In 2023, TenU launched the University Spin-out Investment Terms (USIT) Guide to much enthusiasm from the university innovation sector. By identifying a landing zone for what a positive spin-out and investment deal should look like, the USIT Guide provides evidence of the shared commitment of experienced stakeholders to accelerating the journey from research to market, so new ideas can quickly become solutions to the greatest challenges of our time.

The USIT Guide was also well received by the UK government which recommended it as a starting point for negotiating spin-out deals for life sciences, in its response to the 2023 Independent Review of University Spin-out Companies.

As the Government pointed out, the USIT Guide is focused on patent-rich technologies, such as life sciences, where the enterprise operates in capital-intensive, highly regulated environments that require significant investment to develop a product. It therefore is also applicable to companies operating in other deep tech sectors where similar principles apply.

So why the need for a new guide?
USIT for Software has a different focus: software spin-outs, companies based on source code that may involve know-how, data, database rights and copyrights, and often no patents.

Like the first USIT Guide, USIT for Software is designed to offer a landing zone and guidance on what a positive deal should look like. But it also recognises that, in the case of software, which may not have the strict regulatory frameworks of life science companies and/or the inherent need for significant capital investment, the pathway from research through company formation to exit can be very different.

Specifically, it highlights that a focus on customer needs is a common thread among software companies. With less attention paid to protecting the originating technology, and in the context of a lower regulatory requirement, founders and management teams work with potential customers to translate the technology into a marketable product or service, with time-to-market a key priority. As this guide shows, this has implications for the founding team, the business plan, funding rounds, and the pathway to exit, all of which are built with much more flexibility and dynamism in mind.

USIT for Software was created with the same rigorous characteristics as the USIT Guide. Spearheaded by TenU, USIT for Software was developed throughout 2023 and agreed upon by experienced representatives of leading university innovation offices (UIOs), and prominent VC firms listed below. The document benefitted from detailed comments by specialised law firms Goodwin Procter, Taylor Wessing LLP and Venner Shipley LLP, and a sector-wide consultation process including PraxisAuril, the Royal Academy of Engineering and the British Private Equity and Venture Capital Association (BVCA).

We invite all involved in creating university spin-outs to embrace the goodwill inherent in USIT for Software. We repeat the call to action of the USIT Guide: Use it to facilitate the spin-out process, accelerate deals, strengthen investor returns, and secure a sustainable research base. Use it to build enduring companies that increase societal impact and generate healthy economic growth. Use it to succeed.

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“USIT for Software is the result of sector-wide collaboration to create a set of recommendations for investment in software spin-outs. This effort builds on the USIT Guide for the life sciences and deep tech sectors, complementing each other and creating recommendations for the full spectrum of low to high IP companies. USIT for Software will be transformative to the software sector, encouraging more academics to work with universities to create successful spin-outs, and accelerating investment deals to support the UK’s economic growth. Research England commends the Guide for consideration by the university sector and its partners.”

Jessica Corner
Executive Chair
Research England

“Strengthening relations between universities and the VC and founder communities is critical to achieving sustained growth in key sectors of the economy. This rigorous and collegial USIT initiative, in both life sciences and now software, demonstrates that there is a shared commitment to achieving this important goal.”

Tim Haines
Executive Partner, Managing Director
Abingworth

“Founders who are meaningfully incentivised to spin out and grow their companies are at the heart of a successful innovation and entrepreneurship ecosystem. The ease of the spin-out process matters greatly. USIT for Software offers a framework for enhancing transparency and aims to enable more effective collaboration between the university, VCs, and founders.”

Ana Avaliani
Director of Enterprise
Royal Academy of Engineering
“PraxisAuril welcomes the expansion of the USIT recommendations to include software, which will increase the range of new company opportunities that will benefit from its guidance. TenU’s UK members are part of our broader knowledge exchange professional community and are demonstrating the value of peer-to-peer learning to advance research commercialisation across the university sector.”

Stuart Wilkinson
CEO
PraxisAuril

“This guide will be an invaluable resource for aspiring founders, serving as their compass in the start-up journey. It will provide knowledge of best practices for software companies and act as a beacon for founders to know what good looks like. Looking back, I wish it had existed when I started Oxford Heartbeat.”

Katerina Spranger
Founder and CEO
Oxford Heartbeat

“The UK is brimming with bright ideas born in universities. This guide will help ensure that software spinouts can be formed quickly, and deliver for founders, universities and investors.”

Michael Moore
Chief Executive
BVCA

“With so many brilliant businesses waiting to be spun out of British universities, I welcome this effort to speed up dealmaking. I look forward to seeing more research breakthroughs becoming commercialised as real-world innovations, helping to achieve a more dynamic and faster-growing economy.”

Poppy Gustafsson
OBE, CEO
Darktrace
Executive Summary

The University Spin-out Investment Terms for Software Guide (USIT for Software) was developed to offer consistent and transparent recommendations, to minimise transaction costs and to simplify complex negotiations. Developed with a focus on software spin-outs, USIT for Software offers guidance on common spin-out pathways and negotiation approaches in order to strengthen the ability of university entrepreneurs to create transformational businesses.

USIT for Software builds on the USIT Guide, which has a focus on resource-intensive, patent-rich spin-outs and is applicable to enterprises operating in the life sciences and deep tech sectors. The USIT Guide is extensive in outlining potential terms in both term sheets for spin-out formation and a Heads of Terms for licensing. Each term includes an explanation of the term itself and common factors in its negotiation in a way that is easily accessible, fair and without bias to any party.

USIT for Software focuses on what characterises software spin-outs, so it is recommended to keep both guides handy. In order to help readers navigate the differences, section 4 provides a comparative summary table outlining the terms in the two guides for quick reference.

USIT for Software is structured in four sections:
The first section introduces the reader to university spin-out investment and shares the vision for the overall guide.

Section 2 characterises software spin-outs as distinct from their patent-rich counterparts. Generally less encumbered by the regulatory framework of life science spin-out pathways and often with a reduced need for capital to develop a product, software spin-out pathways present more flexible and dynamic approaches resulting from a focus on customer needs and time to market. The section therefore draws out the potential implications of these approaches for the capitalisation table, management, business plan and licensing.

Section 3 contains detailed recommendations, in two parts, for negotiating deal terms between universities, founders and investors. The first part focuses on term sheets for software spin-out formation; the second part on Heads of Terms for software licence agreements. Each term is given detailed consideration, providing clear recommendations on common practice and explaining the rationale for different positions under different scenarios.

Finally, as outlined above, section 4 offers a summary table comparing the two guides, the USIT Guide and USIT for Software, so that readers can find contents and potential differences quickly.

Recommendations
USIT for Software offers a reference point intended to be used sensibly by practitioners who must adapt to and recognise the specifics of each deal. It makes the following recommendations for its users:

• **Value from customer interaction**: Software businesses evolve through continued engagement with customers, understanding their developing needs, and identifying where the technical advantages of the piece of software can deliver distinctive performance. In many instances, speed to market is key, with spin-outs launching with a minimum viable product (MVP). This can differ from life sciences and deep tech spin-outs, which place greater emphasis on protecting the originating technology and gathering data to prove technical performance. This different distribution of value between founding IP and accumulated founder–customer interaction, and the resulting speed of technology development, contributes to the justification for the approaches outlined below.

• **Founding equity**: The founder’s equity in software spin-outs is typically 90–95%, with university equity at 5–10% for the value created by universities in the establishment, development, translation and commercialisation of research.
This landing zone reflects the generally lower resource needed to generate and develop the software spin-out opportunity to an investible stage, when compared to life sciences and deep tech spin-outs. Section 3.2.3 outlines different scenarios under which the range may be considered and encourages examination of particular circumstances to determine final equity positions.

Distribution of the founder equity is decided by the founding team, who will need to consider reward of past inventive contributions and incentivisation of the future operating team.

- **Licence fees and simplicity:** Licence fees are generally more simplified in IP licence agreements with software than with life sciences and deep tech spin-outs, e.g., signing/upfront payments or an annual fee may be the primary licence fee, and development milestones are less common. The common landing zone for royalty rates on net sales is 0.5–2%, depending on IP type and other terms of the deal. Section 3.3.1 offers specific circumstances under which this range may be considered, and lays out additional considerations for determining royalty rates.

- **University timelines and processes:** Focus should be on lean spin-out formation for university software spin-outs with bootstrapping being a viable option to enable early customer engagement. Prompt, cohesive engagement across all parties can greatly fast-track preparative activities, such as clarifying IP ownership. As soon as a term sheet is received, it should take no longer than three months to sign and finalise all outstanding IP licence and company documentation. Universities publishing clear and transparent processes and timelines can further speed up formations. Speed does depend on parties to the transaction minimising counter-negotiations.

- **Spin-out preparedness for change and exit:** University software spin-outs may plan for long-term company growth or may adopt a strategy for earlier exit. Exit pathways can include mergers and acquisition (with or without earn-outs), acquihires (acquiring primarily for the company’s employees), or IPOs. Where an M&A transaction is an anticipated exit pathway, software spin-outs should prepare from the outset for a speedy exit transaction, including establishing a data room early on. At spin-out formation, it is important to set expectations about what will happen to the IP licence arrangements at an exit transaction to avoid protracted exit processes. A spin-out may need to allow for activities over several months if it wants to change commercial arrangements with the university.

We encourage stakeholders to work collectively to deliver faster and more effective spin-out development. This will ultimately increase economic growth and job creation and provide more solutions to societal challenges through the development and application of transformative technologies from university research.

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Introduction
1.1 What is USIT for Software?

USIT for Software, short for the University Spin-out Investment Terms for Software Guide, is a set of best-practice investment and licensing terms for university software spin-out company formations. It has been developed and agreed upon by leading global VC investors and universities, and includes input from leading law firms and industry partners.

USIT for Software has been created in response to feedback from users of the USIT Guide, reflecting on the different challenges and opportunities in developing software spin-outs compared to life sciences and deep tech spin-outs, which warranted further reflection on the recommended deal terms.

The UK government’s response to the Independent Review of University Spin-out Companies published in late 2023 notes that: ‘Software spin-outs are becoming more common, but the market dynamics, importance of IP and capital-intensity of software companies can differ from more traditional spin-out sectors such as pharmaceuticals. The adoption of new guidance aimed at software will lead to fairer deals for software spin-outs.’ The response then goes on to extend an invitation for TenU to develop this new guide.

USIT for Software was created through a series of roundtable sessions convened by TenU’s six UK members and venture capital investors. The investors included funds associated with universities: Oxford Science Enterprises and Cambridge Innovation Capital, and independent venture capital firms with significant software spin-out experience: IQ Capital, Local Globe and Octopus Ventures.

The parties reviewed the USIT Guide’s recommendations across 22 inter-related items that define a typical university spin-out investment deal and made new recommendations specific to software spin-out companies. Drafts were revised at regular intervals by representatives from legal firms: Taylor Wessing, Goodwin Procter LLP and Venner Shipley LLP. Following a period of consultation, the parties incorporated feedback from the university, VC and founder communities, with support from professional associations PraxisAuril, the Royal Academy of Engineering and the British Private Equity and Venture Capital Association (BVCA).

As with the USIT Guide, USIT for Software has been designed to create a landing zone for a fair deal and to share best practice in a transparent manner for all stakeholders in order to speed up the process to form university software spin-outs. The aim is to enable investors and founders to make financial returns and universities to deliver positive impact from their research.
UIOs are increasingly critical to a healthy and vibrant innovation ecosystem. They are continuously evolving and innovating, developing new ways of working to ensure positive outcomes for entrepreneurial academic staff, such as the development of USIT for Software. At the same time, all universities are unique and have different levels of resources available to focus on innovation. UIOs must work to ensure efficient use of a university’s finite resources for the long-term sustainability of its enterprising activity.

