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CONNECTING VISION TO REALITY 2009

Legal and Tax: Operational Advice

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Goodwin Procter LLP

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- Over 900 attorneys in Boston, Hong Kong, London, Los Angeles, New York, San Diego, San Francisco, Silicon Valley, Washington, D.C.
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- Internationally recognized expertise representing technology companies, as well as private equity and venture capital firms
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- Fund formations
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- Securities offerings
- Universal shelf take-downs
- Venture financings

Extensive private equity, venture capital and investment banking client base allows us to leverage relationships on behalf of our clients

Known for structuring innovative, tax-advantaged solutions

The Big Question

- What can I do to reduce the risks that a liquidity event will be derailed?

The Answer

- Set the table *now* to maximize credibility and flexibility in order to be able to take advantage of opportunities as they present themselves

Avoid Due Diligence Surprises

Capitalization and ownership

Sales and use tax

Material contracts

- Assignability
- Exclusivity
- Termination and renewal

Intellectual property issues

- Open source
- IP ownership (employees and consultants)
 - NDAs and inventions agreements
- Joint ownership of IP

Employment issues

- Employees vs. consultants/contractors
- Exempt vs. non-exempt
- Handbooks that can be contracts

Pursue Strategic Patenting

- Patent commercial advantages, not neat ideas
- Patent lasting advantages, not fads
- Patent what can be noticeably infringed
- Use multiple applications to build a “fence”
- File before commercializing if foreign rights matter
- Keep one application pending to cover evolving activities

Raise Capital Opportunistically

Realistically estimate amount required

- It almost always costs more and takes longer to achieve an exit than predicted

Plan for the long term

- Provides flexibility to survive market down turns
- Allows management to focus on building the business vs. constantly raising capital

Access traditional and emerging government-based funding sources

- R&D refundable tax credits
- Stimulus funds

Consider U.S. Venture Capital Funding

Is CCPC status important?

- Tax Advantages of CCPC Status
 - Capital Gains Deduction
- Reinvestment Opportunities
- Canadian Employee Stock Options
 - Tax Deferral on the Exercise of Stock Options
 - Tax Deduction on the Gain from Options
- Investment Tax Credits for Scientific Research and Experimental Development
- Small Business Deduction
- Deduction of ABILs (allowable business investment losses)

Consider U.S. Venture Capital Funding

- U.S. VCs are primarily structured as limited partnerships
- U.S. VCs investing in Canada must avoid tax in Canada on disposition of shares in portfolio company
 - A purchaser of taxable Canadian property is required to withhold 25% of the purchase price unless a s.116 clearance certificate is obtained however obtaining a s.116 clearance certificate is a problem for most U.S. VCs
- **Result:** U.S. VCs typically prefer to invest in U.S. corporations with Canadian operating subsidiaries

Very Real Issue

Consider U.S. Venture Capital Funding

What level of funding is being sought?

- U.S. VCs typically seek to invest more per investment than their Canadian counterparts
- Exchangeable share structure typically used to avoid a deemed disposition in Canada adds expense
- Amount of capital being deployed needs to justify the additional expense

What/Where is likely exit?

Consider U.S. Venture Capital Funding

Consider Canadian-based financing strategy if...

- Can qualify as a CCPC and need refundable tax credit
- Do not need venture capital from the U.S.
- BDC or labor sponsored fund will be a lead investor
- Anticipated future funding likely to come from Canadian investors
- Anticipated exit is a Canadian IPO or sale within Canada

Consider U.S. venture capital financing if...

- Can not qualify as a CCPC
- Can qualify as a CCPC but do not need refundable tax credits
- Principal investor is a U.S. LP
- Anticipated future funding is likely to come from U.S. investors
- Anticipated exit is a U.S. acquisition or IPO

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Key Legal Issues for Emerging Software Companies

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Presented by:

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Introduction

Top 5 Legal Issues:

1. First steps: Develop an IP Strategy
2. First steps: Open Source Policy
3. Software licenses: IP reps/warranties vs. indemnities
4. Risk Coverage: Insurance Pitfalls
5. Understanding Insolvency



1. 1st steps: Develop IP Strategy

Can't wait until "can afford it" as inaction can seriously prejudice ability of the company to protect it's IP assets

Right IP strategy for each company will depend on the stage of its life cycle

Early Stage Company

- Where emerging companies need to make budget choices, achieving base IP protection is relatively inexpensive – e.g. through copyright registration and/or employee/contractor documentation re copyright assignment/waiver of moral rights
- Register trade-marks relatively early to capture the goodwill of the company as it grows

Maturing Company

- As company matures, obtaining patent protection becomes more important
 - **BUT** need to be careful to limit disclosures made during early phases – e.g. in client meetings – to ensure early conduct does not prejudice later patent registration = a very common problem
- Need to develop strategy re patenting enhancements, improvements, etc. to grow the company's IP portfolio

