vcj Venture Capital Journal

News and Analysis of the Private Equity Markets December 2002

Coping with Poor Corporate Hygiene in the Early Stage Company

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A venture capitalist's portfolio is comprised of many companies, varying in stages of development and value creation. A minority of these companies may unknowingly conceal major deficiencies that can seriously impact the quality and timing of a future financing or liquidity event. From an external perspective, they appear to be on track—a new CEO with an impressive pedigree, a transformational technology platform and an untapped market. Internally, however, catastrophe lurks, due to an early set of bad decisions. The inexperienced VC needs to be operationally involved to detect these "Trojan Horses."

Poor corporate hygiene manifests itself in a number of ways. But these symptoms do not have to sound the death knell for a portfolio company. What follows is a discussion of examples of poor corporate hygiene and the remedies that were employed.

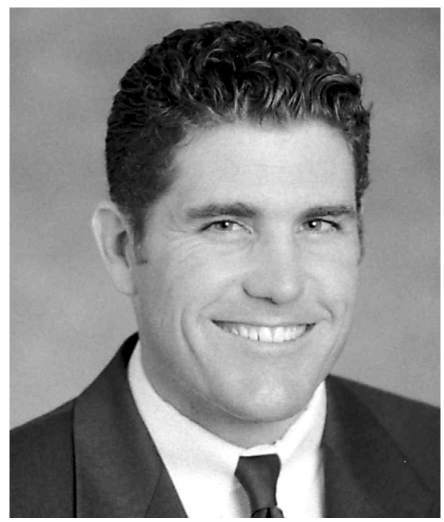
Too Many Options

Equity is the emerging company's staple alternative to traditional consideration or compensation. Despite the continuing controversy over expensing stock options, it remains a primary recruiting tool for early-stage companies. Likewise, corporate partners, customers, suppliers and lenders often seek to obtain equity, usually in the form of warrants, in lieu of traditional cash compensation or as an equity sweetener. A startup that issues excessive equity equivalents with senior and preferential rights during its formative stages presents a VC with formidable, but not insurmountable, issues.

A good scrubbing of a potential portfolio company's capitalization will often turn up disturbing equity arrangements. It may also produce the existence of arrangements previously unaccounted for, such as "side letter" equity agreements that are quickly forgotten.

One software startup recently compensated its suppliers with warrants. Some savvy recipients received very favorable terms: underlying preferred stock; prohibitions against granting senior registration rights in the future and the absence of any company or underwriter cutback option on those rights; preemptive rights on future equity issuances by the company; and negative covenants.

This was an untenable environment for the venture firm involved, given the diminution to the startup's anticipated returns. For example, the VC would be *pari passu* with the warrant holders on liquidation preference as a result of the



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warrant holders' right to receive new warrants to purchase the same securities the VC received in the financing. Moreover, the warrant holders' excessive registration rights would take seniority over the new preferred stock, due to the warrant holders' inability to be cutback.

The VC was also concerned about the fact that some warrants had been issued to the company's large customers. In certain cases the value of a warrant that is issued to a customer might be deemed a rebate, precluding a company from booking all proceeds as revenue. The VC was concerned about the potential impact on the financials and how it would affect the company's ability to obtain additional customers. The venture firm was also concerned about the "genuineness" of the revenue and whether it would be recurring absent additional warrants.

The greatest concern to the VC was the fact that the warrant holders—unlike the VC and other preferred investors—were assured preferential rights without having to participate in a new investment. This "call," coupled with the diminution in returns and the cloud created by various novel and unresolved issues, could have killed the deal at hand.

