TECHNOLOGY & DIGITAL TRANSACTIONS

Term Sheets and Tech Deals: Key Considerations

KAYE SCHOLER

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Foreword

Any sufficiently advanced technology is indistinguishable from magic: Ecommerce and other information age applications enabling institutions and individuals to transact their earthbound business in virtual space certainly fit futurist Arthur C. Clarke's adage. Yet, pull the digital superhighway's seamless curtain of instantaneous anytime, anywhere access aside and what's revealed is a thicket of intersecting systems driven by their own, very real, practical and legal concerns.

The realities of relying on this patchwork of technologies—and being increasingly dependent on third-party online or mobile websites, cloud-based applications and/or social media networks to promote business enterprises, operate key functionality and conduct core business transactions—place tremendous responsibilities on those who must pull off the trick of making the "magic" work, seemingly effortlessly, by successfully obtaining and safely providing these foundational technological services and systems.

This report, *Term Sheets and Tech Deals: Key Considerations*, focuses on some of the key aspects businesses regularly have to address with their investors, customers, suppliers, partners and regulators. Prepared by members of Kaye Scholer's respected Technology & Digital Transactions group, it addresses ways to stay current with issues surrounding new technologies, which continue to arrive more quickly and bring with them growing lists of concerns as well as business issues with potential long-term impact that fintech startups should consider when taking on investors.

Specifically, the three articles in this report concisely address term sheet negotiations between fintech startups and financial services companies, the promise and problems of hyperlinked contract terms, and managing third-party contract obligations.

Novel technologies, mobile delivery, big data and innovative payment systems, in conjunction with increased intellectual property and individual privacy rights and data security concerns, as well as shifting jurisdictional considerations, continue to reshape the market for both established and emerging companies across all industries. Operating with the quickness connected commerce demands, Kaye Scholer's Technology & Digital Transactions lawyers advise clients in dealmaking across virtually all operational, revenue-generating and strategic areas of their businesses.

Our keen commercial instinct for rapidly identifying and prioritizing key business and legal risks helps clients efficiently manage the regulatory, privacy, technology and financial infrastructure issues inherent in the increasingly intricate and interconnected "anytime, anywhere" e-economy. As all companies increasingly use technology as a core part of their business, they turn to us to advise them on the full spectrum of issues, including new product development, from ideation phase through product launch to ongoing legal compliance and product maintenance; acquiring, licensing or building technology, data and payment systems; creating strategic alliances with other companies to help scale and increase the technology footprint; building ecommerce products and services; and advising on strategies to manage the heavy demands of corporate governance, contracting and compliance.

We hope that this report provides insight into the ever-evolving and increasingly important role that contracting and other legal considerations play in successful ecommerce interactions. As always, we welcome the opportunity to continue our discussion of these issues in greater depth.

Fintech Term Sheet Negotiations: Key Issues Beyond Price

Michael Penney
Counsel

Fintech startups and the regulated financial services companies (FSCs) they hoped to disrupt have realized the benefits of cooperation over competition. FSCs are seeking out the technologies, talent and business models developed by fintech startups to complement organic growth and M&A strategies, as well as to develop competitive advantages. Likewise, fintech startups wish to leverage the global product distribution platforms and compliance infrastructures offered by FSCs. For venture backers and startup founders, FSCs also now serve as primary paths to liquidity events.

As a result of the mutual interests and benefits, the volume of venture investments, joint ventures and acquisition transactions between FSCs and fintech startups has increased significantly. The following issues are often overlooked in term sheet negotiations, complicating the transaction process and placing the benefits of cooperation at risk.

Implications of "Control" Under the Bank Holding Company Act.