UIOs may consider approaches to additionally encourage academic founder engagement and founder voice representation early in commercialisation activities. Some universities are appointing academic and student ‘champions’ to make sure university founders and UIOs are regularly communicating, considering each other’s needs and soliciting feedback for both continuous improvement and optimised commercialisation activities.

Creating successful businesses from university research is critical to solving global challenges. UIOs must support and enable diverse communities of academics, researchers and students to become capable founders, to achieve their personal ambitions, and to deliver the impact missions of their universities.

**The Role of Universities and University Innovation Offices in Spin-out Success**

Universities play critical roles in driving spin-out success, including supporting academics in the following ways:

- salaries for academic founders whilst working on/for spin-outs;
- upfront financial and resource costs of IP protection;
- introductions to important networks, e.g., mentors, investors, customers and service providers;
- support in the creation of an effective business model;
- support in technology due diligence;
- support in IP due diligence to clarify IP ownership and deliver efficiently into the spin-out;
- use of labs and specialised equipment during, and often after, spin-out formation;
- leverage of the university brand for negotiation with customers and investors;
- access to translational funding and potentially investment funding;
- shared income from IP licensing with employees, and
- the option of forming consultancy relationships with the spin-out.
1.3 Who is USIT for Software for?

Like the USIT Guide, USIT for Software was created to guide all academics and researchers embarking on a software spin-out journey, all UK universities that are forming venture-backed software spin-outs and all investors who wish to invest in UK university software spin-outs.

USIT for Software is designed to support the first stage of negotiations, saving time, energy and money, while also preventing deal-scuppering disagreements. Instead, that energy and time can be devoted to the development of the spin-out and the technology.

USIT for Software may also be useful for new practitioners in universities, spin-outs, and investment firms, as they seek to improve their detailed understanding of commercial and legal terms. University administrators may consider it as a basis for refinement of their policies, as they seek to maximise the impact generated by academic research.

Research funders may refer to USIT for Software as a way to set expectations for the economic return on the commercialisation of their funded research. They may also find it a useful tool to evaluate specific deals. In many cases, universities require consent from research funders before they can commercialise a new technology. In such instances, USIT for Software may allow research funders to make consent-to-commercialise decisions more quickly.
1.4 How Should USIT for Software be Used?

USIT for Software incorporates the understanding that all software spin-out formations and investment rounds are different and that there will be occasions when the optimal terms for the deal sit outside of its scope.

Variances may be driven by the inclusion of different types of registrable and non-registrable IP and their interplay with university IP policies, as explained below. In such cases, USIT for Software can still play a role as a baseline from which deviations can be explained, so that any variances are understandable to all parties.

USIT for Software builds on the USIT Guide, which contains extensive explanations of most deal terms encountered in the life sciences, deep tech, and related university and investor positions. It focuses on what is unique to software and has not repeated the explanation of terms where these translate to all sectors.

In order to navigate the differences between the two guides, section 4 of USIT for Software includes a handy summary table that shows the different terms included in each guide and how they differ, if at all.
Unique Challenges and Opportunities of Software Spin-outs
2.1 What is a University Software Spin-out?

The fundamental rationale for being a university spin-out is the basis of the business on intellectual property with university ownership. This holds true regardless of the status of the founding team — whether they are academics, researchers, students or third parties: if the basis of the business is IP with university ownership, the company is considered a university spin-out.

In its most simple form, a university software spin-out is a company which:

- requires only source code and/or object code to be licensed or transferred from the university to the company at formation for the business to be viable;
- uses code derived from academic research generated within the university;
- has a lower capital need to commercialise than other technology types;
- operates in a regulatory-light environment, and
- has an accelerated speed to market.

In many instances, a university software spin-out can be more complex than this most simple form. It may require multiple forms of IP with university ownership, e.g., know-how (including confidential information, data), database rights and copyright (including software code), may require a higher level of capital for commercialisation activities and/or may expect to operate in a highly regulated market. Whilst software patents are less common, if the IP is in the form of a software patent, or relies on resource-rich inputs, some universities will consider the company to be a conventional spin-out, whereas others will also consider it as a software spin-out. This will depend on the relevant IP policies of individual universities.

Note that if the business basis is IP owned by students or external partners, the company is considered to be a start-up rather than a spin-out, and the student will have the freedom to pursue their business as they wish. The following table summarises the classification:

<table>
<thead>
<tr>
<th>Types of IP</th>
<th>Types of Founder</th>
</tr>
</thead>
<tbody>
<tr>
<td>Know-how, data, database rights and software code with university ownership</td>
<td>Academic</td>
</tr>
<tr>
<td></td>
<td>Post Doc Researcher</td>
</tr>
<tr>
<td></td>
<td>Software spin-out</td>
</tr>
<tr>
<td>Software patents with university ownership</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Know-how, data, database rights, software code, patents fully owned by the student or external partners</td>
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</tbody>
</table>

*Some universities only consider a spin-out to be a software spin-out when there is no patent involved.
Building on the table, it therefore follows that a university software spin-out is NOT:

- A university spin-out based on software and hardware. Hardware and physical elements will likely influence overall perceived deal value with terms different to that of software alone. The USIT Guide should be considered for guidance on terms for this type of spin-out;
- A software start-up company that relies on code and IP generated outside the university environment;
- A software company based on IP owned by a university student.

Understanding IP for Students

Students may create IP within the university environment from activities including novel ideation, research, projects or contractual undertakings. Who owns this IP can be dependent on factors including the type of IP, how it was created, how it was protected and the relationship the creators have with the university.

Each UK university will have its own policy on how IP created by students is managed, including ownership determination. There will be some circumstances where IP created by the student is owned by the student (students are generally not considered an employee of the university) and other circumstances which result in the university or other third-parties owning the IP in part or in full. It is important before commencing research and project works that the student and university clarify how potential student-created IP will be managed, including understanding ownership rights. Examples of such situations needing consideration can include, (and are not limited to) whether the student is:

- continuing historic or existing research owned or funded by the university;
- working on research with researchers employed by the university;
- working on research that is subject to third-party IP obligations;
- accepting a sponsorship agreement where the sponsor insists on IP access rights, etc.

→ Oxford University Innovation Limited v Oxford Nanoimaging Limited judgment

The UK Patent Court recently considered matters in relation to students and universities sharing benefits derived from IP rights created from academic and research student activities. In Oxford University Innovation Ltd v Oxford Nanoimaging Ltd, it was found students are generally treated as consumers, rather than employees.
In this case, the individual was specifically employed as an intern before the start of his studentship, and in a manner where it was reasonably expected inventions might be made. He then became a PhD student of the university and the court held that he was to be treated as a consumer. It was found that, while this student was the inventor of IP created, the IP rights created while he was a student were owned by the university as a consequence of his studentship agreement and the university’s statutes. The court also found the terms of the studentship, including sharing of equity in the spin-out company and revenues from the related IP licence between the parties, were fair and within the requirements of good faith. The court cited that, in the absence of the IP provisions, a student may appear better off in terms of raw entitlement, though may also be worse off in several other aspects (centred around lack of university assistance, including IP protection, right to royalty streams and spin-out equity that may otherwise be conceded in partnering with a commercial entity). The licence was found to be valid.

The High Court’s judgement is a reminder for universities to clearly communicate their policies on IP ownership rights and student contributions.

Some universities now offer student start-ups a waiver letter or equivalent to confirm the university has no interest in the student’s IP at the formation of the student start-up. This helps minimise the potential for future challenges to IP ownership and freedom to operate. A university will commonly undertake due diligence activities on IP generated by students before offering such a waiver letter or equivalent, to remove concerns that relevant third parties may have about the university making an ownership claim over IP rights at a future point in time. A speedy diligence process and issuance of letters can assist the student start-up in attracting and securing external funding.

USIT for Software is primarily intended for university software spin-outs based on the following types of IP:

- Software reliant on unregistered IP rights, such as copyright, know-how (including small-scale data libraries, data training sets etc) and database rights.
- Open-source software with university ownership published by academic staff.

For university spin-outs developing software in deep tech areas and/or highly regulated markets, (e.g., med-tech, digital health tech, artificial intelligence, machine learning, blockchain, cyber security, etc), the pool of IP with university ownership may be more complex and may include registered IP such as software patents and/or large, resource-intensive data-sets derived from other research (e.g., large-scale medical databases). This IP may be underpinned by substantial amounts of research time and funding, and other valuable resources and support. In the case of companies working in a regulated market, there is unlikely to be an accelerated route to commercialisation. Individual university IP policies may determine whether these companies will be considered as software spin-outs falling under USIT for Software, or whether they will be considered as conventional spin-outs where the USIT Guide may be better suited.
Software spin-outs are unique in that they are not dependent on the development of anything physical: there is no requirement to develop hardware or sustainable materials that might be core to a deep tech business, or biological compounds that might be core to a life sciences business. As a result, the development pathways are typically much shorter and less capital-intensive.

The table below shows some of the key differences between software and life-science spin-outs, and the implications are further explored in the sections below:

### Unique Characteristics of Software Spin-outs

<table>
<thead>
<tr>
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<th>SOFTWARE</th>
<th>LIFE SCIENCE/DEEP TECH/HARDWARE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Time to Market</strong></td>
<td>Shorter development times, rapid scalability, iterative</td>
<td>Lengthy research, clinical trials &amp; regulatory pathways</td>
</tr>
<tr>
<td><strong>Commercialisation</strong></td>
<td><strong>Pathway</strong></td>
<td>New physical product to market</td>
</tr>
<tr>
<td></td>
<td>Subscription, software as a service, partnerships, often embedded into existing workflows rather than standalone products</td>
<td>Patents for compounds/devices/innovations</td>
</tr>
<tr>
<td><strong>Intellectual Property</strong></td>
<td>Copyright, know-how, open-source license, trademark, database rights, patents are less essential, but investors still want to see what the barriers to entry are. Applied algorithm patents are particularly valuable in medtech.</td>
<td></td>
</tr>
<tr>
<td><strong>Funding Requirements</strong></td>
<td>Relatively low initial funding, though big tech is driving up the cost of talent</td>
<td>Significant funding to support infrastructure, research &amp; clinical trials</td>
</tr>
<tr>
<td><strong>Regulatory Requirements</strong></td>
<td>Generally fewer, but depends on application</td>
<td>Shorter development times, rapid scalability, iterative</td>
</tr>
<tr>
<td><strong>Exit Strategies</strong></td>
<td>Acquisition by tech companies or IPOs</td>
<td>Acquisition by pharma/verticals companies, partnerships, licensing, IPOs</td>
</tr>
<tr>
<td><strong>Market Dynamics</strong></td>
<td>Highly competitive, rapidly evolving, agile strategies to capture market share</td>
<td>More stable competitive landscape with longer product life cycles and slower adoption</td>
</tr>
<tr>
<td><strong>Investor Due Diligence Focus</strong></td>
<td>Technology, market fit, user acquisition, scalability</td>
<td>Clinical trial results, regulatory pathways, safety and efficacy, IP</td>
</tr>
</tbody>
</table>
2.3 Value From Technology and From People

In software spin-outs, investors are increasingly placing business value in the people — i.e., the founders and management team — and their hard yards to gain traction with customers, in comparison to the technology. This premise has significant influence on relevant deal terms: if the business value of software companies is heavily captured in the people, then the lens on the cap table can be different to where business value is mostly in the IP alone.

