

INTO THE GREY ZONE AND BEYOND . . Protecting Your Legal Interests in the New Multimedia Environment

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INTRODUCTION

The world has changed for developers. . .

Ten years ago, all a developer was expected to know about his or her legal rights was where to sign a "boiler plate" agreement on the dotted line. Since then, the world has changed and developers have become the target of both the entertainment industry and the money men. The legal issues confronting even a secure and high profile developer in this new environment can be incredibly daunting, ranging from the most basic questions about contract scope to the most esoteric third-party licensing debates. In addition, many development shops find themselves asking the question: why not explore alternatives to the traditional developer/publisher relationship? That question raises legal issues concerning venture capital, joint ventures, acquisitions and specialized distribution deals. There's no such thing as a standard deal in the "grey zone."

Where do you fit in?

The past few years brought a frenzy of merger and acquisition activity among the "players" in multimedia. The conventional wisdom was that the era of the independent developer, whether large or small, had ended. Hollywood and Sand Hill Road converged to invest in famous names, encourage corporate takeovers by traditional media conglomerates and impose a big film studio culture and PR on the interactive software world. Then the investors sat back to reap their profits . . . and within a short period of time, panic set in and the buyers became sellers. The newcomers to the interactive software industry quickly learned that independent developers can't be left out of the strategy, because of a few incontrovertible facts:

- **You can't get hits without hitmaker talent.** Traditional media publishers love to talk about "content" as though a license and a good PR campaign are the formula to a hit, as long as you can plug in a few competent programmers and celebrity pitchmen. Those in the industry have always known that the ability to design a great game for the

current market is a unique talent that's reserved to only a few, game-savvy people. You can't just put a movie on a CD and have a hit game.

- **Great developers don't give up their intellectual property without a fight.** The best developers have created proprietary technology to enable them to do their work, and they are attached to it. They also come up with ideas that they hope will make them rich and famous. No one automatically assigns these rights to a publisher any more.
- **The development process takes longer than you think.** It's not just that it takes at least 18 months to finish a great game. Smart developers expect there to be safeguards built into the process to make sure that the publisher doesn't get distracted, make significant (and costly) changes to the design or simply cancel the project. Milestones don't get delivered without payment these days.
- **Everyone in the industry talks to each other.** The best developers know who has the best producers and the best attitude. They also know what kinds of deals are being made and who's making them. Publishers lose credibility when they pretend that they "never" negotiate this point or that one, or when they insist on royalties below the norm.

The result: after the consolidation comes the shake-out. As everyone in the industry knows, the hitmaker talents are leaving the big companies again to start up new independent development groups, and they've got proprietary technology, great game ideas, and deal making connections. Once corporate noncompetes run out, there will be even more development start-ups in the marketplace, all headed up by the people who really know how to satisfy the consumer. If you are one of these people, it's never too early to strengthen your position by:

- **Knowing your company's goals**
- **Protecting your building block assets**
- **Making the right deals**

Each of these points involves both business savvy and strategic legal planning. This paper takes a brief look at both aspects of the process.

KNOWING YOUR COMPANY'S GOALS

If your goal is to take your independent development shop through the full corporate life cycle, advance planning to preserve and manage intellectual property rights is a must at every stage. The life cycle goal might be going public or selling out. Just as validly, it might be controlling a closely-held company that stays independent and provides a great working environment for its founders. Regardless of the "exit strategy," protection and planning should start on day one.

□ In the start-up phase

□ **Determine:** The company's goals. What appeals most to the founders?:

*Controlling a profitable long-term business or achieving a short-term, well-compensated exit?

*Producing original product or establishing a third-party provider client base?

*Growing an in-house staff or relying on outside contractors?

*Developing technology or content?

Or any combination of the above. . .

□ **Make sure:** the company is ready to do business before it starts. You need:

***Adequate capitalization.** Take the figure you think is appropriate to meet goals for 12 months and double it. Where the money comes from depends in large part on answers to the above questions.

