

AMANDA HAYWARD
Scheer & Company

Amanda Hayward, Ph.D., is a Vice President at Scheer & Company. At Scheer, she has been a leading member of engagement teams pro-



viding corporate strategic advisory and consulting services to a broad range of clients, including both

publicly and privately held companies. She has more than five years of company building experience, and played a role in the founding of Sophberion Therapeutics, Tengion, Respimetrix and Aegerion. She has experience at a variety of levels including fund-raising, licensing, operations, recruiting, human resources, facilities and lease-line negotiations, and financial modeling.

SIOBHAN MCCLEARY
Sills Cummis Epstein & Gross P.C.

Siobhan McCleary, Esq., is an attorney at Sills Cummis Epstein & Gross P.C. Her practice focuses on representation of private equity



funds and their portfolio companies, including venture capital financings and merger-and-acquisition trans-

actions. She has extensive experience representing start-up and early-stage technology, biotechnology and pharmaceutical companies in all aspects of the business cycle, from formation through multiple financings to IPO, as well as corporate counseling for day-to-day operations. Contact Siobhan at smccleary@sillscummis.com or 973-643-5386.

CAPITAL GROWTH INTERACTIVE®

2006 VENTURE GUIDE

WWW.CAPITALGROWTH.COM

Venture Capital and Start-Ups: A Legal Perspective

There are many challenges facing entrepreneurs attempting to organize and grow a successful technology or life sciences company. They must focus on development of the product, raising capital and recruiting quality executives to manage the process. Unfortunately, there also often tends to be a laissez-faire attitude toward legal matters, including issues surrounding documentation and compliance.

Once the company looks to raise its first round of institutional financing, this absence of a firm legal foundation can be a significant deterrent to venture capitalists, reflecting a lack of sophistication on the part of the management team. While there is no doubt that product quality and management team experience are the most important factors that a potential investor considers when choosing the next portfolio company, having sound corporate practices can remove an additional substantial hurdle to completing that first round of institutional financing.

For a technology or life sciences company, the intellectual property portfolio is one of the most important assets. The ability of the company to protect, maintain and manage that portfolio is the main focus of any potential investor. While most potential investors would conduct their own intellectual property due diligence, the company must be prepared to demonstrate that it has the rights to the technology it is developing.

Some important areas to focus on are:

1. In the event that the founders and/or employees independently created any of the intellectual property being developed prior to joining the company, the rights to such intellectual property must be transferred to the company and documented properly. While some founders may prefer to license their intellectual property to the company, the failure of the company to directly own this major asset may result in a drop in valuation. Also, if the founder or employee created the technology while at a previous employer, that previous employer may have claims to future related technology under certain circumstances.

It is imperative that an analysis of such legal claims be conducted and, if necessary, such claims be released in writing by the previous employer.

2. To the extent that the company owns such intellectual property and that is patentable, the company should have filed the appropriate applications and commenced patent prosecution. To the extent that the expected market for the product may not be limited to the United States, such applications should be filed in the appropriate foreign jurisdictions. In the event that the company does not have the funds prior to the institutional financing to cover the costs of such filings fees, the company should file provisional applications. If the inventor files a regular patent application within one year based on the same disclosure, the regular patent application will have a priority date of the filing date of the related provisional application.

3. To the extent that the company owns such intellectual property and that it is not patentable or the company does not wish to patent it, as in the case of software, the company should take all the precautions necessary to protect it as a trade secret. At a minimum, the company should have every individual or entity that has been provided with or has access to such intellectual property sign a written confidentiality agreement or non-disclosure agreement. This includes not only employees but consultants, contractors, advisors, potential investors and partners. In the event that the company does not do so, it may not be able to claim such technology is protected as a trade secret at some critical point in the future.

4. To the extent that the company will be creating additional intellectual property going forward, it is highly advisable that each and every employee, consultant and contractor sign an invention assignment agreement, assigning to the company any and all rights that such employee, consultant or contractor may have to the new technology as permissible given any third party obligations. In the event that the company hires someone other than an >>

Venture Capital and Start-Ups: A Legal Perspective

>> employee to develop technology, there is a common misperception that the company would own such technology given that the company paid for it. However, this is not the case and the company must comply with certain intellectual property laws to guarantee its ownership, including specific provisions contained in a written contract.

5. To the extent that the company in-licenses such intellectual property from a third party, this arrangement should be documented in writing and contain reasonable terms and conditions. Many institutional investors will review the economic terms closely and may require that they be renegotiated if too rich. Also, in the event that the licensor is a university, an analysis of the university's policies and procedures related to commercial exploitation must be completed to assure compliance.

CAPITAL STRUCTURE

Another area of great importance to potential investors is the capital structure. Potential investors will look at existing equity issuances and related terms, such as stock valuation, vesting and buy-back rights. Potential investors also do not like strange devices that cause disharmony among the founders, management and, if applicable, licensing institutions.

Some key factors to consider are:

1. In connection with classes of stock and number of shares outstanding, as a general rule, the simpler the better. Only one class of common stock should be issued prior to the institutional investment. If the company has seed investors, those seed investors should have received common stock or, in the alternative, debt that is convertible into the equity being issued as part of the institutional round of financing. The aggregate number of shares outstanding should be neither too high nor too low.

2. In connection with equity compensation and management, it is very important that management be properly incentivized. The company should adopt an option plan in the early stages of formation that is compliant with

applicable federal and state laws. Those shares sold or options granted to management and employees should be reflective of industry standards and subject to vesting with an appropriate cliff where possible.

3. The company must have complied to date with federal and state securities laws in connection with the issuance of its securities. The minimum penalty for noncompliance is rescission, which would give the purchasers of such securities the right to force the company to unwind the sale and refund the purchase price to the purchasers. There is the potential for additional fines as well as criminal liability under certain circumstances.

MANAGEMENT AGREEMENTS

It is well established that even a company that has a great product will, in most circumstances, fail if it does not have a quality management team. Often, for an early-stage technology or life sciences company, potential investors are investing in the members of that management team with the belief that such individuals will be able to execute the business plan and lead the company to commercial success. As a result, potential investors will want to confirm that those individuals will not leave the company after the financing. Therefore, the execution of written employment agreements with key members of the management team is imperative. Each such individual should also be subject to a reasonable non-compete, as should any other employee that creates or has access to crucial confidential information. The standards of enforceability are dictated by state law and an analysis of the specific language that must be contained in each agreement should be conducted.

While there are many other legal matters that require appropriate documentation and compliance with applicable laws, most are capable of being resolved at the request of the potential investors prior to closing. However, certain key areas, such as those mentioned above, are not easily fixed if previously ignored. More importantly, the company may inadvertently lose a potential source of much needed capital. ■

“The absence of a firm legal foundation can be a significant deterrent to venture capitalists, reflecting a lack of sophistication on the part of the management team.”