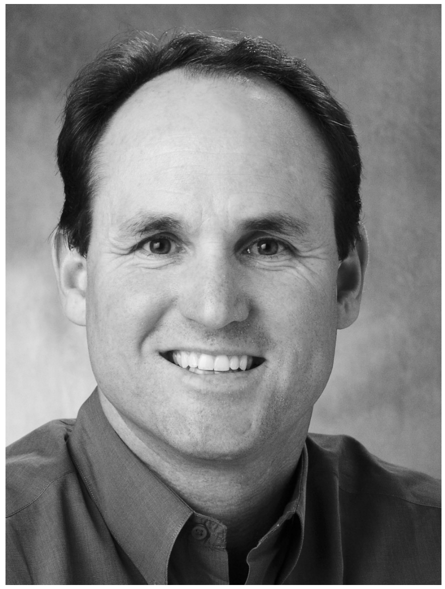
A number of solutions were considered: forfeiture of preferential rights, reduction of the company's pre-money value, and replacement warrants to acquire a preferential class of common stock junior to the preferred but senior to the regular common in liquidation.

Ultimately, the warrant holders retained their right to acquire the preferred stock but with a number of "clean ups," as well as a delayed financing. The strike price was set as the preferred stock purchase price to avoid any anti-dilution triggers and adverse "cheap stock" accounting issues. In a further attempt to mute the objectionable "call" right, the cashless exercise provision was removed from the warrants.

Another example of problems posed by giving away too much equity involved a genomics startup that structured a "discovery royalty" arrangement with its founder. Under this arrangement, any future discovery that was created by the founder or was the residue of an earlier discovery and used by the startup would generate royalties to the founder that could be taken in cash or equity at a discount to the last round of financing.

The VC in the startup's first institutional round was troubled by the founder's outside position relative to his own company, as well as the unpredictable level of dilution created by future discoveries. The venture firm also did not want to see its investment being used to buy innovation from a company insider.

Various solutions were discussed, including requiring the founder to terminate the arrangement and assign any new



Jim Thornton, Guide Ventures

discoveries to the company or maintaining the arrangement but deleting the more onerous provisions, namely the equity discount. The VC was able to convince the founder to terminate the arrangement and assign to the company the rights to all past and future discoveries related to the business. In exchange, the VC agreed to allow a significant option grant to the founder and approved a consulting agreement that provided for periodic formula option grants over the next five years.

Unconventional Structure

Emerging companies too often have unconventional corporate structures. For example, a medical device client formed itself as a limited liability company (LLC). The structure was chosen due to the flow-through nature of any losses. From the VC's standpoint, the LLC was a poor investment vehicle for a number of reasons:

- As a "pass-through" entity for corporate level tax purposes, the LLC presents problems for VCs with ERISA considerations or foreign limited partners that wish to avoid trade or business income.
- LLC interests or "units" cannot qualify as "small business stock" under Internal Revenue Code Sections 1202 or 1045. Only stock issued by a domestic C corporation qualifies as "small business stock," allowing the investor to exclude from gross income 50% of the gain on a sale or exchange or defer the gain by rolling over the proceeds into replacement small business stock.
- An LLC makes it cumbersome to create the complexities of a multi-tiered capital structure involving common stock and preferred stock, as well as the use of options for compensatory purposes.
- The LLC structure presents unconventional corporate governance principles, such as a determination as to whether the entity will be member managed or manager managed, who the manager will be, where a traditional board or advisory structure fits in and who has ultimate fiduciary responsibility.

Fortunately, the transition from an LLC to a C corporation is an easy and relatively inexpensive process. For Delaware companies, the process has been simplified by statute. Delaware-domiciled LLCs are authorized to merge into or consolidate with a Delaware or foreign corporation with relative ease.

In the case of the medical device company, it was domiciled outside of Delaware, so an alternative approach was required. New counsel was introduced to advise the company on the most appropriate method of conversion. They discussed a contribution of the LLC's assets to the newly formed C corporation in exchange for stock or, alternatively, a distribution of the LLC's assets to the LLC members, who would then contribute the assets to the C corporation for stock. These approaches, with their focus on a transfer of assets, are often taken in an attempt to leave behind unwanted liabilities or "skeletons." Unfortunately, the new entity is sometimes deemed to succeed to liabilities of the old entity under an amorphous successor liability theory.