1. 1st steps: Develop IP Strategy

Important to conduct own internal due diligence prior to taking advantage of significant market opp's (e.g. sale of the business)

Should have documented assignments of copyright & waivers of moral rights from personnel to avoid contesting ownership

Case studies:

- **Software company sells to a larger buyer**
 - Buyer's due diligence review: seller's licences to 3rd party licensors are ambiguous re ownership
 - So buyer requires sellers to obtain clear assignments from licensors, subject to a holdback on purchase price
 - Licensors have little motivation to execute & concerns re risk of inadvertently assigning licensor's own IP
 - = Additional stress on transactions & real impact on the purchase price bottom line
- **Also in context of sale, independent contractor did not execute assignment of copyright/ waiver of moral rights**
 - As sale, contractor in good bargaining position, so software co must pay premium to reflect same
 - May also delay timing of sale

2. 1st steps: Open Source Policies

As part of IP Strategy, must understand if and how open source code should be used in the co. software products

Common misconception that open source software is “free” (i.e. not subject to licence) = many pitfalls

Open source policies set out:

- when open source can be used in applications which will go to market, including process to review proposed use of open source against uses permitted by the open source licence
- when open source can be used as tools
- prohibitions on using “viral” open source

Case study:

- **Software company sells to a larger buyer**
 - Buyer’s conducts open source audit as part of due diligence review: seller’s software products contain open source which is being used contrary to the open source licences
 - Buyer will either not purchase the deficient software or will apply a discount to the purchase price, unless seller develops a non-open source work-around to address the issue = cost + timing issues
 - If share purchase, Buyer may apply a discount in any case to address risk stemming from use of open source prior to implementation of work-around

3. IP reps/warranties vs. indemnities

Reps & warranties: Considered to be material term of agmt, so:

- if breach, more damages?
- if breach = material breach = likely grounds to terminate
- Licensor should only give non-IP infringement reps & warranties where some comfort they are true, so = > need for IP due diligence

Indemnities – Differences:

1. Licensor is not making “promise” to customer
 - Rather, licensor is stating that if their product is infringing, licensor will defend & hold harmless the licensee
 - So no mat’l breach if IP infringement = agmt is not terminable
2. IP indemnity can be qualified, so if pre-conditions are not met indemnity is not effective – a significant defence for licensor, esp. re 3. (Excusive Remedy) below. Normal preconditions include:
 - Receiving timely notice of the claim
 - Providing all co-operation to the indemnifying party
 - Providing full rights to licensor to settle the claim
3. IP indemnity is often the exclusive remedy for IP infringement
4. IP indemnity is for 3rd party claims only: excludes direct claims by licensee against licensor

4. Insurance Pitfalls

Issues re First Party Insurance

“first party triggers”:

- direct damage triggers: result in direct damage/loss of tangible property (e.g. fire at provider server farm & need to replace servers)
- business interruption triggers: an adverse event results in interruption to provider’s operations such that provider is unable to fund ongoing costs without insurance funds

Exclusions

Bailee/property of others insurance:

Provider may be hosting customer assets (e.g. customer servers at provider server farm; or customer hardware inventory of provider)

BUT customer asset damage claims will be excluded from provider:

- property insurance, as not provider’s property, &
- general liability insurance, as under care/custody/control of provider

Therefore Licensor requires either:

- **bailee insurance:** as form of liability insurance, will only be responsible to customer for negligence & limited to the actual loss sustained; therefore coverage may be insufficient
- **property of others coverage:** preferred form of coverage as no recovery pre-condition that there was provider negligence

4. Insurance Pitfalls

Issues re First Party Insurance

Exclusions

Contingent Business Interruption: claims stemming from damage to assets which are not owned by the provider, even though the cause of damage is an otherwise insured peril; e.g.'s:

- provider is managing the servers of a customer & relying on power source that the customer controls
 - provider is relying on a subcontractor and their site to provide an element of the provider's service
- = provider should ensuring policy incl. **Contingent Business Interruption** coverage, which lists each subcontractor's site as a location on the policy
- each non-owned asset upon which there is reliance is then expressly identified & the related business interruption risk insured

4. Insurance Pitfalls

Issues re Third Party Insurance

“Third party triggers”: e.g. **general liability**: customer claims for damages caused by provider actions/omissions (e.g., bodily injury, off-site property damage, customer business interruption/loss of use);

typically provides coverage for costs re the defense & payment of damages re third party claims, IF underlying triggers are insured

in most “occurrence based” insurance contracts payment of defense costs is unlimited until claim settlement/adjudication

The “Hammer” Clause

BUT licensor should determine if the insurer has included a **“hammer clause”** which caps the insurer’s exposure past the noted limit

Applies where:

- insurer may want to settle but the insured does not, or
- there is a judgment against insured & insured wants to appeal but insurer does not.