In software spin-outs, the value of the technology assets that transfer into the business at the point of spinning out from the university can be lower in comparison to life sciences. The relative importance of the founding technology can also diminish significantly as time goes on. For instance, as the founders engage with customers, they can develop the product to address customer needs that may be different from those originally envisaged.

Software businesses evolve through continual engagement with customers, understanding their developing needs and spotting where the technical advantages of the software can deliver some distinctive performance. This different distribution of value between founding IP and accumulated founder-customer interaction contributes to the justification for different founding equity stakes.
2.4 Clarity of Use Case and Customers

Many university software spin-outs will launch with no more than a hypothesis and a technology with a performance advantage in particular types of work — and for university software spin-outs, an early formation, even before there is a clear prospect of institutional investment, is encouraged.

Typically, these early university software spin-outs will find their precise use case iteratively through engagement with multiple customers, developing minimum viable products (MVPs) and evolving the product (and creating value) rapidly by addressing feedback received through a series of sprints.

This product-market fit search is characterised in lean start-up methodologies and is the basis of many accelerator programmes. Engaging multiple customers requires significant organisational momentum and dominates the work breakdown structure for a software business.

Not all revenue is equal, however. Founders will seek to attract the most prestigious customers for their sector to enhance their prospects and valuations. Value inflection can be established by customer-following as much as by proof of technology success.
2.5 Evolving Away from Foundational IP

For software spin-outs building software products based on specific sector datasets within certain regulatory environments, the utility of an end-product may be relatively defined at the start, with the company operating and focussing efforts to attain the pre-determined product specifications.

However, for most university software spin-outs, the ultimate use case or application that delivers business value is not necessarily known at the outset. If the foundational IP is a know-how package including some original code, the business may evolve to different use cases following interaction with customers. In this scenario, the business may no longer be dependent on the originally licenced code from the university and may seek to terminate the licence.

The university may take a view that the original university-created IP still provided the foundational value to build from, and/or that the business is still drawing on solutions based on the principles developed in the original code. This is hard to evidence either way in practice and underscores the need to comprehensively define the IP schedule and improvements definition, and to structure any related IP licence and licence fee obligations accordingly, at time of licensing (see Section 3.3.2).
2.6 Spin-out Evolutions and Changes are the Norm

As an early-stage company starting out, university spin-outs can be incredibly agile in responding to market needs and changes. Product development pathways and marketing strategies can evolve quickly with changes occurring rapidly from the outset.

A university spin-out’s structure will reflect this operating environment and will be dynamic in nature. Changes are considered the norm, not a signal of dysfunction. They are the output of enabling entrepreneurs to bring new ideas, new features and new products to market in response to customer demands. At the same time, management, staff and board members will also likely change as the company swiftly moves through its lifecycles and requires different skill-sets.

A university software spin-out should be thinking about these changes well in advance with appropriate talent recruitment and succession plans, cap tables, employee stock ownership plans (ESOPs), vesting schedules, chains of titles and other personnel and operational-ready processes and plans in place.
2.7 Speed

Speed is a critical factor for the success of a university software spin-out. There is a much faster dynamic in the software sector — the faster an MVP can be launched, the faster the product can go to market, generate recurring revenues, and deliver returns to the investors and other shareholders. Spin-outs should be encouraged to form early, bootstrap and generate customer traction as a way to attract investors.

Investors are generally seeking spin-outs that can demonstrate progress, realise growth and execute a vision. For universities to satisfy the expectations of software investors, there is a need to move quickly and transparently. It can be difficult keeping investors engaged if the spin-out formation process is long and cumbersome.

 Universities publishing their software spin-out and exit processes, along with timelines for each stage (including National Security Investment and export control approval steps, where relevant) in a clear, simple and easy to interpret form can greatly enable speedy timeframes. It removes ambiguity, sets expectations and provides all parties with certainty and commitment ahead of time. It also has the benefit of giving confidence to potential university software spin-out investors, who prefer companies to be formed prior to engagement.

However, if assurances are given of appropriate formation timeframes, this becomes less of an issue. Similarly, where clear processes are mapped for exit activities, faster transactions can be executed which can mean more exit strategy choices and the optimisation of exit value for the spin-out.

Creation of Lean Spin-outs — Bifurcating Spin-out Formation and Investment Rounds

Spinning out software companies may involve bifurcating spin-out formation and investment rounds. Software spin-out companies could (and should) be formed without direct or immediate line-of-sight of investment, enabling important customer feedback and company value creation to begin early. This may see the negotiations for the formation process more between the founders and university, and the negotiations for the investment round more between the founders and the investor. In practice, this may see investors seeking to influence UIOs and university agreements via their links with the founders, and founders seeking to influence UIOs by requesting their support in the negotiations with investors. Here, a three-way dialogue across the parties is advantageous and recommended.
The USIT Guide’s Recommended Terms
3.1 Recommended Terms

Like the USIT Guide, USIT for Software’s recommended terms are intended to be used as reference points, with negotiations adapted in accordance with the specifics of each deal opportunity.

USIT for Software offers the following recommendations specifically for software spin-outs, recognising that software technologies often have different characteristics to technologies of more resource-intensive sectors. USIT for Software’s recommended terms also recognise that not all software spin-outs are the same, with software spin-out variations consequential of the different IP forms incorporated.

The recommended terms below discuss only those terms that differ from the recommended terms of the USIT Guide. Please see the USIT Guide for all other recommended terms (Section 5 and here).
3.2 Term Sheet
Spin-out Formation

3.2.1 Total Deal Value

For any university spin-out, deal value takes into consideration the terms of the shareholdings and investment, and the terms of the IP licence in totality. Where software-based spin-outs are formed, there may be a different weighting on foundational technologies to that of life sciences and other resource-intensive sectors. Often (though not always), the software spin-out opportunity has required less resource support from the university to progress to an investible stage.

The technology in a software spin-out can also move away from the foundational IP developed at the university relatively quickly, as detailed customer engagement helps to iterate and refine product development. There may or may not be an IP licence agreement between the university and software spin-out, depending on the nature of the technology underpinning the software spin-out (e.g., open-source software, patented software, etc). As such, while the structure of the term sheet (spin-out formation) and licence agreement HoTs are similar for software spin-outs and spin-outs from resource-intensive sectors, the financial-related terms often differ.
3.2.2 Incentivising Active Founders

A key consideration for potential early-stage investors in software spin-outs is the founding team. In addition to core investment opportunity attributes, (total addressable market, serviceable obtainable market, speed to market, competitive environment, etc), much value is placed on the founders and their anticipated ability to interact with and respond to customers to help drive product development, rather than rely on foundational IP alone.

For a software spin-out, the business value is often considered to be more about the founders and their professional capabilities than the foundational technology from the university.

It is likely to be important for founders to demonstrate incentivising equity positions to help give assurances to potential investors that they have ‘skin in the game’ and will be part of the company to later inflection points.

One way to demonstrate this is to show material equity positions for founders through to (at least) series A fundraising. A very general rule of thumb is that potential early-stage investors will likely want to see active founders and employees owning c.50% of equity post series A investment. (Note, this position also endorses the university founding equity position at 5–10%).

It is good practice for software spin-out founders to model various scenarios across their fundraising strategy. By applying varying dilution rates for each of the envisaged capital raises, using dilution levels observed in the market as well as the founders’ own level of dilution they are willing to accept, future state series A cap tables can be loosely ‘back-propagated’ through investment rounds to determine an optimal starting cap table point. Below is a worked example of a software spin-out through three typical rounds of investment: pre-seed, seed and series A.

At each investment round, new shares are created for the incoming investors, which dilutes the shareholdings of the prior investors. In addition, option pools are created or topped up to provide additional stock options for members of the spin-out team.

---

1 There are many organisations providing analysis on fundraising and observed equity dilutions relevant for particular rounds.
In the example below, the initial formation assumes 90% of equity with the founding team and 10% with the university, fully dilutable. The shareholding of the founding team dilutes to approximately 36% of the company post series A. With the addition of around 14% of stock options, the founding team and employees have access to approximately 50% of the shareholding of the spin-out.

**Example Cap Table for Software Spin-out: 90% Founder Equity, 10% University Equity**

<table>
<thead>
<tr>
<th>Form</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Founders’ Shares</strong></td>
<td>90%</td>
</tr>
<tr>
<td><strong>Uni Options</strong></td>
<td>10%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Pre-seed</th>
<th>Option Pool 10%</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Founders’ Shares</strong></td>
<td>63%</td>
</tr>
<tr>
<td><strong>Options</strong></td>
<td>10%</td>
</tr>
<tr>
<td><strong>Uni Options</strong></td>
<td>7%</td>
</tr>
<tr>
<td><strong>Pre-seed</strong></td>
<td>20%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Seed</th>
<th>Option top up 5%</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Founders’ Shares</strong></td>
<td>47%</td>
</tr>
<tr>
<td><strong>Options</strong></td>
<td>13%</td>
</tr>
<tr>
<td><strong>Uni Options</strong></td>
<td>5%</td>
</tr>
<tr>
<td><strong>Pre-seed</strong></td>
<td>15%</td>
</tr>
<tr>
<td><strong>Seed</strong></td>
<td>20%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Series A</th>
<th>Option top up 5%</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Founders’ Shares</strong></td>
<td>36%</td>
</tr>
<tr>
<td><strong>Options</strong></td>
<td>14%</td>
</tr>
<tr>
<td><strong>Uni Options</strong></td>
<td>4%</td>
</tr>
<tr>
<td><strong>Pre-seed</strong></td>
<td>11%</td>
</tr>
<tr>
<td><strong>Seed</strong></td>
<td>15%</td>
</tr>
<tr>
<td><strong>Series A</strong></td>
<td>20%</td>
</tr>
</tbody>
</table>

Company Founders + Employees have c.50% of captable post series A

This example demonstrates a fully dilutable approach, which is widely used in equity investment rounds (see USIT Guide, section 3.2 for further information) on equity.

In practice, the dilution will vary for each investment round, dependent on the size of the investment round and the valuation of the company agreed by the founders and the investors. This can be driven by the technical complexity of the IP, speed of growth and broader resource requirement to go to market. The Employee Share Option Pool (ESOP) will also need to be optimised, driven by factors such as the recruitment plan and speed of recruitment, as discussed in the original USIT Guide.
Investment Rounds

Raising capital is a constant activity for any spin-out or start-up. Growing from investment round to investment round will likely involve meeting different investors and investor types as well as achieving different investment criteria. Although not universal, some general criteria are provided for a software spin-out to consider as it readies for its next investment round and optimises its attractiveness to potential investors:

**Pre-Seed**

- the spin-out team is known and ready to progress the company’s operational activities;
- company establishment fundamentals are mostly or fully complete, e.g., incorporation structure, IP licence agreement executed, relevant IP requirements in place, cap table compiled, etc;
- may be involved in an accelerator program to facilitate efficient progress;
- MVP in development, near completion, or even recently launched;
- customer engagement plan established/commenced;
- current and next phase organisation chart established.

Pre-seed investment rounds are generally the earliest type of investment and help the company establish operations. Often the founders themselves, the founders’ families and friends, high net worth individuals, and/or angel investors are the funders of pre-seed capital. Some venture capital firms deem pre-seed ‘too early’ to invest in, owing to the need to match investments to their own fund’s risk and return profile.