***Professional organization.** Consult an accountant and lawyer to set up your basic bookkeeping, help make organizational decisions and prepare the appropriate documents and government filings. The small investment you make to do this right now will save many dollars in professional fees later.

***Good management.** Whether your shop starts with one employee or one hundred, someone needs to take responsibility for operations and legal compliance.

□ **Action Items:** Begin:

*Technology protection and human resources programs described below

*Establishing alliances with potential publishers and partners, getting the word out on who you are and what you offer

*Systematically giving a close legal review to contracts to ensure that no rights are compromised or erroneously given away

*Putting legal documents into place that protect the company in the future: founders' stock/buy-sell agreements, executive employment agreements, transfer of technology documentation etc.

In the mid-cycle phase

□ **Re-evaluate and re-assess**: the decisions made in the start-up phase.

*Start-up phase goals. Have things changed?

*IP protection programs. Are they sufficient?

*Current professional advisors/board members. Still appropriate in view of goals?

□ **Make sure**: the company's business model is still adequate to support its goals.

***Adequate capitalization**. Does the company need more money? If so, where should it come from? (See action items)

***Well managed**. Does the company have the right people in the right positions to achieve its goals? Does it have/need a professional CFO, CEO and/or business development officer?

***Key employees are satisfied**. Does the company need to expand its employee benefits packages? Are legal requirements being met?

□ **Action Items**:

*Board determines if, when and how to raise money. Venture capitalists? Strategic industry partners?

*Conduct legal compliance review to make sure rights are intact. Review form documents in-use, in particular employment agreements and policies, nondisclosure agreements, confidentiality agreements, first look agreements etc. Audit licensing agreements to assess ownership issues.

*Retain CPA firm for independent GAAP audit.

*Board assesses where company is in relationship to its goals.
What changes need to be made to achieve the planned exit?

- **Mature phase.** IPO? Merger/Acquisition? Ongoing strategic alliances? Planning at the early stages, as described above, will provide the necessary legal foundation to allow the company to take whichever path is most appropriate.

PROTECTING YOUR BUILDING BLOCK ASSETS: TECHNOLOGY AND HUMAN RESOURCES

If you're an independent, protecting your technology and human resources are the groundwork to any successful deal, whether it's a simple development contract or a strategic partnership.

- **Proprietary Technology (PT).** What tools and techniques has your company created for its own use? What has it created for others that it wants to use again?

- **The Basics:**

- * Treat all unpatented PT as trade secrets and keep records of what PT exists, including enhancements.
- * Ensure that no one, including clients and contractors, gets access to PT without a license or other authorization. □Carve-out□ PT from every developer contract, regardless of who owns deliverables.
- * Require all employees to sign confidentiality agreements.
- * Adopt trade secret policies and educate employees PT protection.
- * Copyright code and materials that are not trade secret

∥ **Examples of Advanced PT Protections:**

*Retain ownership of any code created by company and license-back usage rather than work-for-hire, treat all code created as PT.

*Retain ownership of technology created in conjunction with work-for-hire. Require carve-out of non-PT rather than PT.

*Require separate licensing fees for PT.

*Retain PT rights to any platforms (including Internet) not specifically negotiated

*Establish patent and trademark program (including domain names)

∥ **Protecting Confidential Information.** How to keep your business plans, product ideas and marketing strategies confidential?

∥ Nondisclosure Agreements

∥ Navigating need-to-know issues

∥ Unauthorized employee disclosures

∥ **Retaining talented employees.** How to hire them? How to keep them?

∥ **The Basics:**

*Establishing and maintaining creative culture.

*Incentive (bonus and equity) programs.

*Employment/confidentiality agreements.

*PT ownership issues.

