



Understanding Key Provisions of Basic Business Contracts: A CFO's Guide to Efficient and Effective Contract Review

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Cautionary Note

The information in this presentation is not to be construed as a substitute for a thorough legal review of a contract by an attorney with the appropriate expertise and level of experience

GENERAL

- **Matters Applicable to Review of all Contracts**
 - Form of Agreement - Which party should be providing
 - Identifying what is negotiable and must be negotiated
 - Making sure business terms conform to the understanding/LOI/MOU (*i.e.*, price, rent, quantity, territory, scope, term, etc.)
 - Term and Termination Provisions – How and when can you ***or your successor*** or the other party get out of the agreement?
 - Indemnities

GENERAL

- **Matters Applicable to Review of all Contracts (cont'd)**
 - Choice of Law; Venue for Disputes
 - Which party is more likely to bring an action to enforce the agreement
 - Defendant's state vs. plaintiff's state
 - Dispute Resolution
 - Arbitration vs. Litigation
 - Single arbitrator vs panel of arbitrators
 - Risk of arbitration
 - Limited litigation clause as an alternative
 - Carve out for matters requiring equitable relief
 - Prevailing party attorneys' fees

Other Contracts

■ Other Contracts Not to be Taken for Granted

- Privacy Policy
 - Assignment/transfer of personal information
 - Evolving area of law – need to update
- Terms and Conditions
- Any agreement that grants exclusive rights
- Any agreement that contains restrictions on business activities (*e.g.*, noncompete or nonsolicitation obligations)
- Long-term contracts
- Any agreement that can or can't be easily terminated, depending on which side of the agreement you are on

Template Agreements

- **Every business should consider having well-vetted template agreements for the following basic contracts:**
 - Employee Offer Letter (exempt employee)
 - Employee Offer Letter (non-exempt employee)
 - Executive Employment Agreement
 - Employee/Contractor Confidentiality and Invention Assignment Agreement
 - Independent Contractor Agreement
 - Nondisclosure Agreement (Unilateral)
 - Nondisclosure Agreement (Mutual)
 - Customer Contract (*e.g.*, license agreement; MSA; etc.)

Template Agreements

- **Benefits of Well-vetted Template Agreements**
 - Facilitates due diligence by potential investors and acquirers
 - Makes contract management easier
 - Reduces legal spend on contracts
 - Creates efficiencies
 - May facilitate customer/client acquisition
 - Avoidance of adverse/unintended consequences
 - Avoidance of compliance issues

Basic Business Contracts

- Nondisclosure Agreements (mutual and unilateral)
- Memoranda of Understanding/Letters of Intent
- Real Estate Leases
- Employment Agreements
- Independent Contractor Agreements
- IP License Agreements (inbound)

Contract Basics

General Rule: The form of agreement is typically provided by the party providing the product(s) or service(s), or making the offer, that is the subject of the agreement

Exceptions:

- When other party has significantly more negotiating power
 - Large companies (*e.g.*, Google; Oracle)
 - M&A transactions with sell-side auction process
- When the party providing the product or services is not properly prepared with its own templates

Nondisclosure Agreements

■ Pre-Review Considerations

- Nature of transaction/business purpose
 - M&A transactions
- Nature of the other party
 - Potential competitor?
- Mutual vs unilateral NDA
 - Which party will be providing all or most of the disclosure?
- What is expected to be disclosed

Nondisclosure Agreements

■ Key Provisions/Issues

- Definition of Confidential Information
 - All information disclosed (subject to exceptions) vs requirement to specify which information is confidential
 - Requirement to follow up with written confirmation after oral disclosure
 - Should include notes and documents created by the receiving party in connection with its review
 - Should include and protect third party information in possession of the disclosing party
 - Exceptions

Nondisclosure Agreements

■ Key Provisions/Issues (cont'd)

○ Exceptions to Definition of Confidential Information

➤ Shifting the Burden of Proof

“The obligations under Paragraph 2 (Nonuse and Nondisclosure Obligations) of each party, as a Recipient, shall not apply to Confidential Information ***that Recipient can document and demonstrate*** (a) was in the public domain at or subsequent to the time such portion was communicated to Recipient by Disclosing Party through no fault of Recipient; (b) was rightfully in Recipient's possession free of any obligation of confidence at or subsequent to the time such information was communicated to Recipient by Disclosing Party; (c) was developed by employees or agents of Recipient independent of and without reference to any information communicated to Recipient by Disclosing Party; (d) was communicated by the Disclosing Party to an unaffiliated third party free of any obligation of confidence....”

