
SPIN-OFF STARTUP TERM SHEET CASE STUDY

PARTIES

BigTechCo, Inc. ("BigTech") is a very large, Silicon Valley-based, publicly traded, Fortune 100, hardware technology company with a considerable in-house research and development group. BigTech's primary business is the manufacturing of central processing units for desktop computers and mobile devices. Like many large companies, BigTech frequently expands through acquisition of related technologies. It also develops its own technologies in-house and even has a special program that encourages and rewards employee entrepreneurial endeavors. Where the in-house developments are speculative or merely tangentially related to BigTech's central line of business, BigTech will spin-off the technology into its own company to live or die on its own. Executives at BigTech believe this lets the technology compete in a free market as any other startup which can accelerate the technology and could create a nice return on investment for BigTech. As the technology develops, BigTech will sometimes buy-out the startup once the technology is proven thus bringing it back in-house, but frequently it will simply maintain its equity position in this new company and hold it as it would any other stock in its investment portfolio.

As part of BigTech's investment portfolio it allocates approximately 15% of the total portfolio to high-risk venture capital investments made either in its own name or as part of a venture or angel investment group. Startups that arise through their own research are included in the 15% high risk allocation. BigTech's Board of Directors is intrigued by the return on investment potential of this high-risk portfolio but is always worried about shareholder reactions to this portion of the company's operations. Able is the Director of the BigTech Venture Group.

NewCo Tech Company, Inc. ("NewCo") is a startup located in Madison, Wisconsin. NewCo was founded by Baker and Carter, both ex-employees of BigTech. Baker is an electrical engineer, with a Ph.D. from the University of Wisconsin ("UW") and worked on new hardware projects at BigTech. Carter is also a graduate of the UW with a degree in software engineering. He worked on firmware and operating system architecture at BigTech. As part of BigTech's research and development team they created a new software-based routing system that will make streaming on the internet significantly faster. While the technology works in conjunction with BigTech's hardware, the system will actually work with any hardware. BigTech thought this technology would actually have a bigger impact if it were spun-off into its own company where it could work with BigTech and its competitors. In January of 2017, BigTech gave Baker and Carter a substantial severance package and permission to start NewCo.

FACTS

Baker and Carter, being alumni of the University of Wisconsin at Madison and with family in the area, have chosen to move back to Madison and start up NewCo. They sought out legal services from the University of Wisconsin Law and Entrepreneurship Clinic ("L&E Clinic"). In conjunction with the L&E Clinic, Baker and Carter formed NewCo Tech Company, Inc. a Delaware Corporation with its principal place of business in Madison, WI. They have rented office space at University Research Park and used part of their severance package to purchase the equipment they will need to finalize research on the system that they are calling NETWORKFUNCTION.

Baker will be the CEO and Carter will be the CTO. They will need to hire 3-5 engineers for research and 1 marketing officer to start doing customer validation. Together these 6 positions will each cost at least \$100,000 per year plus equity incentives. The L&E Clinic is creating an employee option pool representing approximately 100,000 shares of NewCo.

Baker and Carter will forego salaries until NewCo is generating revenue; Baker will own 550,000 shares of NewCo and Carter will own 450,000. Their interests will vest pro-rata over the next four years with a 1-year cliff of 25% of the vesting interest. They valued their contributed assets of equipment and cash at \$50,000 – enough to get them a full year of rent, a small travel budget, and any additional equipment they might need.

Table 1: NewCo Capitalization Table

Name	Date Acquisition	of Shares	Vested	Valuation	Share Price
Baker	01/01/2017	550,000	137,500	\$50,000	.05
Carter	01/01/2017	450,000	112,500	\$50,000	.05
Employee Option Pool	TBD	100,000		TBD	TBD
Proposed BigTech (see below)	Date of Close	165,000	165,000	\$132,000	.80

The core technology of NETWORKFUNCTION was created at BigTech. Based on the employment contracts of Baker and Carter and intellectual property law, anything the two created at BigTech is the property of BigTech. BigTech has filed two patents and is claiming copyright over the core functionality that is NETWORKFUNCTION. The first patent covers the firmware implementation of the system (“P294”), the second patent covers the cloud architecture necessary for the system (“P573”), the copyright covers the software necessary for the system to operate (“C483;” together, all are “Core IP”).

THE NEGOTIATION

BigTech would like to invest the Core IP licenses in exchange for an equity stake in NewCo. BigTech has forwarded the NewCo Exclusive License Term Sheet (attached to this narrative) for review and comment. Some key features of the Term Sheet include:

- BigTech will retain ownership of the Core IP and license it to NewCo.
- NewCo will reimburse BigTech for the costs of acquiring the two patents and the copyright; BigTech will defend against any potential patent or copyright infringement issues,
- a milestone fee, and
- non-dilution of a 15% equity position in any round of financing up to \$2M aggregate financing.