The Bank Holding Company Act and its related rules (BHCA), to which most FSCs are subject, can complicate transactions because the BHCA provides that a FSC "controls" the startup if it holds more than 25 percent of the startup's voting stock, controls its board or otherwise has a controlling influence (for example, contract-based negative consent rights). A fintech startup controlled by a FSC also may need to implement portions of the FSC's compliance programs and governance practices, which could affect the startup's culture and cost efficiencies. As a result, the structure of a joint venture or minority investment must balance the benefits of keeping the startup separate from the FSC, thereby maintaining its culture of innovation, with the FSC's ability to protect its investment and achieve its strategic objectives. To mitigate BHCA-related issues, FSCs and fintech startups should analyze the implications of control on the post-closing business model and consider whether each party's transaction objectives can be achieved in a structure where the FSC does not control the startup.

Potential Accounting Impacts.

Transactions between FSCs and fintech startups often use earn-outs and milestone payments to bridge valuation gaps. Venture investment transactions and joint ventures also frequently include purchase options that enable the FSC's complete acquisition of the startup. FSCs and fintech startups too often address the accounting implications of contingent consideration, consolidation, minority interests and purchase options after the valuation is set and the term sheet signed. Unfortunately, the accounting for earn-outs, milestone payments and purchase options can lead to adverse consequences for the earnings of the FSC. To minimize the risk of renegotiating material transaction terms, including price, material accounting issues should be analyzed and considered in connection with the initial term sheet negotiations.

Employment Terms and Employee-Related Closing Risks.

It is not uncommon for acquisition term sheets to be signed after a high-level discussion about compensation levels for key employees, leaving material details to be sorted out later. The employment policies, practices and cultures between FSCs and fintech startups, however, often differ significantly. For example, fintech startups have reporting structures that are flat relative to the hierarchy of an FSC, so startups often liberally use equity incentives for all levels of employees while FSCs often provide meaningful equity compensation to only senior employees. Additionally, FSC compensation programs are subject to external regulations that are not applicable to fintech startups. Accordingly, FSCs and fintech startups should seek more than a high-level understanding of employment packages, incentive compensation programs, reporting lines and key employment policies (e.g., bonus clawback rules) at the term sheet stage to assess risks relating to employee retention and related closing conditions appropriately.

By addressing these often overlooked issues, in addition to valuation and other common term sheet points, FSCs and fintech startups will increase the odds of successfully completing transactions that realize the benefits of cooperation.