Nondisclosure Agreements

■ Key Provisions/Issues (cont'd)

- The Residuals Clause – License to Steal?
 - Typically used by large companies when they are the receiving party
 - Provides that if a party learns some general information regarding the other party's IP while working with the other party, the party learning such information is free to use that information retained in its unaided memory, regardless of the confidentiality or non-use restrictions in the agreement
 - Typically resisted by the disclosing party
 - Language could be interpreted as a trade secret license

Nondisclosure Agreements

- **Key Provisions/Issues (cont'd)**
 - If you have to live with a residuals clause:
 - Make sure that it applies only to use and not confidentiality obligations
 - Should be limited only to information that can be retained from the receiving party's "unaided memory"
 - Exclude trade secrets
 - Make it clear that no copyright or patent license is granted
 - Limit what is actually disclosed to the extent possible

Nondisclosure Agreements

■ Key Provisions/Issues (cont'd)

○ Sample Residuals Clause - “Fair and Balanced”

“The Receiving Party shall be free to use for any purpose the residuals resulting from access to or work with the Confidential Information of the Disclosing Party, *provided* that the Receiving Party shall not disclose the Confidential Information except as expressly permitted pursuant to the terms of this Agreement and this Section shall not apply to any of the Disclosing Party’s trade secrets included in Confidential Information. The term “residuals” means information (other than trade secrets) in intangible form (*i.e.*, not written or other documentary form, including tape or disk), which is incidentally and unintentionally retained in memory by persons who have had access to the Confidential Information, including ideas, concepts, know-how or techniques contained therein and where the source of the Confidential Information has become remote (*e.g.*, as a result of the passage of time or the person’s subsequent exposure to information of a similar nature from other sources) such that the person can no longer identify the Confidential Information’s confidential source; *provided, however*, that no license to any patent or copyright of the Disclosing Party is granted under this Section.”

Nondisclosure Agreements

- **Key Provisions/Issues (cont'd)**
 - Restrictions
 - Non-disclosure, except:
 - To employees and other representatives with a “need to know”
 - Legal proceedings, including any between the disclosing party and receiving party
 - Non-use, except for the purpose
 - Define the “purpose”

Nondisclosure Agreements

■ Key Provisions/Issues (cont'd)

○ Term/Expiration Date vs Perpetual

➤ Impact on Trade Secrets

➤ Protecting Trade Secrets

“The receiving party’s obligations under this agreement shall remain in effect for a period of two years from the date hereof, except with respect to any Confidential Information that constitutes a trade secret of the Company under the Uniform Trade Secrets Act (the “UTSA”), the receiving party’s obligations under this agreement shall remain in effect until the date that such information no longer constitutes a trade secret under the UTSA.”

➤ Receiving party may demand identification of trade secret information

➤ Non-disclosure vs non-use obligations

Nondisclosure Agreements

- Governing Law; Venue for Disputes
 - Mutual vs Unilateral NDA
- Return of Confidential Information
 - No longer possible to return or destroy all confidential information

“Notwithstanding the foregoing, nothing herein shall require the alteration, modification, deletion or destruction of back-up tapes or other back-up media made in the ordinary course of business, *provided* that said back-up tapes or other back-up media is stored in a manner that prevents unauthorized access or use of Confidential Information. Any Confidential Information that cannot be returned or destroyed (including oral Confidential Information) shall remain confidential, subject to the terms of this Agreement.”

Nondisclosure Agreements

- Representations and Warranties

- No reps and warranties regarding information disclosed

“All Confidential Information is provided "AS IS" and without any warranty, express, implied or otherwise, regarding such Confidential Information's accuracy, completeness or performance. Only those representations or warranties which are made by a party in a final definitive agreement regarding a Proposed Transaction, when, as and if executed, and subject to such limitations and restrictions as may be specified therein, will have any legal effect.”

- Assignment

- Agreement (rights and obligations) should be assignable in connection with a sale or reorganization of either party

MOUs and Letters of Intent

■ Purpose

- A non-binding statement of the intention of the parties to enter into a transaction
- Outlines the basic terms of the transaction; may “smoke out” key/controversial terms
- Provides a moral obligation on the part of the parties to negotiate and complete the transaction
- May contain useful binding provisions such as confidentiality, exclusivity, access and non-solicitation of employees and/or customers

MOUs and Letters of Intent

- **Caution**

“Non-binding” MOUs/letters of intent may be more binding than you think.....