Examples: if insured does not agree with insurer to settle claim for \$X, the insurer’s exposure is capped at:

- \$X plus 50% of future costs incurred in defending the claim; OR
- 150% of \$X

4. Insurance Pitfalls

Issues re Third Party Insurance

Divergence between outsourcing contract & insurance policy re scope of permitted recovery of damages

- E.g. contract may allow for licensee to recover of exemplary or punitive damages in the case of licensor's breach of confidentiality obligations, BUT policy may only allow for payment of direct/compensatory damages

Exclusion of contractual liability from scope of coverage

- In order to be covered,
 - must be **agreed by insurer**: should ensure insurer reviews contract; OR
 - the **liability to the customer would have existed even in the absence of the contract**; e.g. pursuant to a claim in tort.

5. Understanding Insolvency

Licensor has certain remedies available where customer is insolvent, but not yet bankrupt

- E.g. can terminate for (a) material breach, in which case any claim for damages will be another (generally) unsecured claim against the estate of the debtor service provider or (b) based on the fact of the debtor's insolvency

BUT upon the initiation of a BIA proposal or a CCAA plan = a “**stay**” is created which limits certain licensor remedies

BIA: Licensor counterparty to agmt:

- cannot rely on licensee **pre-filing defaults in payment** (can rely on other defaults – e.g. re performance)
- cannot rely on ***ipso facto* clauses to terminate** the contract
- can invoke other types of pre-filing breaches by the debtor, if they are sufficiently fundamental, to terminate (e.g. re performance)

CCAA: unlike BIA, cannot rely on **any defaults, even re performance**

Chapter 11 US Bankruptcy Code: all ***ipso facto* termination rights are stayed**

5. Understanding Insolvency

Two effects:

Licensors should try to “beat the stay” where bankrupt client

- by looking past the formal *ipso facto* clauses, & focusing on implementing **early warning governance mechanisms** so customer can “beat the stay”
- EW mechanisms could include a certain level of periodic **financial reporting, and**, on such a periodic basis, an **officer’s certificate** certifying that there has been no such material adverse change
- But depending on licensor bargaining position these EW mechanisms may be difficult to ‘sell’ to a large client

Licensee may equally try to beat the stay in the event that licensor was to go insolvent, via draft def’n of “insolvency event” in technology agmt which is **broader than formal bankruptcy**; if it is, parts of insolvency event termination trigger will not be stayed as not *ipso facto* clauses. Potential licensee issue = language may be too broad

- provider/provider’s applicable dept ceases to carry on business in ordinary course
- ... or Customer otherwise has reasonable cause to doubt Provider’s financial stability (including concerns over Provider’s ability to perform its obligations under any Service Schedule consistently and in a sustained manner)

Conclusion

Emerging companies can find it difficult to determine at what time in their life cycle they should implement best practices to mitigate legal risk

These five issues, based on experience, should assist in understanding & prioritizing some of those issues

Connecting Vision to Reality*

2009 Report on Emerging Canadian Software Companies:
The CEO Perspective

Tax & Legal Issues

Audrey Diamant

May 13, 2009



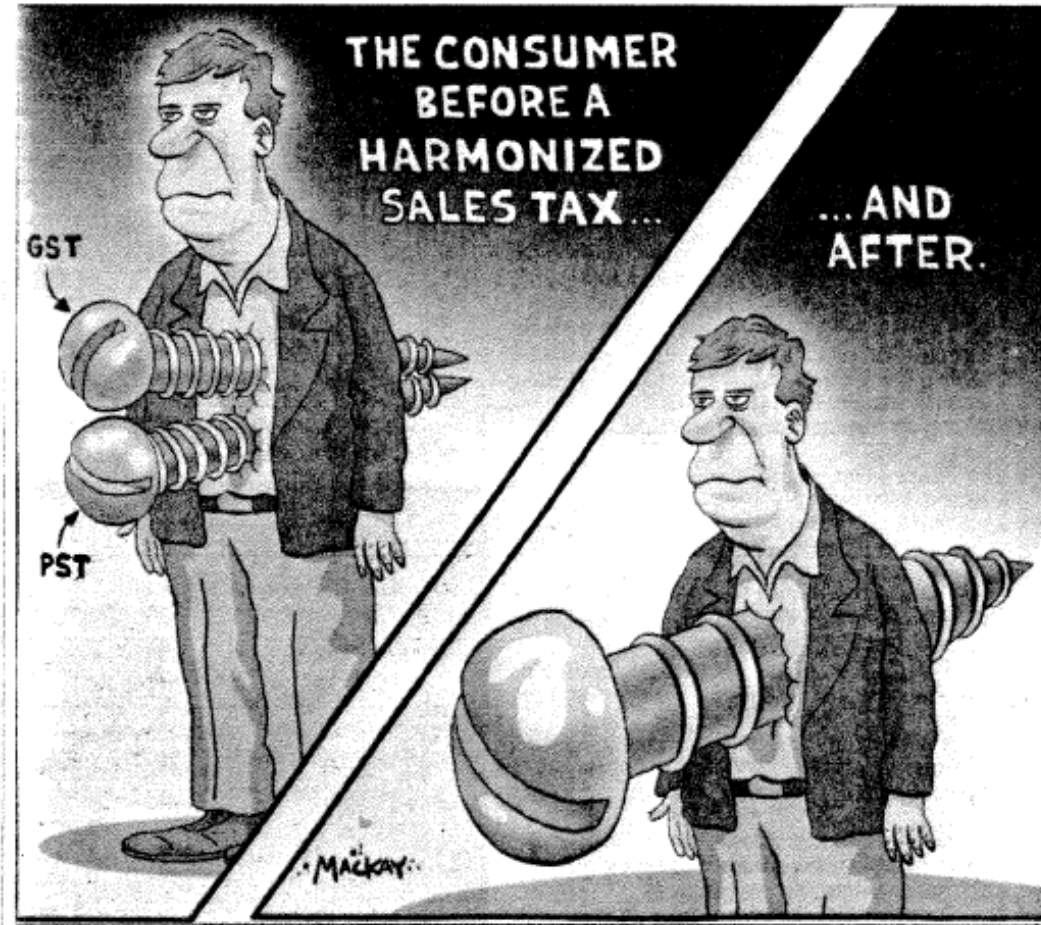
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Agenda