Family, friends, high net worth individuals and angel investors play an important role in the ecosystem, funding very early-stage opportunities and providing much needed capital to help start off a spin-out company. They can also provide much additional benefit through mentoring and networks. The rewards for these types of investors are generally more favourable investment terms than other, later investors as well as the reward of supporting the entrepreneurs in driving the business and societal impact.
Seed

- MVP near launch, or has been launched and being used by independent customers;
- feedback from customer usage being obtained. Continuing product development;
- evidence of commercial traction and customer confidence in product offering. Potentially first customers signed (‘proof of concept income’);
- understanding of scaling activities, break-even requirements, path to annual recurring revenue (ARR), etc.

Seed capital can be provided by existing investors (as above) as well as from venture capital, strategic investors and some private equity.

Series A

- use of product offering by multiple, independent customers;
- evidence that product is meeting an unmet need and is providing value to users;
- achieving or nearing revenues, (ideally recurring revenues, as opposed to proof-of-concept income, with some investors targeting evidence of £1M ARR ), etc.

Series A can be provided by existing investors (as above) as well as from additional venture capital, strategic investors and private equity.

It is recommended that investment rounds raise enough capital for the company to achieve its next inflection point (often approximately 18–24 months activity). This helps to keep dilutions manageable for existing investors and at the same time presents an investment opportunity generally more attractive to an investor.
3.2.3 Equity Split between Founders and the University

For spin-outs formed with university-originating software technologies, the recommended landing zone of founder equity awarded to the academic founding team is 90% to 95%, with the remaining equity retained by the university being 5% to 10%. Both ranges are before any dilutive third-party investment.

At the point at which IP is created by employees, the university invariably owns 100% of the university-derived IP rights by virtue of employment contracts. However, the university will allocate a significant amount of founding equity in a spin-out company to founders where the spin-out commercialises that university-derived IP. The recommended 90%-95% equity landing zone allocated to founders for a software spin-out is substantially higher than that recommended in the USIT Guide for resource-intensive spin-outs such as in the life sciences and deep tech. It reflects the generally lower level of university resources consumed to generate and develop the software spin-out opportunity to an investible stage, as well as the different distribution of value between founding IP and subsequently accumulated founder-customer interaction that drives further IP development.

When considering the 90%-95% equity landing zone for founders, characteristics that can have influence determining an appropriate founder equity allocation include whether:

- the university software spin-out is of the most simple form, commercialising ‘nominal’ university-derived IP (e.g., non-registered IP rights created by less intensive university resources) and requiring little university support for commercialisation activities;
- the university software spin-out is party to an IP licence agreement with the university;
- the university software spin-out has a requirement to secure a certain level of cumulative investment etc;
- the university software spin-out requires more university support for commercialisation activities.
A founder equity position at the higher end of this landing zone, i.e., around 95%, will be more applicable to software spin-outs with university-derived unregistered IP rights (e.g., know-how copyright and confidentiality inherent in the software, code and/or algorithms) and requiring little to no support from the university in its commercialisation activity. A founder equity position at the lower end of this landing zone, i.e., around 90%, will be more applicable to software spin-outs with some university-derived registered IP rights (e.g., patent, trademarks, etc), IP that has been resource-intensive to create (whether registered IP rights or not) and/or requires support from the university in its commercialisation activity.

It is noted that founder equity positions for software spin-outs can occur outside of this range e.g., where the software development relies on resource-rich university research outputs (such as medical-related datasets) and related IP licence fees are minimal (or not requested at all). Here, the USIT Guide may be useful. There may also be instances where there is a contractual or policy requirement for additional equity to be held by the university for (and equity realisations distributed to) third parties, e.g., funders, certain types of inventors (university policy dependent).

The importance of considering the deal in its entirety when negotiating founder and university equity is reiterated. Licence fees payable under an IP licence with the university, other deal terms within either the term sheet and/or HoT, and the university’s ability to utilise the university-derived IP underpinning the software spin-out in other ways, etc., are all potential influencing factors. The landing zone is a recommended range, and it is expected the parties will negotiate on the basis of the deal specifics and particular software spin-out opportunity scenario.

**Note:** Universities will generally require a software spin-out to provide assurances (often within the licence agreement) that it has licensed all the university-owned IP required to deliver the business plan and exploit the technology.
University Equity

There are multiple reasons why the university might retain an equity stake at the time of spin-out formation. These can include, but are not limited to, the following:

- recognition of the university support and contribution given previously (and continuing) for the technology, the academic founders, and the academic company’s staff development;
- the ability for the spin-out to leverage university resources (including the enablement of the spin-out formation itself) and facilities;
- the ability for the spin-out to leverage the university brand, noting that some universities require additional consent for brand use in particular marketing materials;
- depending on a specific university’s policy, further motivation for academic staff involved in the spin-out who may benefit directly (i.e., by a return to the individual) and/or indirectly (i.e., by a return to their department or university) from the university’s shareholding;
- access to university connections, including investors, management teams etc., through their UIOs – bringing experienced talent pools and increased potential for innovation;
- as equity holder and licensor (i.e., the lever effect, described in the USIT Guide), added flexibility for the university to amend certain licensing clauses, including revenue-bearing clauses where relevant;
- spin-out governance support and consent matters;
- compliance reasons (e.g., funders, government, etc).
Support for Technologies and Teams that Universities Aspire to Provide

**Technology Support**
- Funding, labs, experimental equipment, computing infrastructure, software access, technicians
- Translational funding
- Engagement of research funders to gain consents to commercialise
- IP protection, patent funding, attorney access
- Technology development funding, e.g. proof of concept funding

**Team Support**
- Research
- Strategic partnerships & collaborations
- Education
- Training programmes, competitions, prizes
- Team formation
- Scoping, business planning
- Upskilling
- Connections to entrepreneurs with sector experience
- Mentors & coaches

**Business Support**
- Licence
- Investor networks, grant support, seed funds
- Fundraising
- Accelerators
- Business formation
- University brand leverage / incubation spaces
- Growth
- Venture funds / Rewards to inventors through revenue share
3.2.4 **Founder Equity and Reward to Inventor**

In addition to founder equity in the spin-out company, universities may also recognise and reward their academic inventors\(^2\) and spin-out founding staff through sharing of commercialisation revenues, as defined in the university’s ‘reward to inventor’ policy. When considering the academics’ potential return for their founding activity, it is useful to briefly describe the three main ways in which academic staff can contribute to a software spin-out’s formation:

1. Founding Inventors, meaning inventors of the founding university IP that are participating in the spin-out. Founding Inventors are likely to receive founder equity in the spin-out. They may also be recognised for their inventive contribution to the originating IP through the university’s ‘reward to inventor’ policy;

2. Non-Founding Inventors, meaning inventors of the university IP that are not participating in the spin-out. Non-Founding Inventors are likely to be recognised for their inventive contribution to the originating IP through the university’s ‘reward to inventor’ policy\(^3\). They may also receive a small amount of founder equity from the spin-out;

3. Non-Inventive Founders, meaning non-inventors who are participating in the spin-out. Non-inventive Founders are likely to receive founder equity in the software spin-out, and unlikely to be recognised under the university’s ‘reward to inventor’ policy.

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\(^2\) Under patent law, to be an inventor there is a need to demonstrate that an invention has been made. Practically, this can be difficult for software creation at the university level and university IP policies may choose to refer to inventors in a broader sense, e.g., to mean an inventor and/or creator for the purposes of software.

\(^3\) Where the university policy stipulates Non-Founding Inventors are to be rewarded via equity as part of the university’s “reward to inventor” policy, the equity may be held by the university on behalf of the Non-Founding Inventor, in addition to the university’s equity stake.
The founding team of a software spin-out may be made up of Founding Inventors, Non-Founding Inventors, Non-Inventive Founders and incoming external team members. A balance needs to be struck by the founding team on allocating equity amongst themselves in a way that recognises past efforts by individuals prior to the university spin-out formation and incentivises future contributions to the spin-out’s operations as highlighted in section 3.2.2

Distribution of founder shares

Non-Founding Inventors
Asking the following questions can help the spin-out’s decision making:

1. **Who will be part of the spin-out?**
   Individuals actively participating in the spin-out should generally receive more founding equity than those individuals not part of the spin-out or not actively participating in the spin-out.

2. **What will be their level of participation?**
   Individuals participating in the spin-out in a full-time capacity should be allocated more equity than those participating part-time. Individuals acting for the spin-out in an advisory capacity may be better recognised and remunerated via an advisory or consultancy agreement rather than (or alongside a reduced portion of) founding equity.

3. **What is their role in the spin-out?**
   A CEO should arguably receive more equity than an operational role, given a CEO’s accountability for the company. Similarly, other C-suite positions should attract a higher equity allocation than other positions with less responsibility and risk, though not as high as a CEO.

4. **What is their experience, network and/or other attribute(s)?**
   Career experience, professional networks, ‘can do’ attitudes and other aligned attributes can influence a spin-out’s decision on founding equity allocations. One approach to benchmarking this is to estimate the salary the individual would expect in industry and offer an ‘equivalent’ founding equity allocation. A top up could be added to help further incentivise (e.g., 3–5%).

It is recommended that founders enter into a Founders Agreement to govern their business relationships, including roles, responsibilities, equity allocation, vesting and leaver arrangements (see also 3.2.6).
3.2.6 Vesting Schedules

As a follow-on to the leaver provisions discussed in the USIT Guide, the importance of vesting schedules is re-iterated in USIT for Software.

It is in the interest of the spin-out’s longer-term success to incentivise key founders to be active in the software spin-out to at least series A. Alignment between investors, founders and company vision empowers founders to effectively drive business growth and create value. Equally, it is also in the spin-out’s interest to have clear mechanisms for staff leaving the company and for managing bad leavers.

The speed of development and progress, as well as the rapid need for evolving expertise typical for software spin-outs, can result in high incidences of at least one founder departing the company in the early stages following spin-out formation. Larger founding teams, the pace of progress, product pivots, and stage-of-growth lifecycles for university software spin-outs can mean founder roles change quickly and move in unexpected directions. The company’s need to undertake corporate development, business development, human resource activities, etc., may swiftly become a core focus equal to (and sometimes greater than) product development. A fully committed, competent, experienced CEO that genuinely leads the spin-out can make the difference between success and failure. The spin-out’s strategic and operational needs may not be congruent with the founder’s original ambition, skill set and/or available capacity and they may wish to step aside. Founder splits, as well as management team and board member changes as the company evolves and grows, are common experiences, not exceptions.

It is recommended that the university software spin-out is very clear on the vesting schedule for its founders and ESOP recipients.

A vesting schedule of four years (for more complex spin-outs) or three years (for less complex spin-outs) with a one-year cliff is common.\(^4\)

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4 Cliff Vesting: How It Works and Types [investopedia.com].
• **Accelerated Vesting**

The market is currently seeing more instances of accelerated vesting schedules, where options are vested at a faster speed than outlined in the original vesting agreement. The trigger for accelerated vesting periods is usually dependent on the achievement of specific milestones and may be single trigger or double triggers. Examples of these triggers can include a merger, acquisition, or IPO of the company, specific employee or company performance achievements, or a negotiation point should an employee leave the company.

Accelerated vesting schedules have particular benefit for the employee with their options vesting sooner, though it can also be beneficial for the company to further incentivise certain types of value-add activity. There may be additional tax implications for an individual to consider when accelerating vesting of stock, especially where they are granted under an Enterprise Management Incentive (EMI) option scheme. It is recommended that tax advice is sought by the individual before agreeing to proposed vesting schedules.

