

TheCuttingEdge

Spring 2006

The newsletter for Technology Transfer specialists



Welcome to the spring issue of The Cutting Edge. We hope you find it relevant and interesting, and would welcome any feedback on other areas you would like to see addressed in future issues.

This issue looks at whether the rules on EMI options affect a spin-outs' ability to attract top management. A recent case concerning confidential information is also reviewed.

Spin-outs – the story so far...

James Went, a corporate finance lawyer at Manches, summarises the findings of the recent review of university spin-outs 'Creating Success from University Spin-out Activity' carried out by Library House on behalf of the British Venture Capital Association.

In November 2005, the British Venture Capital Association (BVCA) published its report on university spin-out activity in the UK. This report builds on information gathered by Library House on 435 spin-outs from leading universities in the UK (2004 Library House Spin-out Monitor) by adding qualitative information obtained from questionnaires circulated to venture capitalists, universities and spin-out companies together with follow up interviews with the respondents. The result is a useful study of university spin-out activity with a focus on the key challenges facing spin-outs and suggestions as to how they can be met. It also contains some interesting comparisons with spin-outs in the US and early stage technology companies from other backgrounds.

Space does not permit a full analysis of this lengthy report (which is available on the BVCA website at www.bvca.co.uk) but here are a few highlights.

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Finding the right woman (or man)

The survey asked spin-outs and university technology transfer offices (TTOs) what they found most challenging in developing investment proposals. Recruiting experienced and talented entrepreneurial management ranked highest, followed by demonstrating to investors the potential on exit.

The management problem is a perennial one since the skills required are not those that most academics have been required to use in their careers so far. While universities have begun to develop greater links with appropriate entrepreneurs, the BVCA believes that a key difficulty is negotiating an appropriate incentive package. TTOs are seen as overvaluing the science, suggesting that despite recognising the need for good managers, when it comes to the crunch they aren't willing to pay for the all-round value that they can bring to the business. The report suggests further priority is given to this issue with TTOs sharing experiences and salary information.

The report suggests that TTOs believe that putting in place the right management team with the skills to meet investors' needs will provide a solution to most of the remaining challenges. However, the BVCA suggests that further education of academics and technology transfer professionals on the challenges of operating a business and the needs of investors is still desirable.



The importance of IPR

The review analysed four main strengths that VCs were looking for in spin-outs – the innovation; the team; the market; and the investment case – and broke these down into sub-categories which were then rated by VCs, TTOs and spin-outs. It was found that, broadly speaking, VCs and TTOs were singing from the same hymn sheet and attributed common levels of importance to the relevant strengths.

However, an interesting finding was that VCs rated the level of IP protection for the technology as significantly more important than TTOs. 'Developing intellectual property that is clean and robust' was cited by VCs as a key challenge and a primary responsibility for TTOs. This requires a thorough approach to IP protection and examination of the prior art and TTOs should consider whether their institution's IP is properly protected at all stages in its development. The BVCA suggests that this may involve training researchers on the basics of protecting IP rights and further developing procedures to protect the results of research where appropriate.

Too much, too soon?

One key contention of the report is that spin-outs are being formed at too early a stage, before delivering proof of market and technology. The review found that spin-outs were seen by VCs as undeveloped compared to investment opportunities in other early stage technology companies.

Motivations cited for early formation included: establishing a legal entity which could attract equity investment or to which IP could be transferred signalling separation from the university; and enabling universities to meet targets for setting up companies (implicit or explicit). There may also be strong tax advantages in certain circumstances.

However, the BVCA suggests that the early stages of development of potential 'spin-out' technology would be better carried out within the research institution, with grant funding being used to develop the technology and provide proof of concept. Once that stage has passed, the decision can be taken as to the best route to further develop the concept, be that establishing a spin-out company or licensing the technology. Indeed, the conclusion may be that further research is required or that the technology is, for the present at least, a dead end. In that case it is preferable to establish that before a company has been spun out and further time and money has been spent on the project.

In addition, companies that are formed too soon may not be sustainable in the long run. Such companies can have an adverse effect on the market generally, diminishing the commercial credibility of the TTO and its projects and reducing the size of the investment cake available for more developed companies.

The report therefore reinforces the importance of TTOs, founders and their advisers critically assessing each project and reviewing whether or not the time is right to set up a company.