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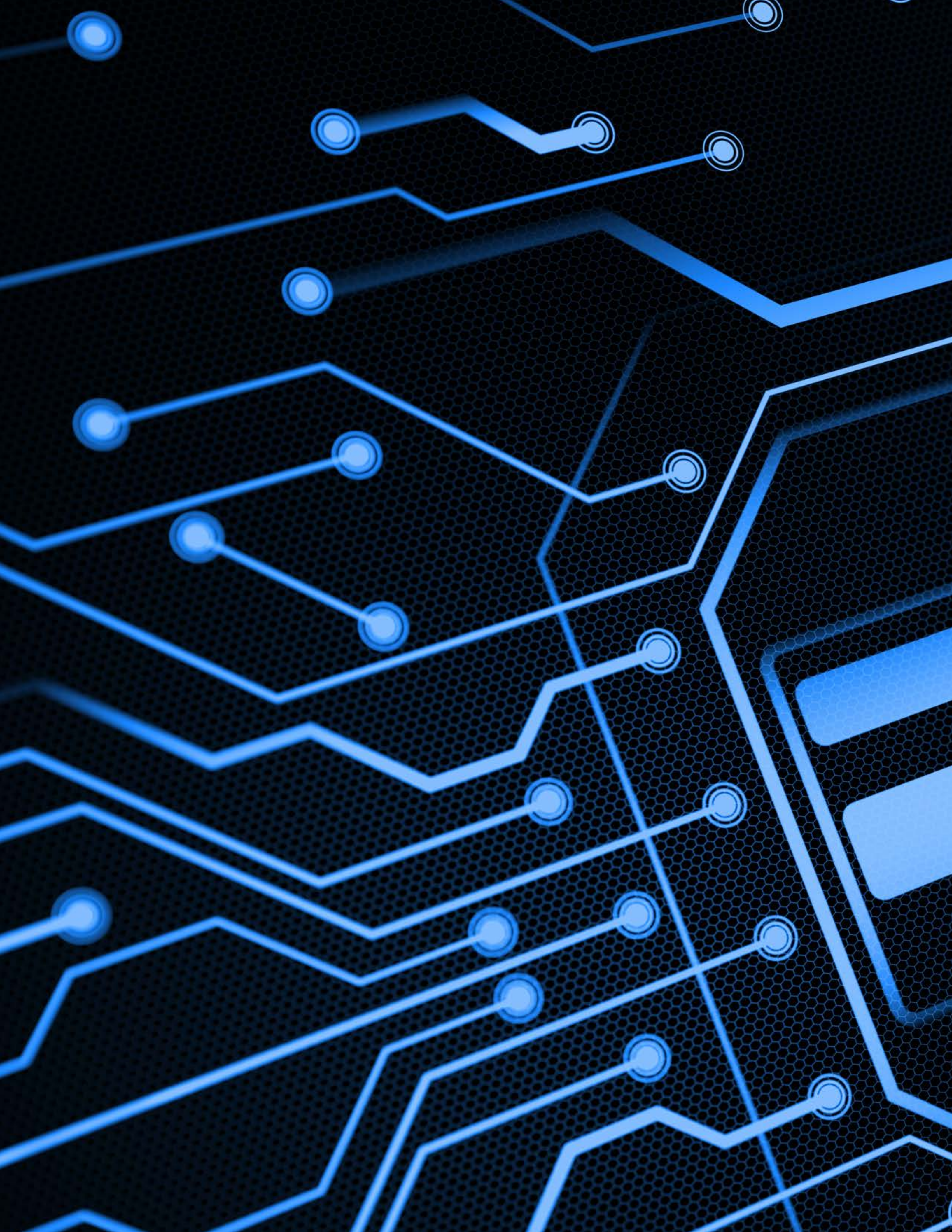

Pitfalls of Present-Day Contracts: Hyperlinked Contract Terms

Glynna Christian
Partner

Molly Bright
Senior Manager, Client Services

Cloud-based services and data services are creating new contract challenges for service providers—and their customers. Many of these issues relate to the myriad changing pass-through terms required by a service provider's own network of underlying agreements with the sub-providers of the services and data needed to make the service provider's cloud-based services operate. These agreements may include arrangements with cloud infrastructure providers, software providers and data providers that often require the service provider to ensure that its customers comply with acceptable use policies, limitations of liability, indemnification and intellectual property licensing or other content requirements.

In such a layered operating environment, how can a service provider easily, efficiently and effectively incorporate these terms into its customer agreements? Frequently, the answer is for the service provider to embed hyperlinks to these contract terms in its customer agreements.

Hidden Problems with Hyperlinked Contract Terms

Despite how seemingly straightforward the hyperlink solution appears, challenges exist on both sides of the coin. Increasingly we are seeing that this convenient solution for the service provider can be difficult from their customers' perspective. The convenience of being able to change the terms as the provider needs, in order to keep them up-to-date, is an issue for the customer because the terms they thought they understood and had previously agreed to, have been changed unilaterally—often without the customer even being aware of the occurrence. Service providers may believe they are providing an easy way to keep all parties informed; their customers may feel they are swimming in quicksand as they try to keep abreast of changing contract terms to which they find themselves already obligated. The service provider needs to ensure that it is diligent about how it rolls out any updated terms or, if the links themselves change from what is represented in a customer's agreement, the contracts may no longer be enforceable. For the customer, even finding the correct referenced term can be a challenge as oftentimes the provided URL goes to the service provider's main website where customers are on their own to hunt in search of the specific references and left to guess if they've found the appropriate terms.