• **Reverse Vesting**

An alternative to standard vesting schedules and option allocations is reverse vesting, where shares and ownership interests are awarded to an individual upfront. Reverse vesting has similarities to standard vesting in that the individual ordinarily needs to achieve certain milestones, including time with the company (often minimum three years), to retain ownership of the shares. Where the milestones are met, the shares stay with the individual regardless of whether the individual stays or departs the spin-out (other than sometimes in extreme cases such as fraud). Where the milestones are not met, the spin-out retains the right to repurchase the shares (proportionate to tenure, usually at no profit) or to convert them into worthless deferred shares. Like standard vesting and accelerated vesting, the reverse vesting approach is adopted to incentivise core team members to stay with the spin-out and build value. University spin-out teams considering issuing shares subject to reverse vesting of shares should seek tax advice as doing so post-incorporation and/or post value creation can lead to tax charges being incurred without any actual cash distributions (‘dry income tax’) for UK directors and employees.
It is recommended that university software spin-outs spend time to optimise the company’s cap table, including ESOPs and vesting schedules, as much as possible from the outset. For example, where cap tables are skewed with passive, non-operating shareholders, it can be challenging for university software spin-outs to successfully fund raise from later stage investors. ESOPs can be used to some extent to ‘correct’ unwieldy cap tables, with later stage investors issuing new stock options to keep the percentage of company ownership by the founders at an attractively high level, though that comes at the cost of diluting earlier investors. An alternative approach for replacing non-active founders (and other shareholders seeking early exit) can be the inclusion of discount rates for equity buy-outs and secondary transactions (e.g., 80% discount to last round). However, neither mechanism is an ideal ‘fix’, and it is best practice to maintain the cap table to be as investible as possible from inception.
3.2.7 Investment Tranches

Software spin-outs often develop quickly, generally achieving operational goals and value inflection points faster than their counterparts in resource-intensive sectors. Tranchéd investments in software spin-outs are uncommon – the next tranche generally is the next fundraising round.
With universities holding a smaller equity position in software spin-outs (i.e., 5–10%, see section 3.2.3 ‘Equity Split between Founders and the University’ above) than that of university spin-outs operating in resource-intensive sectors (i.e., 10–25%, see USIT Guide), it is common for universities to have board observer rights or just information rights at founding. It is less common for the university to have a board seat, unless specifically asked by the spin-out, if there is opportunity for training and development for a less experienced university-employed board director, and/or if the university (or affiliated entity) makes an investment in the spin-out with board rights attached.

Where a university has information rights, it is expected that relevant information such as board meeting and other key meeting minutes, and company updates is provided in a timely manner, usually within 30 days. This is in line with the USIT Guide’s guidance.
3.2.9 Transaction Timeframes

The faster development pace of software spin-out companies combined with a generally simpler formation process should result in quicker establishment and transaction timeframes than those described in the USIT Guide.

Focus should be on lean spin-out formation and bootstrapping, particularly given that the software product will rapidly evolve as the company gains continued customer traction. This also allows the software spin-out to negotiate directly with incoming investors.

### Software Spin-out Timeline (Scenario 1)

<table>
<thead>
<tr>
<th>SPIN-OUT PROJECT KICK-OFF</th>
<th>INCORPORATION</th>
<th>INVESTMENT TERM SHEET RECEIVED</th>
<th>TERM SHEET AGREED</th>
<th>SPIN-OUT &amp; INVESTMENT COMPLETE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Academic</td>
<td></td>
<td>1 month</td>
<td>1–2 months</td>
<td></td>
</tr>
<tr>
<td>Secure the IP</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Explore HoT, Execute the Licence</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Form the Founding Team</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Execute the Corporate Docs</td>
<td></td>
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<tr>
<td>Seek Investors</td>
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<td>Explore Terms</td>
<td>Agree Term Sheet</td>
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### Software Spin-out Timeline (Scenario 2)

<table>
<thead>
<tr>
<th>SPIN-OUT PROJECT KICK-OFF</th>
<th>INCORPORATION</th>
<th>INVESTMENT TERM SHEET RECEIVED</th>
<th>TERM SHEET AGREED</th>
<th>INTEGRATION &amp; INVESTMENT COMPLETE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Academic</td>
<td></td>
<td>1 month</td>
<td>1–2 months</td>
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<tr>
<td>Secure the IP</td>
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<tr>
<td>Draft the Licence</td>
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<tr>
<td>Form the Founding Team</td>
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<td>Draft the Corporate Docs</td>
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<td>Seek Investors</td>
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<td>Agree Term Sheet</td>
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</table>
University Activities Pre-Investor Term Sheet

Multiple preparative activities with varying lead times are required to validate an opportunity and form a university software spin-out. Activities can include (and are not limited to):

- Opportunity validation
- IP definition
- Funder notices
- Founding team arrangements
- Funder consent to commercialise* 
- Business case 
- Inventive contribution confirmations 
- Inter-institutional agreements 
- Founder agreements 
- Revenue share agreements 
- Marketing materials 
- IP due diligence (IP DD)** 
- IP assignments 
- Corporate/licence drafts 
- TS / HoT negotiations 

Collegial and pro-active academic, TTO and third-party stakeholder interaction can speed up activity timelines.

*Some funder terms and allowable periods for gaining consent to commercialise can be several months. It is strongly recommended the consent to commercialise process be commenced as soon as possible to avoid spin formation and IP licensing delays.

**IP DD can include open-source software licence analysis. As this can take substantial time, it is strongly recommended IP DD be undertaken as soon as possible and before HoT/IP licences are agreed. See ‘Understanding Open Source Software Licences’ below.
It is in both the academic team’s and the university’s interests to work early and closely together to fast-track the period from spin-out project kick-off to investment term sheet stage. This period can take several months, as additional third-parties such as funders and other universities may be involved in due diligence activities and securing of IP. Academics at as early as ideation stage, well before investors are engaged, are encouraged to speak with the UIO. Cohesive engagement and effective communication between all parties as early as possible can shorten this period significantly, as several kick-off activities can be efficiently undertaken in parallel, and items agreed ahead of receiving a term sheet. Often, an investor will prefer to engage with a spin-out that has already formed, though if spin-out formation processes and timelines are clear, and it is seen that all parties are working collegially to finalise the spin-out’s formation, an investor will more likely be comfortable to progress investment discussions at an earlier stage.

It is recommended that universities target a maximum 30-day period for term sheet negotiations, commencing upon receipt of the investment term sheet, and a maximum 60-day period to finalise formation and transaction activities, commencing from once the term sheet and HoT (see Section 3.3) are agreed. In practice, some execution activities are able to be undertaken in parallel, rather than sequentially, and where possible, this is encouraged to further speed up whole transaction timeframes.

It is also recommended that universities have clearly-defined, published, and readily-accessible procedures showing the steps, processes, signatories and timeframes required to complete the software spin-out formation process. The inclusion of examples of steps and case studies as part of the published procedures would be beneficial.
3.2.10 Exits

Many university software spin-outs grow successfully and remain operating as an independent entity for years. For other university software spin-outs, complementarity with an existing corporation may be obvious, with M&A and an earlier exit a desired outcome of the software spin-out’s growth path. In these instances, the speed at which a university software spin-out can facilitate the M&A transaction can impact the exit valuation achieved.

An exit value is often calculated as a multiple of the company’s annual recurring revenue, ARR (e.g., 4–6X ARR is sometimes used as a ‘rule of thumb’ to determine the value an investment could realise at exit, i.e., the return on the investment). Where founders anticipate M&A as the exit, having expectation of desired exit valuation, an understanding of the underlying factors needing to be achieved for that valuation, as well as being prepared for the potential M&A transaction well in advance, will improve the likelihood of a successful exit transaction.

‘Earn-outs’ are a common feature for private company sales transactions and can be a useful tool to bridge the gap between the company seller’s purchase price expectations and the company buyer’s purchase price expectations. Earn-outs are a type of condition precedent on the spin-out company where the company is expected to achieve certain targets to gain additional compensation from a buyer as part of a sale of a business. The targets are post-deal and are often financial (e.g., related to sales targets), though can include non-financial (e.g., product development) milestones too.
Acquihire, a type of acquisition, is another path to exit where a company is acquired for the skills, knowledge and expertise of its personnel rather than its products and/or services. Exit values for acquihires may differ to other exit values for traditional M&As given the focus on employees over products. For acquihires, exit values are likely to be heavily weighted to retention packages for team members rather than ARR.

Where a M&A exit is desired, it is recommended that software spin-outs prepare from inception for an early transaction and be positioned to facilitate acquisition by a larger technology corporate within a relatively short turn-around (e.g., 30–60 days). This includes being placed to solicit counter offers from corporate competitors.

At foundation, the software spin-out should begin to establish and populate a data-room, consider the exit terms it would be willing to accept, along with a best alternative to a negotiated agreement (BATNA), understand the university's requirements and processes for enabling a fast exit, and begin to pre-empt and complete activities that can be completed in advance of a potential exit. Understanding the university's policy on making the software spin-out's licensed IP available to third-parties, including potential acquirers, will be important. Ideally, the relevant terms and conditions should be discussed as part of the HoT negotiations at the time of entering into the university — software spin-out IP licence agreement, where relevant (see Section 3.3).
### 3.3 Heads of Terms

**IP Licence Agreement**

As with the USIT Guide, the whole deal is to be considered in totality, bringing together the term sheet and HoT to ensure productive negotiations and swift spin-out transactions.

As with the term sheet for software spin-outs, the HoT will largely be more simplified than that of their life sciences counterparts. This reflects the types and quantity of IP being licensed, the nature of software technologies in development and the operating environment of software companies.

#### Software-Specific IP Licence Agreement Templates

Universities may want to consider a simplified HoT and IP licence agreement template that is more tailored for software-specific licences, drawing from the terms and conditions of their full HoT and IP licence agreement template. Where the IP estate for the licence with the software spin-out consists of non-registered IP rights, certain clauses in conventional HoT and IP licence agreements can become redundant (e.g., historical patent costs), or varied (duration of the royalty period, recognising standard patent term is 20 years, where copyright is 70 years after creator’s death; sub-licensing terms where a sub-licence is a form of sale, etc). Preparing software-specific HoT and IP licence agreement templates can help speed up the transaction process.

Software spin-outs can be based on different forms of IP, and it is important the IP is sufficiently defined to enable and substantiate the HoT. It is recommended when preparing the HoT that the university considers:

- what the IP is (e.g., registered IP rights, non-registered IP rights, publicly available open-source software, duration and utility of associated IP rights, etc);
- how the IP has come about;
- whether the IP is owned by the university at all, or whether the university has waived its rights and/or the software has originated from outside the university;
- whether IP is subject to any third-party rights (including for IP derived from assets such as libraries, certain data-sets etc);
- what the overall strength of the IP elements is combined, and
- how the spin-out opportunity has been enabled.
There may be instances where the university-owned IP required by the university software spin-out is at its most simple form, e.g., copyright relating to code shared publicly via an open-source platform. Here a HoT and IP licence agreement is not likely justifiable. However, where more complex IP with university-ownership is required by the university software spin-out, the more important it is to have HoT to ensure an aligned understanding of the IP licence arrangements.

Examples of Different Types of Software Spin-outs and Requirements of HoT:

1. Software spin-out based on open-source software only (i.e., published by academics, with university ownership).
   *Unlikely to have HoT.*

2. Software spin-out based on copyright, know-how, data and/or database rights with university ownership, which can include IP derived from resource-rich university research outputs and/or the need for ongoing access to updated and new data in databases.
   *Likely to have HoT, though is university-specific.*

3. Software spin-out based on software patent(s) and other registered IP with university ownership, with or without additional non-registered IP.
   *Highly likely to have HoT.*

Once the required university-owned IP required by the university software spin-out is defined, it is recommended that the university also applies the appropriate evaluation and benchmarking tools to help inform the setting of HoT detail.
Intellectual Property Rights for Software

Software can be protected by one or more different forms of IP right. The two most important forms of rights are copyright and patents:

- **Copyright**: Copyright is an unregistered IP right and protects the expression of an idea, but not the underlying idea. It can be used to protect original works, such as literary and artistic works. Literary works are defined in law to include computer programs. Copyright can be used to protect source code and object code, and other aspects of software, such as scripts. Copyright can also protect images (considered to be artistic works) including icon designs, the appearance of GUI elements, etc.