Incentives for academics

The review also considered what incentives are in place for universities which and individual academics who have a genuine commitment to commercialising technology arising out of their research.

The institutions themselves enjoy no formal incentives for encouraging this activity. There may be financial rewards further down the line, but there is no equivalent to the RAE. The BVCA recommends that the government, in consultation with the universities, develops a comparable incentive mechanism. The RAE is, of course, not without its problems and the particular problem with incentives in this area is the danger of inappropriately shaping activity. This may be the case if they focus on volume of activity or particular forms of commercialisation (e.g. spin-outs rather than licensing), without regard for the quality of the outcome. The measure of success will be the number of successful commercialisations, not simply the number of spin-outs, or even the number of successful spin-outs.

At the individual level, universities should, if they have not already done so, consider introducing formal policies for incentives for academic inventors. Like any employee benefits scheme these require careful consideration of the effects on the tax position and employment rights of founders but, as with any RAE-type scheme, it will be important to ensure they are encouraging the right thing and going for quality over quantity.

Conclusion

While much of this report will not come as news to those experienced in the spin-out field, it does serve as a useful synthesis and reminder of what investors are looking for from a VC perspective. It should therefore be required reading for all technology transfer specialists and may well prompt universities to review their activities and benchmark them against best practice.

For further information please contact James Went on 01865 722106 or by email to james.went@manches.com

Too mature for EMI options?

Patrick Baddeley, a partner in Manches' corporate finance group, explains how pressure from venture capitalists to develop IP to a greater level of maturity before incorporating a spin-out might jeopardise the spin-out's ability to grant attractive incentives in the form of EMI options to its founding management team.

In his article entitled 'Spin-outs – the story so far' James Went highlights two points which emerge from the Library House review of university spin-outs. The first is the importance to successful spin-outs of finding experienced and talented managers to run the spin-outs and of putting in place appropriate incentive packages for these managers. The second is the feeling amongst venture capitalists that spin-outs are being created too early and that the intellectual property on which the spin-outs are based should be developed to a greater level of maturity before being made available to a spin-out.

Enterprise Management Incentives

Enterprise Management Incentives (EMI) are one of the most attractive forms of incentives available to attract talented managers to spin-outs. A manager can receive up to £100,000 worth of EMI options to subscribe for or acquire shares in a spin-out company. EMI options confer two major tax benefits which are not available with unapproved options:

- i. provided that the options are granted with an exercise price which is not below market value, the option holder will not pay any income tax when he exercises the option, only capital gains tax as and when he sells the shares that he acquires upon exercise of the option; and
- ii. taper relief for capital gains tax purposes starts to accrue from the date of grant of the option and not from the date on which the shares themselves are acquired. The option holder is thus usually able to achieve an effective capital gains tax rate of 10% by the time that he comes to sell the shares.

EMI options were introduced by the Government with the express intention of helping to persuade experienced managers to leave larger companies in order to join smaller companies which would then grow under their guidance.

If, however, the venture capitalists' view that intellectual property should be retained and developed to a later stage within academic institutions prevails then there may be a problem under the EMI legislation which would prevent EMI options being granted, thus exacerbating the universally acknowledged problem of finding talented and experienced management.

The Problem

Under the EMI legislation only certain types of activities are 'qualifying activities' i.e. activities which a company can carry on and still be able to grant EMI options. Looked at another way, a company must exist for the purpose of carrying on a 'qualifying trade'. A trade will not be a qualifying trade if it consists (either wholly or as to a substantial part) in the carrying on of excluded activities. The legislation contains a list of 'excluded activities' which includes 'receiving royalties or licence fees'. The list is designed to exclude activities that do not involve the creation of wealth from the creation of new assets. For this reason there is an exception to the basic rule that receiving royalties or licence fees is an excluded activity. If the royalties or licence fees are attributable to the exploitation of a 'relevant intangible asset' then their receipt will not be an excluded activity.

A 'relevant intangible asset' is an intangible asset, e.g. a patent, the whole or greater part of which (in terms of value) has been created by the company carrying on the trade or by a member of the same group of companies as that company. Thus companies which are creating their own intellectual property and then exploiting that intellectual property by licensing it out will be able to grant EMI options. If, however, the greater part of the value of the intellectual property is created elsewhere, e.g. within a university, and that intellectual property is licensed to a spin-out company which then licenses it out commercially, the spin-out company will not be able to grant EMI options.