Both the service provider and the customer face other difficulties as well. There may be inconsistencies in the terms between the contracts that are layered within the URLs, including conflicting terms around termination, renewal costs, changes in authorized users, location changes (to a different jurisdiction and/or provider) of the servers storing information such as software needed by the customer and even customer-owned data, changes to server access locations and inconsistencies in the use of defined terms. The list of possible inconsistencies in today's dynamic business environments is a long one, and these possible gaps can cause confusion for both the customer and the service provider around their respective rights and obligations. Businesses on both sides of a service contract

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are finding their needs becoming more worldwide, and understanding the laws impacting service delivery and use is becoming even more challenging on a global scale (e.g., export, labor, security, etc.). Negotiating changes to such contracts may be necessary as laws change. However, this also poses its own dilemma for both parties. The service provider is likely passing on to their customers the contract terms from their agreements with suppliers. Understandably, the service provider is not going to be enthusiastic about making changes to terms to which it is obligated to a third party. Customers, on the other hand, are not going to be happy hearing they must accept responsibility under terms that are not satisfactory to them for services for which they are paying!

Solving the Quagmire

Despite these circumstances, finding a compromise solution is *not impossible*! From the customer viewpoint, one workaround is to remove the URL reference and change the language in the agreement so that instead of pointing to a hyperlinked page, the reference in the agreement points to a printed version of the URL-referenced pages that becomes an exhibit to the contract. This ensures that both parties are aware of the terms at the URL reference. If the URL reference must stay or if the service provider insists on allowing the terms found at the URL reference to change without an amendment to the agreement, a solution could be to add language ensuring that the terms of the agreement around data protection, confidentiality, limitations of liability and indemnification always have precedence and control over any conflicting terms found at the URL reference. In addition, if changes to any of the terms found at the URL reference would have a material impact on the services provided, reduce the amount of services provided, impact any personally identifiable information or data protection obligations or increase fees or liability, then the customer may demand the right to terminate the agreement with no termination charge.

Service providers also need to consider carefully if they want to pass all of their obligations on to their customers. Service providers may take the view that it is unreasonable to expect their customers to comply with certain obligations or to take on certain liabilities, or that it is not commercially viable to do so. Contractual provisions such as limitations of liability and damages caps should be considered carefully before automatically requiring customers to take on the same liabilities. Accepting certain liabilities without passing them onto their customers may be a cost of doing business for certain service providers.

In summary, for the service provider, managing these multilayered contracts and keeping its customer base contracted under the same updated versions requires a good contract management system. A dedicated staff that is diligent about checking all references contained within the embedded contracts to ensure consistency and compliance with all contractual terms whenever the supplier agreements are updated should also be part of the process to ensure that your company understands its rights and obligations under all of these agreements, and which terms it truly wants to impose upon its customers.

Using Technology Service Providers Is No Silver Bullet

Glynna Christian
Partner

Amy Lauren
Counsel

When millions of customers can be affected by large-scale data breaches at national retailers and major airlines can be literally ground to a halt when technology fails, the increasing dependency of companies across the economy on technology is apparent to everyone. Significantly less apparent, however, is the degree to which companies rely on third-party service providers to supply the technological infrastructure on which they depend, and the legal responsibilities such reliance creates.

Rewards and Risks of Relying on Technology Service Providers

If you are the person tasked with solving the issues that erupt when technology fails at your company, you would most likely be getting on a conference bridge with representatives from a number of technology service providers rather than dealing with corporate headquarters. Technology service providers support the technology infrastructure for most companies in this country and, consequently, can be at the root of many of the technology crises your business faces today.

There are many commercial reasons to rely on third-party providers, not the least of which is that a company will get to market faster and save resources. In many circumstances, it makes more business sense to find a service provider specializing in a particular technology versus building the same thing in-house, which could take years and be at great cost to the company. It is precisely because companies often use service providers to attain unfamiliar technical expertise, that they often feel a great sense of relief that someone else is "handling it," and remove themselves from the details. In doing so, companies often miss the fact that although a third party is now "handling it," they themselves are still on the hook to comply with applicable laws and all of their existing contracts affected by the service provider's activities.