∥ **Examples of Advanced Issues:**

*Nonsolicit/noncompete clauses and enforcement

*Anti-raiding clauses and penalties for third parties

*Trade secret theft by former employees

*Policing misappropriation of third party trade secrets by employees

THE NEXT STEP: LICENSING YOUR ORIGINAL CONTENT

The ability to establish a franchise for original content is a powerful tool for building value. Licensable content must be original with no (or minor) limitations on its use for the highest benefit to the developer. If you're working with original content, it's never too early to figure out what rights must be preserved and to take steps to ensure your content stays clean enough to be available for advanced licensing deals.

□ The Basics:

*Follow trade secret programs, register copyrights and trademarks, keep records establishing originality

*If using independent contractors or licensing in components of the content, make sure all work is assigned and third party representations, warranties and indemnities obtained for every part of the product (music, art, script, photos etc)

*If using actors, musicians, models etc., obtain releases (see below)

*License out original content only for exact intended use: beware of broad grants of rights to publishers, distributors and partners

*Keep content disclosure to need-to-know until public to minimize misappropriation

□ Examples of Advanced Licensing Techniques:

*Multiple publishers/distributors for content on different platforms

*Merchandising rights

*Traditional media rights and derivative work licensing

*TV, cable, ISP licensing concerns

*Partner rights to use content in related media environments and advertising: regulating "moral rights" issues for derivative works and on-line advertising

*International distribution and localization concerns

□ **Examples of Advanced Licensing Issues:**

*Coordinating with performing arts unions (DGA,SAG, AFSTRA, etc)

*International registrations and IP laws

*Policing and enforcing intellectual property theft and misuse

*Coordinating licensee activities, particularly outside US

*Auditing third party distributors

*Clearing and obtaining rights to third-party content and licenses (including music, film, technology, video etc)

*On-line "fair use" and disclaimer issues

□ **Structuring the best licensing deal for your company**

The type of technology or content to be licensed, the allocation of ownership rights (as described above), the desires of the company's shareholders/management: all combine to suggest the best deal structure. In the current multimedia environment, legal creativity rules. Examples of deal models are:

□ **Old-fashioned developer-publisher deal**

limited players
producer/art/music/video at publisher
generally work for hire or equivalent
royalty range depends on history

Example: Publisher "X" contracts with outside Developer "Y" to program famous sports franchise game, Action Luge 96! X provides access to its Luge System tools and licenses, in-house production staff. Y is paid advances, recoupable against royalties, and is charged for various expenses. Y carves out pre-existing technology but everything in the game (including all of the source code) belongs to X.

□ **Independent developer shop deal**

developer employs artists, musicians etc.
developer handles outside contracting

more ownership
more cost/benefit sharing

Example: Action Luge 96!7 is a huge success and X invites Y to develop the sequel, Action Luge 97!7. This time, Y has specific new ideas for the game and also has created a special animation tool (separate from its work for X) that would greatly enhance the sequel. Y carves out all proprietary technology and negotiates a clause giving it ownership of all enhancements and new technology developed during the creation of Action Luge 97!7, along with the right to use source code (under a license from X) for internal development purposes. Otherwise, higher advances but no increased rights.

▮ **Joint Venture: Affiliated Label**

complete developer shop PLUS
primary development costs/control at developer
distribution, service fees at publisher

Example: For this deal, Y has developed its own product, Jamaican Bobsled Fantasy7, building on its previous success and its excellent, protected technology. After prototype, it becomes apparent Y needs some more money to pay third party costs, including platform licensing fees, celebrity endorsements, and really cool music. Affiliate Label deal negotiated with X to give limited guarantees on distribution for other rights (such as on-line and various derivative work rights).

▮ **Joint Venture: Strategic Partner**

strategic partner handles distribution
licensed property may come from partner
goals of partner control type of deal

Example: In this deal, Jamaican Bobsled Fantasy7 is fully funded by Y through a combination of prior revenue and an equity investment by X. The investment deal includes an equity stake in Y plus a distribution deal (3 titles, including Jamaican Bobsled Fantasy7). Deal also includes an option to take the next round and an obligation to share future development possibilities.

The above are just examples: the possibilities for creative structuring are endless, as long as the company has a clear vision of where it expects to end up.