  Via international treaties, it is possible to enforce works created in the UK in some, but not all, countries outside of the UK and vice versa.

  There is no application process: copyright protection automatically comes into effect when the work is created. Copyright protection lasts at least 50 years (in some cases, 70 years) from the death of the creator.

  Copyright can be used to prevent copying and distributing software. This form of IP is, however, limited in that if the software is created independently (i.e., it is not copied), then copyright cannot be used to stop how that independently-created software is used or exploited. Thus, it may be possible to circumvent copyright by clean-room design whereby the underlying functionality of software code is identified, and a requirements specification is created based on a high-level definition of the functionality; the requirements specification is then used to create new code.

- **Patents**: A patent is a registered IP right and is used to protect a technical invention. The invention can relate to a device (such as a server, a mobile phone or a tablet), to a process (which can run on a device) and, in some countries, to a computer program. A patent often includes claims directed to the device — usually how it operates — and to the process. For example, a patent protecting a mobile app usually includes both device and process claims.

  Patents are territorial and so a UK patent cannot be used to stop activity, such as offering to sell or using a patented process, occurring exclusively in the US. Because of this, it is common to obtain patents in multiple countries.
Laws on patentability vary by country. Thus, the ease with which a patent is granted — or scope of patent protection — for the same invention, can differ around the world.

A patent is obtained via an application process which typically takes between two and five years, and a granted patent has a limited life, namely 20 years from the filing date of the patent application. Filing a patent application does not mean that a patent has been granted. Once granted, fees need to be paid periodically to the patent office to keep the patent in force.

• **Other forms of rights:**
  There are other forms of IP rights including database rights, designs and trade marks:

  **Database rights** are similar to copyright and can be used to protect collections of data (or other materials) arranged in a systematic way and which are electronically accessible. **Designs** concern the look or appearance of a product and there are registered and unregistered forms of design protection. A registered **trade mark** can be used to protect a name, logo or other aspects of a brand. As with patents, registered designs and registered trade marks are territorial, meaning that rights in the UK cannot be used to stop activity in other countries: additional steps are needed to obtain rights elsewhere.

  • Finally, **trade secrets** (also referred to as ‘confidential information’) can be protected by a contractual agreement. This can be used to protect a wide variety of things, such as data, know-how and commercial information. Relying on trade secrets requires particular care because if the information becomes public, it is not usually possible to control further distribution.

• **Ownership of IP rights**
  Generally, employers own the IP of their employees if it is generated while the employee is performing their job, although IP ownership needs to be carefully considered since it can depend on several factors such as the country (or countries) in which the IP is created and the specific type of IP.

  ➔ Further information on all these forms of IP can be found at [https://www.wipo.int/about-ip/en/](https://www.wipo.int/about-ip/en/)
Examples of Registered and Non-Registered IP Common to University Software Spin-outs:

<table>
<thead>
<tr>
<th>TITLE</th>
<th>DESCRIPTION</th>
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</thead>
<tbody>
<tr>
<td>Registered</td>
<td>Patent (e.g., utility)</td>
</tr>
<tr>
<td></td>
<td>Registered design</td>
</tr>
<tr>
<td></td>
<td>Trademarks</td>
</tr>
<tr>
<td>Not registered</td>
<td>Copyright (non-registered rights automatic)</td>
</tr>
<tr>
<td></td>
<td>Data</td>
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<tr>
<td></td>
<td>Database rights</td>
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<td>Know-how, etc.</td>
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Understanding Open-Source Software Licences

Open-source software (OSS) exemplifies a belief in openly sharing knowledge. Consistent with a university’s values, OSS facilitates the free flow of thoughts, fosters international cooperation, and promotes the dissemination of technologies for significant societal advantages.

OSS licences are fundamental to the development and distribution of open-source projects. They govern how others can use, modify, or distribute software code. Without a licence attached, your software project might as well not be published at all, as without a licence no one can actually utilise it without infringing copyright.

However, the terms and conditions of these licences can vary significantly across different platforms. It is crucial for researchers to comprehend and contemplate how different licences might impact their future research and commercialisation plans before they publish their software code. Violating the terms and conditions of an OSS licence could lead to expensive legal conflicts or necessitate complete product rewrites.
What is an Open-Source Licence?
An open-source licence grants licensees the requisite permission and rights to use or repurpose the code for new applications or to include the code in other projects. One of the main advantages of open-source code is its visibility, which makes it easier to troubleshoot problems and to understand better how something works when the associated documentation is either lacking or incorrect.

Types of Open-Source Licences
There are over 200 variations of open-source licences, but they generally fall into one of two primary categories — copyleft and permissive:

- **Copyleft licence:** This type of licence ensures that code derived from the original open-source code inherits its licence terms. Copyleft licences, such as the GNU General Public Licence (GPL), Lesser General Public Licence (LGPL), and the Affero General Public Licence (AGPL), require users to release the source code of derivative works of the OSS licensed code under the same OSS licence if they distribute those derivative works. It is important to consider how copyleft-licensed OSS is used as it can affect the licensing of other software that interacts with the OSS. Different licences will operate differently. For example, AGPL will apply to software that is not only distributed in the traditional sense (i.e., via an on-premise network) but also to software that users interact with through a network, such as Software-as-a-Service (SaaS) applications. The most popular copyleft open-source licences, in order of restrictiveness (least to most), are the Eclipse Public Licence (EPL), LGPL, GPL, and AGPL;

- **Permissive licence:** This type of licence provides more freedom. Permissive licences, such as the Massachusetts Institute of Technology licence (MIT), the Berkeley Source Distribution (BSD), and the Apache 2.0 licence (Apache), allow users to incorporate the OSS licensed code into proprietary software and create derivative works of the OSS licensed code without requiring them to release their proprietary source code or derivative works under the same OSS licence. Permissive licences typically only require users to include a copy of the licence and attribution notices with their distribution (i.e., give public credit to the licensor of the OSS licensed code).

There are no ‘good’ or ‘bad’ licences and, as anyone is able to create an open-source licence, there is a large range of licences to consider. The open-source initiative collated a list of 80 licences that it approves of and that are commonly used.
Which Licence Should I Choose?
Choosing the right licence depends on your specific situation and goals. These include the constraints of the developers, the nature of the intended users, the desired compatibility with other software, and the legal and business implications. If in doubt, you should obtain legal advice. However, here are some common considerations:

- **Community Preference**: Use the licence preferred by the community you’re contributing to or dependant on. To avoid potential conflicts or disputes with other OSS developers or users, it is advised to choose a well-known and widely-used OSS licence, such as those approved by the Open Source Initiative or the Free Software Foundation;

- **Existing Library Licences**: It is important to consider whether any of the libraries used in your software may affect your licence choice. If you are using a library licensed under one copyleft licence, the nature of copyleft means you may have to also use that licence. Moreover, copyleft licences are generally incompatible, meaning that two libraries with different licences may not be compatible. It is therefore important to consider the libraries used and other pieces of software that any of the OSS may be used with;

- **Simplicity and Permissiveness**: Different licences will vary in length and complexity. For example, the MIT licence is known for being short and to the point. It lets people do almost anything they want with your project, such as making and distributing closed-source versions;

- **Sharing Improvements**: Is it important that any developments made by other software developers are captured for the benefit of the community? If so, then strong copyleft licences like the GPL will allow people to do almost anything they want with your project, as long as any modifications are released to the public if they are distributed namely 20 years from the filing date of the patent application. Filing a patent application does not mean that a patent has been granted. Once granted, fees need to be paid periodically to the patent office to keep the patent in force.

The goal of an OSS licence is to protect both the authors and users of the software by controlling the misuse and unauthorised use of the code. Therefore, it is crucial to choose a licence that aligns with your project’s goals and values.
Conclusion
Open-source licences are more than just a legal requirement; they are a critical component of a project’s success. By understanding the different types of licences and their implications, you can make an informed decision about which licence is the best fit for your project.

Universities often have a stance and/or policy regarding their preferred OSS licence, and some even provide guidance documents for academics and other stakeholders. It is also crucial to evaluate whether open-source publishing is the most effective way to maximise the impact of software.

It is important to remember that challenges can arise when complying with multiple OSS licences, especially when different OSS is packaged and used together. There might also be terms and conditions from funders and/or requirements from other third-parties that influence licensing choices. **It is strongly recommended academics track OSS used in their code from the commencement of research programmes.**

Finally, it might also be beneficial to consider alternative methods for creating impact without OSS, and it is advised that academic staff consult with their UIO before releasing their software.
While the structure of an IP licence agreement will be comparable to that of IP licence agreements for university spin-outs in life-sciences and other resource-intensive sectors, as described in the USIT Guide, the compilation of licence fees will likely be substantially different.

In the majority of software spin-outs, the university-originating IP will consist of unregistered IP, namely copyright, and/or know-how (including data).

- software is protected by copyright as a type of ‘literary work’;
- databases and their contents can be protected by database copyright, and sui generis database right;
- software development can rely on data and training (and re-training) models;
- know-how can encompass methodologies and/or operating procedures for software development and use.

Where the licensed IP estate consists of unregistered IP rights (e.g., copyright, and/or know-how, including data), licence fees are generally lower than those observed for registered IP rights. There can be exceptions, such as where the software product is close to market, the software product relies on resource intensive research outputs, etc. There are also instances where the licenced IP estate includes university-originating registered IP. Both are considered below.
Signing / Upfront Payment
As in the USIT Guide, a signing/upfront payment from the software spin-out to the university is common and set relative to the overall deal terms in totality, including taking the university’s equity ownership and other licence fees into account.

Depending on the IP type and the software spin-out’s planned development activity, a university may approach the signing/upfront payment as the primary licence fee of the IP licence agreement, potentially in lieu of partial or all royalty rates on net sales (see below).

For example, where the university-originating IP being licensed consists of all unregistered IP rights and where the software spin-out will rapidly develop and iterate the software product based on customer feedback and thereby move away from the originating university IP, it is recognised that the university-originating IP may have value for the software spin-out for a relatively shorter duration. A university should consider what a reasonable duration is during which the IP still offers value to the software spin-out.

In this instance, a period of around five or more years could be considered a realistic timeframe to determine deal value. As such, a common approach is for a university to set a signing/upfront payment of up to ‘£X’ to be paid over a period of ‘Y’ years: for example, a £50,000 signing/upfront payment fee to be paid over a five-year period (i.e., £10,000 p.a. for five years). This may be the totality of the IP licence fees or may be balanced with additional licence fees including a comparatively lower royalty rate on net sales, (see below).

Annual Fees / Maintenance Fees
It is not typically common in HoT for software spin-outs to include annual fees/maintenance fees separate from and in addition to a signing fee/upfront payment, as described above.

Where annual fees/maintenance fees do feature in the HoT, they may replace the signing/upfront payment and may be smaller in size over a longer period of time and balanced against a potential royalty rate on net sales, for example, £2,000–£5,000 over five to ten years, depending on the overall deal value.
Development Milestones

Similarly, it is not common in HoT for software spin-outs to include development milestones, particularly if the university-originating IP estate is made up of non-registered IP (lower licence fees), technology readiness level (TRL) progression is rapid (go to market is the milestone) and/or the software will generally not operate in a highly regulated environment (regulatory-based milestones are not relevant).