MOUs and Letters of Intent

- **Fully Binding Agreements**

“When the parties have reached agreement to be bound on the issues perceived to require negotiation, even though they may express a desire or expectation for a more elaborate and detailed formal document”

Test: Was there a mutual intent to be bound after full consideration of the circumstances and the contract language

MOUs and Letters of Intent

- **Fully Binding Agreements – Factors Considered**
 - The Language Used and Expression of Intent
 - Single most important factor: Express language not to be bound to any transaction unless and until the parties execute a final contract
 - Without such language, other language can show intent to be bound. For example:
 - “If the foregoing sets forth your understanding of the terms, please evidence acceptance and agreement by signing below”
 - “Accepted and Agreed to”
 - Reserving right of approval or conditions such as the preparation of satisfactory documents are not conclusive
 - Reserving “Board Approval of Final Documents” is not conclusive

MOUs and Letters of Intent

- **Fully Binding Agreements – Factors Considered**
 - The Circumstance and Context of the Negotiations
 - Length and details of negotiations
 - Expressed desire or need to have a binding agreement
 - Expression of reliance on agreement
 - Open Terms
 - Are all material economic terms included
 - Court can fill in other, or customary, terms

MOUs and Letters of Intent

- **Fully Binding Agreements – Factors Considered (cont’d)**
 - Partial Performance
 - Has one, or both parties, partially performed
 - Not “reliance” or “preparation to perform” – Actual performance
 - Industry Practice and Customary Form for Such Transactions

MOUs and Letters of Intent

■ Binding Preliminary Agreement/Commitment to Negotiate in Good Faith

“A mutual commitment to agreed major terms, while recognizing the existence of open terms that remain to be negotiated in good faith, within the scope that has been settled in the preliminary agreement.”

- “Good Faith” obligation can be express
 - The parties agree to “negotiate the final contract in good faith”
- or implied
 - An agreement “to negotiate final contract” implies “good faith”
 - Exclusivity provision can imply “duty to negotiate in good faith”
 - Outside date for negotiations can imply duty “to negotiate in good faith”

MOUs and Letters of Intent

■ When Does a Party Breach a Duty to Negotiate In Good Faith

- “This obligation does not guarantee that the final contract will be concluded if both parties comport with their obligation, as good faith differences in the negotiation of the open issues may prevent a reaching of final contract. It is also possible that the parties will lose interest as circumstances change and will mutually abandon the negotiation.”
- “The obligation does, however, bar a party from renouncing the deal, abandoning the negotiations, or insisting on conditions that do not conform to the preliminary agreement.”

MOUs and Letters of Intent

- **Remedies for Breach of a Duty to Negotiate In Good Faith**
 - Old Rule: Reliance Damages Only (*e.g.*, attorneys fees, costs, due diligence expenses, lost opportunities)
 - Newer cases have rejected the rule of “Reliance Damages Only” and have awarded expectancy damages, which have included lost profits and other speculative damages such as loss of the transaction itself

MOUs and Letters of Intent

■ Some Lessons From the Case Law

- Be clear whether the MOU/letter of intent is, itself, binding or not binding
- Be clear whether there is, or is not, a duty to “negotiate in good faith” or even a “duty to negotiate” any terms
- Be clear whether terms in MOU/letter of intent are set, or can be renegotiated. For example:

“The Parties agree to act in good faith and exercise due diligence in negotiating and executing a final and definitive contract **containing the foregoing terms**; *provided, however*, this letter shall not constitute a binding agreement with regard to the contemplated transaction, nor shall the parties be bound to complete the transaction unless and until the parties execute a final and definitive contract.”

MOUs and Letters of Intent

■ Some Lessons From the Case Law (cont'd)

“The Parties agree to act in good faith and exercise due diligence in seeking to negotiate and execute a final and definitive contract; *provided, however*, that this letter shall not constitute a binding agreement with regard to the contemplated transaction **and the foregoing terms shall not be binding on the parties in any such negotiation**, nor shall the parties be bound to complete the transaction **or the negotiations on the foregoing terms** unless and until the parties execute a final and definitive contract.”

