licence fee against its sales and income.

Capital gains tax

Chargeable gains (gains made on the disposal of a capital asset) have an effective tax rate of 33%.

Income tax and PAYE

If the company takes on employees, it will have to operate PAYE on all emoluments paid to employees. It will have to make deductions at source for income tax, the USC and employee PRSI on payments to employees and return this amount to the Revenue Commissioners on behalf of the employees.

Emoluments include all salaries, fees, wages, perquisites or profits whatever arising from an office or employment.

The company will also have to pay employers PRSI for its employees.

Reliefs

The founders may be able to claim some reliefs for the activities of the company. All of the conditions to claim the relief should be checked at the time a decision is made to claim a relief.

Some of these reliefs include:

- **Tax credits for research and development activities:**
  - Where a company engages in certain research and development activities and spends money doing so, it may qualify for tax credits to enable it to offset some of the research and development costs against its corporation tax. Up to 25% of qualifying expenditure may be used to reduce corporation tax. This is in addition to the normal deduction of the expenditure. A company must apply to claim the R&D tax credit and must ensure that it meets all of the requirements. A claim must be made within 12 months of the end of the accounting period in which the company incurs certain of the expenditure.
  - The company must engage in qualifying research and development activities and detailed conditions apply. The activity must involve systemic, investigative or experimental activities, be involved in the field of science or technology and involve either basic research, applied research and or experimental development, seek to make scientific or technological advancement and involve the resolution of scientific or technological uncertainty.

- **Knowledge Development Box (KDB) – favourable treatment for intellectual property:**
  - Knowledge Development Box is a corporation tax relief that applies to income from qualifying patents, computer programmes and in certain circumstances to certified intellectual property. The relief provides for a deduction of 50% of qualifying profits which effectively means that the qualifying profits are taxed at 6.25% rather than the standard 12.5%.
  - To qualify the company must create a usable qualifying asset (a computer programme, an invention that is protected by a qualifying patent or is patentable as certified but not patented by a small company) that earns money from qualifying research and development activities.

- **Capital allowances for intangible assets (including intellectual property):**
  - Favourable tax treatment also applies to the holding of intellectual property assets in Ireland in a company. Capital allowances may be available in the acquisition of intangible assets (which would include many forms of intellectual property).

- **Employment and Investment Incentive Relief for Investments in corporate trades (EII):**
  - EII is a tax incentive which provides tax relief of up to 40% in respect of investments made in certain companies. EII allows individual investors to obtain income tax relief for investments in shares in certain companies up to a maximum of €150,000 per annum in each year up to 2020. Initially relief is available at 30/40th of the investment in the year of investment. The balance of 10/40th is available in the fourth year of investment if certain conditions are met. Qualifying trading companies can raise a lifetime maximum of €15 million. Availing of this EII relief may impact on other State Aids for the company, so the full impact should be considered.

Payment of dividends

One method of giving a financial benefit to a shareholder is to make dividend payments to them.

The payment of dividends has tax consequences on which the company's accountants or tax lawyers should advise.

Taxation matters that may arise on the transfer or disposal of shares e.g. from one founder to another

Capital gains tax

Capital gains tax (currently at 33% of the gain) can arise on the gain made on the disposal of the shares.

The gain is calculated by deducting the value of the shares at acquisition from the sale price or market price of the shares at the date they are sold or transferred. Any costs that had to be paid by the shareholder in acquiring the shares and the costs of selling the shares can also be deducted from the sale price.

The acquisition price of the shares will depend on what was paid for the shares. It can be:

- the par value if issued when the company was formed,
- the price paid for the shares on allotment
- the value allocated to the shares if the shares were issued for non- cash consideration, or
- the price paid if the shares were purchased.

A shareholder should always check to see if there are any favourable tax treatments or tax exemptions that may apply to the sale of the shares.

Tax exemptions and favourable tax treatments are always subject to conditions and each condition will need to be satisfied to claim the tax relief.

Entrepreneur relief is a relief against capital gains tax

One relief that may be available to the founders is entrepreneurial relief to reduce the capital gains tax payable when businesses assets are sold. However, there is a lifetime limit on this relief and it currently only applies to the first €1 million gain.

A founder (if he or she retains the shares in the company for the necessary period - see below) may be able to pay capital gains tax at the 10% rate on the first €1 million gain on the disposal of the shares in the company. If available, this relief provides the founders with a 23% tax saving.

To qualify for the 10% capital gains tax rate the following conditions must be satisfied:

- It must be a disposal of chargeable business assets, some shares qualify (see below);
- in a qualifying business (most businesses excluding businesses holding securities and assets held as investments, development law and developing and letting land);
- by a relevant individual (an individual who has been the beneficial owner of the business assets for a continuous period of at least three years in the five years immediately prior to the disposal of the assets).

Some shares can qualify for relief:

- They must be ordinary shares in a qualifying business;
- The individual must own at least 5% of the ordinary share capital;
- The individual must be an employee or director of a company and spend at least 50% of his working time working for the company in a management or technical capacity;
- The position must have been held for a continuous period of three years in the five-year period immediately prior to the disposal of the shares.

Anti-avoidance provisions

Another issue for the founders and RPO to be aware of is the anti-avoidance legislation that exists for transferring value in shares from the person who holds the shares to another person. This can arise where value in the company is transferred from one shareholder to another without the transfer of shares. It can happen where the person having control of a company exercises control so that value passes out of his shares and into other shares in the company for example by issuing new shares at a price below market value. It could also arise by creating a new class of shares with enhanced rights or providing additional voting rights or dividend rights to an existing class of shares.

The anti-avoidance legislation can result in capital gains tax for the shareholder passing value. Capital acquisition tax may need to be considered by the shareholder receiving the benefit.

Other taxes that may arise on the disposal of shares for the person receiving the shares

Stamp duty

At the time of writing, a rate of 1% stamp duty applies on the disposal of shares, except for shares deriving value from property that is not residential property where a rate of 6% can apply. Generally, the purchaser or receiver of the shares has to pay the stamp duty on the document that transfer the shares, the share transfer form.

A stamp duty payment and a stamp duty return will need to be made within 30 days of the disposal.

Capital acquisition tax

A gift or inheritance of shares can result in an Irish capital acquisition tax liability for the beneficiary (the person receiving the shares). Whether any tax will be payable depends on a number of factors including the market value of the shares, the relationship between the shareholder giving the shares and the person receiving the shares and whether any tax exemption or tax relief may be available.

The current rate of capital acquisitions tax is 33%.

Disclaimer

Tax laws and circumstances change over time.

Tax law can be ambiguous and open to more than one interpretation. It is frequently subject to change as a result of new laws, court decisions and changes in Revenue Commissioners practice so the relevant tax rules should be checked at the time of formation of the company and tax treatment for similar transactions can change over time.

Any steps taken to secure a tax benefit maybe subject to review by the Revenue Commissioners, under section 811 of the Taxes Consolidation Act 1997 (as amended) (the “TCA”) or under other specific anti-avoidance legislation and the Revenue Commissioners may seek to re-characterise transactions using anti-avoidance legislation.

There may be an obligation to report transactions which might enable a tax advantage to be secured to the Revenue Commissioners under the provisions of the TCA.

This commentary on tax issues is for general guidance purposes only and not intended to give specific tax advice for any shareholder (individual or corporate) and it is a matter for all parties to take their own independent tax advice. Taxation issues in other jurisdictions may also need to be considered and addressed.

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