There are exceptions, however. For example, it may be appropriate to include development milestones to reflect accomplishment of certain value inflection points where:

• development of the software product requires comparatively more complex activity and longer timeframes, such as a software product requiring regulatory approval (i.e., regulatory-based development milestones);
• the spin-out is required to raise sufficient capital to support operating runways (i.e., a fundraising-based development milestone);
• value is gained in building customer base volume and prestigious profile (i.e., a success-based development milestone).

Generally, where development milestones are included, they are of nominal amounts.

Royalty Rate on Net Sales

As with the USIT Guide, the overall deal in totality is to be considered when setting royalty rates on net sales, including the university’s equity position and signing/upfront payments as well as other licence fees.

Ordinarily, software spinning out of a university is often at early TRL (i.e., MVP). The software requires the spin-out to rapidly develop further to become a market-appropriate product. During development, the software product can evolve away from its original founding IP, although determining when the software product has materially evolved from its original founding IP can be difficult to assess for non-registered IP rights.
The university-originating software code may also relate to only a certain number of features from a wider range of functions on the software product, akin to ‘combination product’ principles of the USIT Guide (please see royalty stacking and combination products in Royalty Rate on Net Sales in the USIT Guide for further detail).

The royalty rate on net sales should be set to reflect these circumstances.

**Unregistered IP Rights**

Where the university-originating IP being licensed consists of all unregistered IP rights, it is common for the royalty rate on net sales to be 0.5–2%. This is in line with those royalty rates on net sales for know-how-only licences described in the USIT Guide.

However, there are instances where a royalty rate on net sales is not justified, for example, where the only IP with university ownership required by the spin-out is publicly available on an open-source platform. Or it may be that for other IP with university ownership, the university prefers licence fees be a signing/upfront fee only and leverages the university’s equity position instead. Other universities offer the software spin-out the choice between signing/upfront payments or a royalty rate on net sales, to allow the software spin-out to pay licence fees as and when product sales are made.

One consideration for royalty rates on net sales for products relying on unregistered IP rights is the determination of an appropriate duration, noting that the term of protection for copyright is 70 years after the death of the creator, (versus 20 years generally for standard patents).

**Registered IP Rights**

Where the university-originating IP being licensed includes registered IP rights, royalty rates on net sales are skewed to slightly higher levels (i.e., 2%+), again depending on the registered IP type, the IP estate in full, and the product development plan of the software spin-out, as well as other licence fees and university equity ownership.

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5 It is not unusual for academic software to be re-written or ‘translated’ into another language. Regardless, where the licensed product relies on the university-originating inventive concept and licensed invention, it would be expected royalty rates on net sales will still be applicable.
A consideration for royalty rate on net sales is the actual definition of net sales that will be used in the IP licence agreement. In software, out-licensing can be a form of sale. However, in many university HoT templates, out-licensing/sub-licensing terminology can refer to a different situation that can also often attract a different royalty rate e.g., royalty rate on net receipts/royalty sub-licensing income. How out-licensing/sub-licensing is to be defined in the software spin-out HoT and IP licence agreement should be discussed between the parties at the time of negotiating the HoT, with the relevant definitions and clauses amended accordingly to avoid misunderstandings and potential disputes later on.

As in the USIT Guide, universities’ appetite for IP assignment (both non-registered and registered IP rights) is varied. Some universities are gaining comfort with IP assignment for software-focused IP in exchange for royalty buy-out once certain conditions precedent are met, while others prefer to retain ownership of the IP and keep the IP licence in place. The university’s approach to assignment should be a balance between potential benefit for the spin-out and aligning with the risk profile for the university.

**Database Rights**

In the UK and EU, database rights recognise the investment made, be it financial, human or technical, in obtaining, verifying or presenting the contents of the database, whether data, materials, or independent works. Database rights are legally recognised and protect against direct or indirect extraction or re-utilisation of the whole or substantial parts of the contents of the database, or insubstantial parts on a repeated basis. Database rights are additional protection to database copyright, which protects the author’s intellectual creativity in the selection or arrangement of the contents of the database.

Often data and database rights are represented as one in an IP schedule of a HoT.

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6 Note: Including descending royalty rates on net sales (e.g., over time) in HoT could be an alternative approach. This aims to align appropriate royalty rates with the software product’s development and life cycle (assuming continued product development and software iteration moves the product further from the originating IP). In practice, this approach is not used, though could be considered, if needed.
With software commonly spinning out of universities at an early stage, it is inevitable (and expected) that improvements will be made to the software product in development ahead of market launch. Improvements may stem from the university (e.g., technological advancements, new training data available) or from the software spin-out incorporating customer and user feedback to help shape new iterations of the original software.

It is reasonable that where improvements are based on the university-originating IP or on principles within the original university code, and are generated by the university, the software spin-out can take a licence to these improvements via mechanisms described in the USIT Guide. Where the improvements are generated by the spin-out, the company ordinarily owns the improvements at creation.

Improvements to registered IP are generally readily definable, given that the originating IP has been defined at time of licence execution, e.g., by way of patent specification or other documentation.

Improvements to non-registered IP are often harder to determine, particularly if the copyright, know-how and/or data, etc., has not been robustly described in the HoT from the outset. Further, in software, it is more common to refer to derivative works or new releases, version upgrades, etc.
It is recommended in the HoT that the parties:

- precisely categorise IP into relevant asset classes and types, (e.g., specific patent, copyright being particular source code, data being specific library A and particular data-set B, etc);
- clearly define what constitutes an improvement or derivative, given the relevant asset class and type;
- identify the terms as appropriate to the improvements or derivatives relevant to the asset class.

With unregistered IP rights not offering a true monopoly in protecting against copying, unlike registered IP rights, access to improvements on unregistered IP may be less of a commercialisation consideration for universities than that of improvements on registered IP. A university's contribution to the IP is generally more weighted to the underlying invention around the software.

Universities recognise that many improvements to the software and the organic evolution of product development will likely be in response to customer feedback, moving the product away from the founding university IP and initial code. Future software iterations will often be the software spin-out's contribution. To help clearly delineate university improvements from spin-out improvements, it is worth the parties taking time to work through the steps above at the time of HoT negotiations to avoid potential disputes downstream.
3.3.3 **Termination**

Software development is usually rapid and based on customer feedback. Product iterations can move quickly away from the founding IP. Where it can be demonstrated that the software spin-out is no longer developing a product that incorporates the founding IP from the university (e.g., it has undergone a substantial pivot and is developing a completely different product), the spin-out company may look to terminate the IP licence.

However, it can be difficult to determine whether a product incorporates certain IP where that IP is unregistered, and so whether licence termination is fair and reasonable. It may not be obvious or easily demonstrated that the spin-out company is no longer using the original software, that its users are no longer using the originating software and/or that it can comply with the effects of licence termination, such as the return of all originating software to the university, or the removal of all copies of the originating software.

Therefore, it may be more practical to include provisions to enable the software spin-out continued access/use and/or ‘freedom to operate’ in these situations. Such provisions can include:

- agreeing licensing fees that reduce/diminish over time;
- an option for a royalty buy-out;
- the ability to negotiate a revised set of terms upon meeting certain conditions precedent;
- a termination fee, etc.

Such provisions allow for the software spin-out to continue to operate with confidence, minimising the risk of future IP disputes.
Summary of Recommended Terms for the USIT Guide and USIT for Software
4.0 Summary of Recommended Terms

The summary of recommended terms is taken from the USIT Guide released in April 2023. Please see the USIT Guide for a full description of terms described in summary below.

<table>
<thead>
<tr>
<th>Term Sheet (Spin-out Formation)</th>
<th>USIT GUIDE</th>
<th>USIT FOR SOFTWARE</th>
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<tbody>
<tr>
<td><strong>Total deal value</strong></td>
<td>The terms of i) the investment and shareholdings for spin-out formation and ii) the terms of the university-derived IP licence are heavily related, with each countering/enhancing the other. Together they reflect the deal’s (perceived) value, however equity entitlements and IP licence terms are ordinarily codified via separate agreements. They may be negotiated by separate university teams.</td>
<td>Unchanged. The interconnectedness of terms across the term sheet and HoT is equally as relevant in USIT for Software as it is in the USIT Guide. All terms are to be considered in totality when negotiating a deal.</td>
</tr>
<tr>
<td><strong>University equity</strong></td>
<td>Universities take an equity stake in the spin-out for a variety of reasons. The valuation of a university spin-out can vary; however, pre-money valuations should always be based on a clear rationale. For spin-outs with little IP or other assets, more equity will typically be held by the founders than the university. Where spin-outs have more university-derived IP and assets, more weighting is given to the university’s founding equity positions. University founding equity is commonly within the range of 10–25%, though university founding equity can be outside this range in certain circumstances. Most investment rounds will dilute the founding equity holders proportionally to their shareholdings. In some cases, the university holding may be protected from dilution to a certain point, in which instance the university founding equity is outside this range, commonly below 10%.</td>
<td>It is common for the university to have some equity stake in its software spin-outs. This respects the value added by the university in provision of facilities, services and ecosystem contribution for translational research and commercialisation activities. It is recommended founders be awarded 90–95% equity in the software spin-out and universities retain 5–10%. This recommended landing zone takes into account the generally lower resource consumed to generate and develop the software spin-out opportunity to an investible stage. There may be exceptions outside of this 5–10% landing zone range, for example where the software development relies on more university resource-intensive inputs such as patented software, certain databases, etc.</td>
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<tr>
<td>University equity (Continued)</td>
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<td>In some instances, where an investor is willing to invest to de-risk an early project, advanced subscription agreements (ASAs), simple agreements for future equity (SAFES), and/or convertible notes may be used. This delays the setting of a valuation to a later point and may enable quicker access to funds.</td>
<td>Distribution of non-university founding equity should be decided by the founding team, who may wish to consider allocation dependent on future roles of Founding Inventors, Non-Founding Inventors, Non-Inventive Founders and incoming external team members in the spin-out. Ideally, the founding team and employees should be targeting access to c.50% of the company’s shareholding post series A.</td>
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<tr>
<th>Share type</th>
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<th>USIT FOR SOFTWARE</th>
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<td>A single share type for founders, employees and investors can be advantageous to align parties. However, investors often seek a different class of share. This is most commonly a non-participating preference at a 1X multiple.</td>
<td>Unchanged.</td>
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<tr>
<th>Employee share option pools (ESOP)</th>
<th>USIT GUIDE</th>
<th>USIT FOR SOFTWARE</th>
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<tr>
<td>ESOPs are to be created at a size in line with the specific needs of the spin-out for its next planned activity. 5–20% of the fully diluted equity is typical, with most in the UK between 10–15%. Timing of ESOP creation can influence company valuation (post-money vs pre-money) and valuations should be adjusted accordingly.</td>
<td>Unchanged.</td>
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<tr>
<th>Leaver provisions</th>
<th>USIT GUIDE</th>
<th>USIT FOR SOFTWARE</th>
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<tr>
<td>Founders and key employees are often subject to good leaver/bad leaver provisions in order to retain shareholding-based incentives put in place to encourage desired behaviours. It is important to clearly define what constitutes a good or bad leaver, and triggers for each from the start.</td>
<td>Unchanged.</td>
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<tr>
<td><strong>Vesting schedules</strong></td>
<td>Change across management and senior staff members is usual in software spin-outs and companies should carefully consider and be clear on appropriate vesting schedules. Increasing use of accelerated or reverse vesting schedules is being observed in the current market. The end goal should be to maintain the cap table as investible as possible from inception.</td>
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<tr>
<td><strong>Investment tranches</strong></td>
<td>Smaller investment amounts (e.g., under £10m) may be paid as a lump sum. Larger investments (e.g., over £10m) may be paid in tranches linked to the business plan over a 2–3 year period.</td>
<td>Tranching of investments is unusual in software spin-outs. The next tranche is the next fundraising round.</td>
</tr>
<tr>
<td><strong>Pre-emptive right / participation right / right of first refusal (ROFR) / pro rata</strong></td>
<td>Existing shareholders (or sometimes just investors) usually have pre-emptive rights / participation rights / ROFR / pro rata but can lose such rights for future rounds (or slimmed down pro-rata to new holdings) if no investment is made in the present round and pro-rata holding ranges are not retained. Shareholders are usually allowed to transfer rights to ‘permitted transferees’, including affiliate investment funds and, in the case of universities, connected entities.</td>
<td>Unchanged.</td>
</tr>
<tr>
<td><strong>Drag and tag-along rights</strong></td>
<td>All shareholders to have rights where, if any ‘majority’ shareholder has opportunity to sell shares resulting in a change of control, other shareholders are given the opportunity to sell their shares with same exit rights. ‘Majority’ is often defined as a shareholder of at least ‘X’ percent, negotiated between the parties.</td>
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<tr>
<td><strong>Board seats</strong></td>
<td>A university transitioning out of board should be determined by a balance between the university’s equity position and the value it brings to the skills matrix. As a guide, it is common for universities to have board seat entitlement up to ‘X%’ (typically between 5–10% fully diluted) and then transition to observer status or information status, unless asked to maintain its board seat, once the university shareholding falls below this range.</td>
<td>With lower university equity positions, it is less common for universities to have a board seat. Observer or information rights are more typical, unless the university is specifically asked by the spin-out to join the board, there is an agreed training opportunity for an emerging director and/or the university makes an investment in the spin-out with board rights attached.</td>
</tr>
<tr>
<td><strong>Transaction fee / legal costs / monitoring fee</strong></td>
<td>Parties bearing their own costs is a fair approach, incentivising a swift and focused transaction. Alternatively, a spin-out may pay investor legal costs, with payment made at deal completion when incoming investment is received. Where the university uses outsourced legal counsel, the spin-out should also offer to pay the university’s legal costs. Monitoring fees are not usual, with the exception of venture capital trusts.</td>
<td>Unchanged.</td>
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<tr>
<td><strong>Transaction timeframes</strong></td>
<td>Faster timeframes for deal completion are strongly encouraged to reduce the cost of transacting and increase spin-out formations across the ecosystem, with under three months a preferred target timeframe.</td>
<td>Focus should be on lean spin-out formation for university software spin-outs. Cohesive engagement across all parties can greatly fast-track preparative activities, and as soon as a term sheet is received, it should take no longer than one to three months to sign and finalise all outstanding IP licence and company documentation. Universities publishing clear and transparent processes and timelines can further speed up formations.</td>
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**National Security & Investment Act 2021**