- Establish an outside or end date for any negotiations so that you can walk away from the negotiations after that date
- Do not assume that changed circumstances or changed market conditions can justify a change to the basic terms in the MOU/letter of intent

MOUs and Letters of Intent

- **Some Lessons From the Case Law (cont'd)**
 - Can't assume that insisting on inconsistent terms or walking away from the negotiations will only result in reliance damages
 - Can't assume that a breaching party will not be responsible for expectancy damages, including lost profits from the loss of the transaction itself

MOUs and Letters of Intent

- **Should a MOU/Letter of Intent be Used?**
 - May be preferable not to use a MOU/letter of intent, but may be difficult to avoid in certain circumstances
 - MOU/letter of intent takes time to negotiate and adds additional legal fees and process to the transaction
 - May cause confusion or create expectations as to whether there is a binding agreement
 - Public company disclosure concerns – public companies may be required to disclose a transaction when all material terms have been agreed upon

MOUs and Letters of Intent

- **Should a MOU/Letter of Intent be Used? (cont'd)**
 - Better practice may be to have a simple, unsigned term sheet outlining the terms of the transaction
 - Confidentiality, exclusivity and non-solicitation obligations can be addressed in separate agreement(s)
 - If there is no way to avoid a MOU/letter of intent, include only the basic terms to avoid binding agreement concerns and be very clear about the non-binding nature of such terms

Real Estate Leases

- **Negotiation power will vary depending on various factors**
 - Single vs multi-tenant property
 - Size of leased premises
 - Term of lease
 - Identity of Tenant
 - Market/economic conditions

Real Estate Leases

■ Key Provisions/Issues

- Review of Business Terms (*e.g.*, rent)
 - Should be consistent with term sheet/LOI
- Relocation Clauses
 - Applicable to multi-tenant properties
 - Should be deleted
- Indemnities
 - No responsibility of tenant for pre-term or off-premises matters
 - Environmental indemnities – should carve out migration of contamination from adjacent parcels

Real Estate Leases

■ Key Provisions/Issues (cont'd)

○ Landlord Operating Costs

- Typically paid by tenant; known as “pass-throughs”
- Understand what is tenant’s responsibility and how billed (*e.g.*, monthly)
- Expressly exclude from operating costs: depreciation, mortgage debt service, cap ex, legal fees to negotiate or enforce other leases, compliance costs, fines or penalties, fees or salaries of personnel above the property manager
- Negotiate for audit rights

Real Estate Leases

- **Key Provisions/Issues (cont'd)**
 - Assignment and Subletting
 - Will typically require landlord consent
 - Landlord recapture right – If included, negotiate right to withdraw request to assign lease
 - Negotiate release of tenant for assignee with equal or superior financial condition
 - Incorporate up front consent for expected matters
 - Corporate reorganization
 - Subletting of growth space
 - Capital Expenditures
 - Should be appropriate
 - Amortized over the term of the lease

Real Estate Leases

■ Key Provisions/Issues (cont'd)

○ Tenant Improvements

- Landlord does the work or provides tenant allowance
- Tax treatment/consequences of allowances
 - Depends on ownership of the improvements
 - Tax ownership is not the same as legal ownership
 - Construction allowance is income to tenant unless landlord owns the improvements
 - Use of rent holidays or rent-free period
 - IRC Section 110 – Excludes from tenant's income qualifying construction allowances under short-term retail leases
 - Focus on and designate ownership of improvements in the lease; specify that all improvements made with the allowance are the property of the owner

Employment Agreements

■ Key Provisions/Issues

○ Nonsolicitation Provisions

- Enforceability not addressed by California Supreme Court
- Customer/client non-solicitation provisions *generally unenforceable*, though may be enforceable in connection with protection of trade secrets
- Increasing trend towards unenforceability of employee non-solicitation provisions, but caselaw still mixed
- Unlawful nonsolicitation provisions can result in unenforceability of entire employment agreement

Employment Agreements

■ Key Provisions/Issues (cont'd)

○ Nonsolicitation Provisions

“During the Employment Period and thereafter, Employee shall not directly or indirectly through another person **use any Company Trade Secrets** to (i) solicit any managerial or sales employee or officer of the Company to leave the employment of, or terminate his or her affiliation with, the Company, or (ii) solicit or entice any existing or potential client, customer, supplier, carrier or licensee of the Company for purposes of diverting their business or services from the Company, and shall not otherwise interfere with the relationship between the Company and any such customer, agent, supplier, licensee or other business relation.”