In fact, multiple contracts and legal requirements can even govern one single activity performed by a technology service provider, and can create a legal compliance challenge. In the payments space, merchants outsource the processing of credit card payment transactions to "merchant acquirers" and/or payment processors, often believing that once outsourced, the obligations required to process credit card transactions are no longer their responsibility. Merchants are often unaware that they may have other legal obligations that limit or are affected by the acquirer's or processor's activities.

For example, the merchant's agreements with credit card issuers and its required adherence to credit card network rules are all necessary to complete a credit card transaction. These agreements and rules all require merchants to adhere to the most recent version of the credit card networks' security standards, the Payment Card Industry Data Security Standards (PCI DSS), to process or transmit credit card data related to payment transactions. While the merchant may think it will comply with its multiple obligations to be PCI DSS compliant because its acquirer and/or payment processor will comply with PCI DSS on its behalf, the agreements with the acquirer and/or payment processor generally also require the merchant to comply with PCI DSS.

Some acquirers and payment processors will guide you in such a way to help ensure that you can rely on their systems to make your online payment experiences PCI compliant. However, not all are willing to do this, and, even those that do will not take this obligation out of their agreements with you. If their system is not PCI compliant, yours cannot be, either, and you are somewhat oddly in breach of your agreement with the acquirer or payment processor. In essence, these companies want to try their best to make sure you share in the liability in case their compliance fails. This risk can really only be mitigated by practical mitigants such as verifying the acquirer's or payment processor's compliance with certain requirements of PCI DSS through various levels of audits and reporting. Otherwise the merchant risks breaching its other agreements required for payment transactions, possibly resulting in contract terminations, breach of contract claims and/or the inability to offer certain payment methods.

Managing Your Technology Infrastructure Obligations

Merchants outsourcing credit card processing is just one example of how the technology infrastructure of many companies can often be supported by a rather byzantine set of contracts and/or applicable laws. So how does a company get a handle on the panoply of legal obligations that it has in connection with its technology infrastructure? At a minimum, there are three steps:

1. Synthesize all of the relevant contracts supporting the technology infrastructure (including the service provider agreements supporting the business), with the laws, rules, regulations and regulatory guidance applicable to the company's and the service providers' activities;
2. After you have determined the scope of the company's legal obligations, ensure that the service provider contracts contain the "right" contractual obligations. These include requirements derived from applicable laws, specific regulatory expectations of the company in the form of contractual provisions and pass-through obligations and indemnities from the company's contracts that are affected by the service provider activities. All of these terms should be moved into the service provider agreements to ensure legal compliance for the company; and
3. Implement policies and practices, to the extent possible, to address any gaps and mitigate risks if service provider contracts do not have the necessary obligations, such as renegotiating the contracts and/or increasing service provider oversight.

Beyond these contractual issues there are other measures to be implimented by your company to ensure ongoing compliance with laws and contractual obligations and to mitigate legal risks. But ongoing compliance is impossible without first laying the foundation of your company's obligations. It is critical to find technology service providers to support your business—but never forget your business is still your home—it's your responsibility.

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Contributors

Glynna Christian
Partner
glynna.christian@kayescholer.com
+1 650 319 4580

Amy Lauren
Counsel
amy.lauren@kayescholer.com
+1 212 836 7411

Michael Penney
Counsel
michael.penney@kayescholer.com
+1 312 583 2363

Molly Bright
Senior Manager, Client Services
molly.bright@kayescholer.com
+1 650 319 4549

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Industry focused and client driven, Kaye Scholer helps clients stay ahead of the market with the sophisticated legal services and deep industry knowledge necessary to anticipate opportunities and address issues that impact the very foundations of their business. The firm focuses on two key sectors, life sciences and financial services, and draws on its recognized strengths in bankruptcy, corporate, finance, intellectual property, litigation, real estate and tax to offer strategic guidance and sophisticated legal counsel to public and private entities in litigation, transactional or governance matters. Combining the continuity of a century-old law firm with a practical forward-looking, results-driven approach, Kaye Scholer regularly advises clients across the US, Canada, UK, EU and China.

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