On the advice of counsel, the company formed a new C corporation and merged the LLC into the new entity, with the founders receiving shares of stock in exchange for their membership units. With an eye toward prosperity and zeal to oblige new money from the venture firm, the founders were more than willing to forego the pass-through losses from the LLC structure.

Costs of Partnering

Most business plans presented to VCs include a business model that is devoid of any corporate partnering strategy. While a corporate partnering strategy is not a prerequisite for a successful startup, a partnership that reduces or shifts marketing, financial and regulatory risk can be a validating component of any business model. Moreover, a corporate partnership provides a startup with access to valuable licensing networks, management expertise and access to additional capital and markets.

A startup recently presented a compelling investment opportunity, but it was negotiating a partnership with a drug company on terms that were unacceptable to the new VC. The arrangement would have given the drug company access to the startup's new drug discovery tool without giving the startup an opportunity to realize any upside participation in the pharmaceutical company's identification of new drug compounds. On the advice and with the support of its new VC partner, the startup convinced the drug company to provide a royalty arrangement with respect to any new drug-related discoveries that resulted from the startup's tool. The technology behind the tool was a compelling reason for the drug company to accede to this arrangement.

While a well-structured corporate partnering strategy is a valuable element of a successful portfolio company, it may also raise concerns. The startup previously mentioned was so enamored with partnering with a well-known drug maker that it overlooked some important consequences. The contract presented by its large partner did not contemplate the potential imposition of various legal constructs, such as the "corporate opportunity" doctrine, fiduciary duties, and obligations of "good faith" and "fair dealing." These nebulous concepts often require each partner to show the other any related opportunities that come to its attention, to act in a measured manner toward the other party and to assess the liability exposure of competing with the other party, even in a seemingly unrelated endeavor.

These issues can be governed by contract, but often they are ignored. Whether as a result of deference to the larger partner or the reckless pursuit of a promising new partnership in a capital-scarce environment, there is generally a failure by young companies to contemplate negative scenarios and contractually provide for remedies. The result is the application of a poorly defined default standard varying between jurisdictions. This issue takes on added complexity with the existence of competing rules governing the ownership and administration of intellectual property.

As part of its renegotiation of the contract and attainment of the royalty arrangement, the startup and the large drug company revised the joint development agreement to accomplish the following: curtail and clearly define the fiduciary obligations owed to each other; remove the specter of the corporate opportunity doctrine or any obligation to share opportunities that arise; establish a set of physical and conceptual parameters outside of which the parties were free to compete with each other; specify obligations and the degree of effort that was expected of each party; and define ownership of jointly developed intellectual property.

When considering a partnership, startups should contemplate what may happen in a divorce. This potentiality takes on paramount importance when intellectual property is involved. For example, a fabless semiconductor startup entered into a joint development agreement with a large manufacturer of semiconductor devices. Captivated with the prospect of partnering with a big name in the industry early in its corporate development, the startup entered into the agreement quickly. The founders failed to contemplate ownership of intellectual property enhancements, improvements and significant modifications, as well as who would prosecute patent claims on jointly developed intellectual property in a post-divorce scenario. The result was an agreement that significantly favored the large corporate partner if the deal went "sideways."

Because the partnership also provided the startup with a license to use certain technology instrumental in achieving its next few milestones, the VC was unable to overlook the relationship. The situation was resolved by renegotiating the agreement with the support and guidance of the VC. It resulted in a more well-defined and acceptable joint ownership arrangement post-divorce.

Specifically, the parties agreed to maintain joint ownership of any intellectual property developed under the agreement, but the corporate partner would be responsible for prosecuting and maintaining patent claims and the related expense. The startup retained the right to participate in the prosecution of any patent claims. Finally, the corporate partner was responsible for protecting the intellectual property against infringement by third parties and taking all steps reasonably requested by the startup to do so. In exchange, the corporate partner was provided an opportunity to participate with the VC in a new round of financing and received common stock warrants as an incentive.