- Unlawful nonsolicitation provisions can result in unenforceability of entire employment agreement

Employment Agreements

■ Key Provisions/Issues (cont'd)

- Choice of Law – CA vs ???
 - Employment agreement may only be governed by law of another state if employee primarily resides and works in CA and is in fact individually represented by counsel – including specifically negotiating venue, forum and choice of law
 - Does this open the door for an enforceable post-employment noncompete in CA?
 - Noncompetes are governed by Business & Professions Code
 - Matter of public policy
- Confidentiality and Invention Assignment Provisions
 - Put in a separate agreement
- Severance and Bonus Payments – Section 409A
 - Employee can't have discretion as to when payment will be made

Employment Agreements

■ Key Provisions/Issues (cont'd)

○ Term and Compensation

- If agreement has a set term, compensation obligation should terminate when agreement terminates

“If Employee’s employment with the Company is terminated for any reason, then all payments of compensation by the Company to Employee hereunder will terminate immediately (except as to amounts already earned), and Employee will be paid all accrued but unpaid base salary and vacation/PTO through Employee’s termination date.”

○ Vacation and PTO

- Employer may cap accrual but should provide that employee will not receive less than applicable law provides (*e.g.*, SF ordinances)

Independent Contractor Agreements

■ Key Provisions/Issues

○ *Dynamex* and AB 5

- “ABC” Test from *Dynamex* codified and effective 1/1/2020
- Must meet all three prongs of the ABC Test:
 - Worker must be free from the control and direction of the hiring entity in performance of the work, both under the terms of the contract and in fact
 - The work performed by the worker must be work that is outside the usual course of the hiring entity’s business
 - The worker must be customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed for the hiring entity.
- Law codifies a number of exceptions (*e.g.*, doctors, bona fide business to business relationships, referral agency/service providers, certain professional services contracts and more)
- Hiring entity must still meet multi-factor *Borello* test

Independent Contractor Agreements

■ The *Borello* Test:

- Whether the person performing work is engaged in an occupation or business that is distinct from that of the company;
- Whether the work is part of the company's regular business;
- Whether the company or the worker supplies the equipment, tools, and the place for the person doing the work;
- The worker's financial investment in the equipment or materials required to perform the work;
- The skill required in the particular occupation;
- The kind of occupation, with reference to whether, in the locality, the work is usually done under the company's direction or by a specialist without supervision;
- The worker's opportunity for profit or loss depending on his or her own managerial skill (a potential for profit does not include bonuses);
- How long the services are to be performed;
- The degree of permanence of the working relationship;
- The payment method, whether by time or by the job; and
- Whether the parties believe they are creating an employer/employee relationship.

Independent Contractor Agreements

■ Key Provisions/Issues

- Avoid Terms Indicative of Employer-Employee Relationship
 - Officer title
 - Provision for “full-time” or 40-hour work week
 - Restrictive on other employment
 - Participation in employee benefit plans
 - Provisions for vacation or PTO
 - Indefinite or long term
 - Job description vs project description

Independent Contractor Agreements

■ Key Provisions/Issues

- Agreement should be in writing
- Recitals, terms and facts should support meeting the *Borello* test and all three prongs of the “ABC” test
- Contractor should covenant to pay all required taxes on compensation received under the agreement
- Contractor should provide services directly to hiring entity (and not its customers unless an exception is available – *See, e.g.,* CA Labor Code Section 2776(a)(2))
- Contractor to provide own tools and equipment
- Contractor may set own hours

IP License Agreements

- **Inbound vs Outbound Agreements**
- **Key Provisions/Issues**
 - Confidentiality
 - Back-door noncompete
 - Indemnities
 - Licensee indemnified for licensor's IP infringement
 - Should specifically cover patent infringement
 - Patent trolls like to sue licensees
 - Avoid damages limited to fees paid to licensor

IP License Agreements

- **Key Provisions/Issues (cont'd)**
 - Service Level Agreement
 - Applicable to software license agreements
 - Provides licensee with ability to be reimbursed for downtime and other licensor nonperformance
 - Assignment
 - No consent of licensor required for assignment in connection with sale of licensee or to an affiliate of licensee
 - Warranty and Maintenance
 - Maintenance and related fees should start after any warranty period expires

IP License Agreements

■ Key Provisions (cont'd)

- Scope of License
 - Site license vs seat license
 - Assigned users vs simultaneous users
 - Make sure that scope meets licensee's needs
- Term and Termination
 - Notice of licensor termination should be sufficient to allow licensee to migrate with minimal disruption
- Source Code Escrow
 - Licensee also needs license to use and modify source code
 - License must be granted prior to bankruptcy of licensor
 - License effective when source code released from escrow