The Solution?

If there is pressure on universities to develop intellectual property to a greater level of maturity then there must be a danger that more spin-out companies will suffer the problem referred to above. That said, we would not wish to overstate the extent of the problem. It is probably unlikely, even if the venture capitalists' wishes prevail, that intellectual property leaving a university will be the finished article, ready to be licensed out without any further work by the spin-out company. It is also the case that many spin-out companies which exploit intellectual property created by universities do not do so by licensing out that intellectual property. In these cases, the spin-out company may still be able to grant EMI options.

If there is pressure on universities to develop intellectual property to a greater level of maturity then there must be a danger that more spin-out companies will suffer the problem referred to above.

However, we would be interested to hear from our readers the extent to which they have already encountered or believe they are likely to encounter this problem (we have had one instance ourselves). It seems to us that there would be an easy solution to the problem, which would be to have a carve-out for intellectual property created by a 'research institution', similar to the carve-out which was created in last year's Finance Act in order to remove the 'Schedule 22' problem for university researchers (on which see the Summer 2005 edition of *The Cutting Edge*). Thus, even if the greater part, in terms of value, of the relevant intellectual property was created by a research institution, a company which licensed this intellectual property from the research institution would not be prevented from granting EMI options if it subsequently licensed out the intellectual property in return for licence fees or royalties.

The author would be interested to receive comments on this issue by email to patrick.baddeley@manches.com



When is a secret not a secret?

Confidentiality clauses are not always as effective as the parties to the agreement might think. Catherine Rohll, a solicitor in Manches' Technology and Media Department, reviews the recent Court of Appeal decision in the case of EPI Environmental Technology Inc v Symphony Plastic Technologies Ltd and explains why.

Facts of the case

The case concerned the supply by EPI to Symphony of proprietary chemicals used as additives to make certain types of plastic biodegradable. The supply was subject to a number of agreements, including a confidentiality agreement. Under the confidentiality agreement, Symphony was prohibited from using or disclosing any of the confidential information provided by EPI and from analysing the additives supplied or using them for any purpose not permitted by the agreements.

Symphony then started producing its own additive which was, according to EPI, similar in composition and utility to one of the additives provided to it by EPI. EPI claimed that Symphony developed the formula for its own product by analysing the EPI additive and misusing EPI's confidential information (including information derived from the analysis) and sued Symphony for, amongst other things, breach of confidence and breach of the confidentiality provisions in the various agreements. Symphony denied that it had analysed EPI's additive, but argued that even if it had, it would not have gained any more information than was already in the public domain and that use of publicly available information (however acquired) could not amount to breach of confidence.

Because some of the information at issue in this case was commercially sensitive, both the original trial and the appeal were heard in private and only parts of the judgments are available for review. While this makes it difficult to fully understand the reasoning for this particular decision, there are still some general lessons to be learnt from the public parts of the judgments.

Legal Context

Under the general law of confidence, a person has a duty to keep confidential information which he receives in circumstances in which he knows (or ought to know) that the information is confidential. In addition, a party may also impose contractual obligations to keep information confidential, either under a confidentiality agreement or by including confidentiality clauses in some other type of agreement. However, even in the case where there is a contractual obligation, it may still be relevant to assess whether the information purportedly covered by that obligation is, in fact, confidential in nature.

The case law on this point is not clear cut with some cases finding that any claim for breach of confidence must fail if the information in question is in the public domain and others finding that a prohibition on use of public domain information may be upheld if it is conveyed in circumstances of confidence and the recipient gains an advantage by obtaining it in that way. The apparent discrepancy between these cases was highlighted but, unfortunately, not resolved in this case.

The High Court Decision

In the case of *EPI v Symphony*, the High Court held that there had been no breach of the general law of confidence on the basis that the composition of EPI's chemical and its process of manufacture were publicly available. The Court held that the fact that the EPI additive was supplied under the auspices of a confidentiality agreement could not make it confidential when its constituents were published on EPI's website and its manufacturing process was described in a published patent application. The judge said that a logical extension of EPI's argument that Symphony should remain bound by the obligations of confidence in relation to information that was publicly known would be that Symphony would be the only organisation in the world that could not make use of this information. This, he said, would be a bizarre result and was not what was intended by the law of confidence.