The National Security and Investment Act gives the Government powers to scrutinise and intervene in business transactions, such as acquisitions of spin-outs, to protect national security. The act provides for a mandatory notification regime where a third-party takes ownership of over 25% of shares or voting rights in a company operating in 17 specified sectors such as quantum technologies and synthetic biology. This can have significant impact where the university takes over 25% and expert legal advice is recommended.

**Exits**

Exit pathways can include M&A (with or without earn-outs), acquihires or IPOs. Software spin-outs seeking an M&A exit should prepare from the outset for a speedy exit transaction, including establishing a data-room early on. Expectations on post-acquisition IP licence arrangements are important to understand at spin-out formation to avoid protracted exit processes. A spin-out may need to allow for several months’ activities if wanting to change commercial arrangements with the university.

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Note: The 17 sectors are: (a) Advanced Materials; (b) Advanced Robotics; (c) Artificial Intelligence; (d) Civil Nuclear; (e) Communications; (f) Computing Hardware; (g) Critical Suppliers to Government; (h) Critical Suppliers to the Emergency Services; (i) Cryptographic Authentication; (j) Data Infrastructure; (k) Defence; (l) Energy; (m) Military and Dual-Use; (n) Quantum Technologies; (o) Satellite and Space Technologies; (p) Synthetic Biology; and (q) Transport.
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<tr>
<th>Heads of Terms (Licence agreement)</th>
<th>USIT GUIDE</th>
<th>USIT FOR SOFTWARE</th>
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<tr>
<td><strong>Royalties and success-based milestones</strong></td>
<td>Royalties and success-based milestones should be set using technology valuation appraisal methodologies and benchmarking comparators, appropriate to business plan and in line with market rates. Balance the spin-out’s need to preserve early cashflow and back-weighted licence against the university’s need for early returns. Some fee ranges have been included for reference purposes only, with focus on optimising an integrated deal.</td>
<td>Licence fees are generally more simplified in IP licence agreement with software spin-outs. Signing/upfront payments may be the primary licence fee. Development milestones are not common. The common landing zone for royalty rates on net sales is 0.5–2% depending on IP type and other terms of the deal. Software spin-outs in their most simple form may have royalty rate on net sales not applicable. Others operating in more complex environments may find royalty rates on net sales above this landing zone (where the USIT Guide may be more appropriate). Consideration should be given to the duration of royalties payments, given the protection terms afforded by the different types of IP (e.g., patent 20 years vs copyright 70 years following death of creator). Consideration should also be given to the definition of a sale, where an out-licence/sub-licence can be a form of ‘sale’ in software.</td>
</tr>
<tr>
<td><strong>Windfall success</strong></td>
<td>These are payments due when a spin-out achieves valuation-based milestones and/or a liquidity event. They may be linked to exit fees and/or synthetic equity and can be considered as part of a mixed approach to achieve a net financial position, where unconventional licence structures are negotiated. As such, it is important to consider windfall success payments in conjunction with equity and licence fees. This mechanism is rarely used in the UK, and whilst it has some advantages, windfall success clauses are often difficult to draft and implement.</td>
<td>Unchanged. Unlikely to be used in an IP licence with a university software spin-out.</td>
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<tr>
<td><strong>Other products / enabled products / licensed know-how &amp; technical information</strong></td>
<td>Licensed know-how underpinning enabled products should attract lower licence fees. Agreements should list specific know-how items, carefully define enabled products and cap academic support for reducing know-how to practice (typically two days).</td>
<td>Unchanged.</td>
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<tr>
<td><strong>Licensing improvements</strong></td>
<td>For a time-bound period (often two years), the university usually offers the spin-out a licence to narrowly-defined, university-generated improvements of the earlier-licensed university IP, where feasible. This may be an automatic addition to the existing licence, through the inclusion of an option clause in the existing licence, or through the execution of a separate option agreement which in either instance if the option is exercised, can lead to negotiation of new commercial terms relating to the improvements and execution of a separate licence agreement.</td>
<td>A software spin-out’s product development activity will inevitably iterate away from the original software. It is recommended that university-originating IP is categorised in relevant asset classes and clearly defined to avoid uncertainty of improvement (or derivative) generation and ownership later on.</td>
</tr>
<tr>
<td><strong>Field of use / diligence clauses / minimum royalties, annual payments / mandatory sub-licensing</strong></td>
<td>Field scope should be sufficiently broad to support the business plan, with diligence conditions and reversion rights where the spin-out is unable to achieve diligence milestones. Escalating annual royalties and/or maintenance fees can work to achieve right balance of granted rights and may incentivise the spin-out to release non-developed licensed IP. The appetite for possible future IP assignment to the spin-out will be university specific.</td>
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<tr>
<td><strong>Sub-licensing</strong></td>
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<td>The sub-licensee is to be bound by head licence key terms and the licensee should notify the university prior to executing the sub-licence. The licensee will usually:</td>
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<td>• be limited in sub-licensing tiers (commonly one unless otherwise agreed);</td>
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<td>• be obliged to pay head licence royalties, milestones etc., irrespective of whether the licensee or sub-licensee achieves them, unless particular technology or start-up circumstances cause for an alternative negotiated position;</td>
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<td>• recognise other sub-licence amounts due ex. R&amp;D funding as net receipts (sometimes not entirely synonymously referred to as non-royalty sub-licence income);</td>
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<tr>
<td>• have tiered (decreasing) net receipts percentages to encourage technology investment by licensee;</td>
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<td>• apportion relative contribution for bundled IP;</td>
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<td>• be subject to floors for bundled / stacked IP;</td>
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<td>• have a mechanism for dispute resolution;</td>
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<td>• have a mechanism for managing the sub-licence when the head licence terminates, which may include mutual termination, commencement of a short negotiation period between sub-licensee and licensor or automatic allowance for the sub-licensee to take on the head licence (with potential agreement amendments).</td>
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<tr>
<td><strong>Sub-licensing (Continued)</strong></td>
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<td>Continued IP ownership can remain with the university where the spin-out is able to control ongoing strategy and prosecution, or IP can be assigned to the spin-out (post patent issuance) with an exit fee negotiated and reversion rights retained by university. In practice, these may be challenging to enforce.</td>
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<tr>
<th><strong>Patent prosecution and patent expense reimbursement</strong></th>
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<tr>
<td>The university’s incurred patent expenses up to the point of licensing are usually reimbursed by the spin-out. Thereafter, it is usual for the spin-out to lead IP prosecution.</td>
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<th><strong>Reservation of rights</strong></th>
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<tr>
<td>The university will reserve rights (perpetual, worldwide, royalty-free license) for academic research and teaching purposes. Ongoing debate exists on best practice to approach a university’s reserved right to include clinical research and research with third-party industry sponsors.</td>
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<th><strong>Indemnities</strong></th>
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<td>Indemnities, warranties and liabilities are to be considered collectively. It is usual for the spin-out to indemnify the university (and UIO), except where the university has wilfully breached the licence agreement.</td>
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<th><strong>Warranties</strong></th>
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<td>Minimum warranties are ordinarily provided by the university and are knowledge-qualified where possible and relevant. The university will also ordinarily require the spin-out to give assurances it has all the relevant IP from the university needed to exploit the technology.</td>
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## USIT GUIDE

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<tr>
<th>Liabilities</th>
<th>Within the IP licence, limitation of liability is commonly capped (e.g., £10k–£50k). Licensees must have suitable insurances.</th>
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<tbody>
<tr>
<td>Ethical licensing / global access</td>
<td>The spin-out will be prohibited from sub-licensing to proscribed entities. Global technology access is recognised as a ‘nice to have’ and may be provided for under certain circumstances (depending on the technology type, environmental situation and potential burden on spin-out), though, in practice, it is often difficult for the spin-out to oblige. Certain obligations may be voluntarily agreed by parties or mandated by the original funder or university policy.</td>
<td>Unchanged.</td>
</tr>
<tr>
<td>Termination</td>
<td>Although it is expected the spin-out’s software product will iterate away from university-originating founding IP, it can be challenging to determine if and when it has. It may be more practical to include provisions to enable the software spin-out continued access/use and/or ‘freedom to operate’ in these situations (and avoid the licence termination process and the future uncertainties that may bring). Such provisions can include: • an option for a royalty buy-out; • the ability to negotiate a revised set of terms upon meeting certain conditions precedent; • a termination fee, etc.</td>
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Acknowledgements
Acknowledgements

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Welcome to TenU

TenU is an international collaboration formed to capture effective practices in research commercialisation, and share these with governments and higher education communities. Its members work together to increase the societal impact of research.