- Ontario Sales Tax Harmonization
- Ontario Retail Sales Tax (PST) – Audit Issues
 - Custom Computer Programs
 - Non-taxable Services





Ontario Sales Tax Harmonization

Harmonization of the existing Ontario PST and the GST

- Effective July 1, 2010
- Single 13% Harmonized Sales Tax (HST) in Ontario
- 8% Ontario component will be called the “OVAT”
- Rules substantially the same as current GST
 - the exceptions will be key
- Single form to be filed for the HST



Ontario Sales Tax Harmonization

- Harmonization will allow software companies to recover OVAT on most purchases:

Examples of cost reductions include -

- Capital asset purchases
e.g. hardware and software for own use;
- Real property contracts (e.g., supply and install)



Ontario Sales Tax Harmonization

- OVAT will not be recoverable in first five years on:
 - Certain Energy costs and telecommunication services
 - Automobiles and other road vehicles weighing less than 3,000 kg; parts and certain services for vehicles and fuel for such vehicles; and
 - Food, beverage and entertainment expenses.
- During the subsequent 3 years, full recovery phased in.



Ontario Sales Tax Harmonization

What do you need to do?

- Systems changes required (wait for transitional rules)
- OVAT will need to be captured with respect to restrictions
- PST will still apply in four provinces (BC, MB, SK and PEI)
- PST audits in Ontario will continue for 4 years post OVAT



Ontario Sales Tax Harmonization

Issues

- Vendors should review agreements to determine if savings must be passed on - customers may want to renegotiate
- Customers may defer purchases of currently taxable items until after June 30, 2010
e.g. Hardware; software; outsourcing and services contracts
- Certain industries (e.g. financial institutions; residential real estate) do not recover all OVAT paid – impact?



Ontario Sales Tax Harmonization

Opportunities

- Defer significant acquisitions that are currently taxable
- Assistance with customers' systems changes
- Location of servers will be a business, not a tax decision
- Relative 'simplicity' of OVAT v. PST



Ontario PST – Audit Issues

- Custom computer programs are exempt:

“designed and developed solely to meet the specific requirements of and intended for the exclusive use of a particular person”
- Related services non-taxable
- Ministry interpretation and ‘exclusive use’



Ontario PST – Audit Issues

Non-Taxable Services – includes:

- Project Planning - analysis of specifications, determination and verification of hardware and software prerequisites, scheduling, the preparation of reports, review of documentation and discussions of any kind;



Ontario PST – Audit Issues

Ministry Commentary:

Non – Taxable Services remain as such only if:

“... they represent the only service provided, are provided with only non-taxable services, or are not required in order to supply a taxable service...”

- **Impact on installation contracts;**
- **Impact on post - ‘design’ planning**



Ontario PST – Audit Issues

IT Services/Placement Agencies non-taxable if:

- IT consultant not under the agency's direction and control

AND

- Documented as supply of human resources, not directed to provision of taxable services



PST – Audit Issue Summary

- Unbundle taxable vs. non-taxable services
- Ensure descriptions re: non-taxable services are clear and precise
- Ensure services from placement agencies are properly documented
- Where feasible, document ‘exclusive use’ re custom programs

Thank you.



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