For the first part of this exercise, the class should divide in half. Each group should take 40 minutes to discuss the Term Sheet and, as lawyers for NewCo (see below) propose a redline to the Term Sheet.

NEWCo

NewCo, of course, would like the best deal possible for their fledgling company. They are concerned, however, about giving up 15% equity and the non-dilution. NewCo has provided you, their attorney, with some notes from their last team meeting:

- If they bring in someone with prior entrepreneurial experience to help run NewCo it might result in a higher overall valuation, thus helping to reduce the overall ratio of BigTech's \$165K.
- If NewCo aggressively moves away from the core NETWORKFUNCTION technology, the value of the Core IP is reduced
 - o As a corollary NewCo might be more incentivized to stay with the technology (and justify the 15% equity) if they owned the Core IP outright with a Right of Reversion to BigTech if NewCo folds.
- If BigTech is going to own the IP, why should NewCo pay for getting the patents? Shouldn't the risk of the patent not issuing be on BigTech?
- NewCo will need money to move them forward; BigTech's non-dilutable 15% position is likely to be unattractive to the handful of smaller investors they will need to scramble some money together once their own money runs out.

-----CUT HERE-----

In the second part of this exercise, the class will pick one of the two proposed Term Sheets and negotiate for a final Term Sheet, with one team switching sides to represent BigTech. You can accomplish the negotiation by continuing to trade Term Sheets, or you may find it easier to have a conversation.

BIGTECH (ONLY SHOW THIS TO THE GROUP REPRESENTING BIGTECH)

Since this is the first startup by Baker and Carter, the position of BigTech is that a licensing relationship will prevent waste of the Core IP and prohibit Baker and Carter from disposing of the Core IP if Baker and Carter are unable to run the business. This relationship was fundamental to BigTech permitting Baker and Carter to leave BigTech to form NewCo, as such it is non-negotiable. However, it is not inevitable that BigTech's Core IP will always and necessarily be the foundational IP for NewCo's business. Indeed, NewCo will need to do significant development of the Core IP for it to work on a commercial scale.

BigTech is concerned about the inexperience of NewCo's founders in running their own enterprise. While they were wonderful R&D managers for such a large company, they have no experience running a company. BigTech would like to require NewCo that bring someone on with more experience in the startup environment.

BigTech themselves might be interested in putting more money into NewCo if development continues on its promising track. In any event, the executives at BigTech have contacts at a variety of Venture Capital firms that might be able to provide larger funding rounds to NewCo rather than NewCo's proposed piecemeal angel investments.

NewCo Exclusive License Term Sheet – For discussion purposes only

Licensed IP	<p><u>P294</u>: NF FIRMWARE IMPLEMENTATION (PAT/File Opened)</p> <p><u>P573</u>: NF CLOUD ARCHITECTURE (PAT/Filed)</p> <p><u>C483</u>: FRAMEWORK FOR CONTROL OF NF'S BEHAVIOR (CRT/File Opened)</p>
Grant	Exclusive license to make, use, and sell products in designated fields of use.
Field of Use	Networking
Term	Life of patents
Milestone Fee	Upon reaching \$10M in sales in a given year, a onetime 2% milestone payment for the sales that year.
Equity	<p>Equity position of 15%, Company shall issue to BigTech shares representing 15 percent (15%) of the Fully-Diluted Shares Outstanding as of the date of execution</p> <p>Company agrees that BigTech's Share Percentage shall be maintained at 15 percent (15%) until Company receives, in the aggregate, in a single transaction or a series of related transactions, at least \$2.0M of Equity Financing</p>
Patent Reimbursement	No payment for past patent costs (\$20,000 limit) - future patent costs to be paid by NewCo. Current patent costs total: \$19,971
Ownership of Licensed Software	C483 is owned by BigTech
Diligence Requirements	<ul style="list-style-type: none"> • An updated business plan on the 1-year anniversary of the agreement • Consolidated financial statements annually provided to BigTech • Development plan due with the execution of the license and development reports due every six months • First commercial sale (\$650K in product revenue) by 1 May 2019, • If not being developed or no sales for 1 year, license converts to non-exclusive • BigTech has the option to be a Board Observer
Future Securities Offerings	If NewCo offers to sell any equity securities, BigTech shall have a preemptive right to acquire such Equity Securities as may be issued or proposed to be issued by Company from time to time. Such preemptive right shall apply with respect to any Equity Securities issued by Company after the Effective Date, whether such additional Equity Securities constitute a part of the

NewCo Exclusive License Term Sheet – For discussion purposes only

	Equity Securities presently or subsequently authorized or constitute Equity Securities held in the treasury of Company. BigTech shall have the right to acquire Equity Securities of the type being issued in an amount equal to the product of (i) BigTech's Share Percentage immediately prior to such issuance, multiplied by (ii) the number of Equity Securities of the type that are to be issued to all Persons pursuant to such issuance. If BigTech decides to participate in the "A" round, BigTech will have an option to take a board seat.
--	---