The High Court also held that there had been no breach of the contractual obligations of confidence imposed on Symphony. The reasoning for this was given in the confidential part of the judgment. However, it can be inferred from the parts of both the High Court and the Court of Appeal judgments that are available that the Judge found that Symphony had not, in fact, analysed the EPI additive or misused any information provided by EPI in developing its own product.

EPI appealed against this decision. One of its grounds for appeal was that because, EPI said, the Symphony additive was so similar to its own, it should be for Symphony to prove that it had NOT analysed the EPI product and misused EPI's confidential information in creating its own product, rather than for EPI to show that it had. EPI argued that Symphony had not proved this and therefore that the Judge had been wrong to hold that Symphony had not analysed and copied its additive.

The Court of Appeal Decision

The Court of Appeal rejected EPI's arguments and upheld the High Court's decision that there had been no breach of confidence or contract by Symphony. It further held that EPI was incorrect in arguing that the burden of proving Symphony had NOT analysed EPI's product and misused EPI's confidential information rested on Symphony – the burden of proving this remained with EPI throughout.

Unfortunately, as noted above, the Court of Appeal did not deal further with the question of whether publication of information always destroys the confidentiality in it or answer the question of whether it is possible to enforce a contractual prohibition on analysing a product if to do so would only provide information that could otherwise be obtained from public sources. Its reason for not doing so was that this would have been a purely academic question in this case as the Court of Appeal had already upheld the High Court's finding that Symphony had not analysed the EPI additive. Also, the answer to the question might depend on the facts of the case, for example whether or not the claimant had voluntarily put the information into the public domain, and the Court's determination in this particular case would therefore have little value in terms of precedent. The Court further noted that this is a question of considerable general importance that does require resolution by it or by the House of Lords, but that it was far too important to decide on the basis of hypothetical facts.

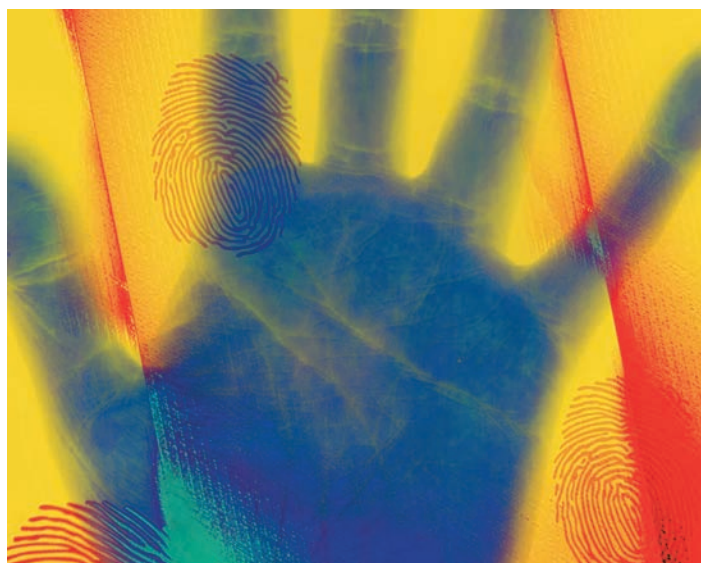
Practical Points

The important point to note from this case is that when providing confidential information under contractual provisions imposing obligations of confidence, you may not be able to rely on those obligations unless the information provided is truly confidential.

In the context of providing materials, while you may be able to prevent certain uses of the actual materials that you provide, it may be more difficult to prevent the recipient from analysing the materials and producing their own similar or equivalent materials that they can use and disclose freely. It is therefore important to consider the inclusion of provisions that prevent analysis or reverse-engineering of the materials in any material transfer agreement, although if this analysis would only provide the recipient with information that is already publicly available, you should bear in mind that these provisions may not be enforceable.

It is also worth remembering that while patents may provide the best protection for inventions, they also result in publication of the invention which can provide opportunities for others to work around the claims of the patent and avoid infringing it. It also means that information disclosed in the patent application may no longer have the necessary quality of confidence that it needs to be protected under the general law of confidence or contractual liability provisions.

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For further copies of this newsletter or to discuss any of the issues raised here please contact Catherine Rohll in our Oxford office on 01865 722106 or by email at catherine.rohll@manches.com

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