Bad Licensing

Poorly negotiated licensing arrangements jeopardize a portfolio company's business model. Examples include the failure to anticipate liquidity events, surrender of patent prosecution and strategy to a large corporate partner, and provisions that rest approval of reseller channels or trade discount amounts solely in the hands of licensors.

One problematic situation involved a medical device startup with an impressive in-licensed patent portfolio. Some of the licensed technology was actually a sublicense from a large device company that was itself licensing the technology from a major university. The startup relied heavily upon the sublicensed technology, rendering it dependent upon the device company as licensor. For example, the startup was unable to license derivative discoveries directly from the university for a new application. In addition, if the underlying license was terminated between the university and the device company, the startup's sublicense was automatically terminated without any assurance that the university would agree to license the technology directly to the startup.

After renegotiation, the startup was able to acquire certain rights that allowed it to ease its reliance on the device company as licensor. Most notably, it obtained the right, upon termination of the master license, to step into the large device company's position as primary licensee.

The most difficult hurdle that the startup and its venture backer faced was the result of an ambiguous assignment clause in another license agreement. This clause could arguably be read to require consent from the licensor in a transaction involving the sale of the company, even if the company itself remained intact. Eventually, the startup received an offer from a publicly held device manufacturer to acquire all of its assets, including the assignment of the license rights. Through internal due diligence, the company discovered that the potential buyer had competed with this particular licensor. An initial discussion with the licensor confirmed that an impasse had been reached, since the licensor was reluctant to consent to the assignment of the license.

A number of sophisticated alternatives were discussed, including the acquisition of alternative technology. However, the price of acquiring or even licensing the alternative technology was exorbitant and was likely to sink the proposed offer. In the end, the startup and its buyer made an expensive concession to the licensor in exchange for its consent. The licensor received an additional license fee and royalties of 8% on the net income earned from the sale of products derived from the license.

Additionally, the buyer's right to use the license was narrowly defined and significantly curtailed from what the startup had originally been granted. As a result, a portion of the purchase price was deferred as earn-out payments to the two founders over an extended period. Any royalty payments received by the licensor were deducted directly from the earn-out payments.

Ineffective Boards

Venture firms often face a difficult set of decisions regarding board composition in early financings. They typically defer these decisions out of fear that a deal may fall apart or concerns that the entrepreneurs will perceive them as "taking control" of the board.

The experience of one early stage company illustrates the dangers of an ineffective board. The founder had assembled a board of cronies that quickly extracted an inordinate number of options for its members. These so-called "mentors" spent very little quality time with the company, possessed no Rolodex for recruiting or partnering and had little understanding of the technology, the industry or its direction. The result was a "rubber stamping" of CEO recommendations and minimal scrutiny of company practices and results.

Despite the shortcomings of its board, the company possessed impressive wireless technology and its founder had an extraordinary penchant for innovation. In its first round of institutional financing, the startup courted a handful of top-tier venture firms, with two of the VCs co-leading the round. The VCs were excited about the prospects for the company, but each wore scars from experiences with other companies possessing entrenched and ineffective board members.

VCs usually interpret entrenched boards as a signal that a company is disdainful of objective outside representation and is seeking capital with a modicum of "interference" from investors. The VCs knew in this case that the founder was unsophisticated in corporate governance and that his board was not representative of his expectations. So, the venture firms made the funding contingent on an overhaul of the company's board.

The result was a redesigned board. The number of directors was capped at five. Each VC was given one board seat, and industry experts who the VCs would help identify within two months of the financing would fill two seats. The company's founder took the final board seat, with the understanding that in six months he would hand it over to an experienced CEO brought in to run the company.

As evidenced by the previous examples, corporate hygiene is an important barometer for VCs to consult when assessing the health of their portfolio. Concealed deficiencies or other warts often exhibited by startups do not have to be deal killers. The key is for the VC to identify the problems early and to work closely with competent and enlightened advisors to resolve them.

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