

PRESENTATION:

**THE BUSINESS SIDE
OF INTELLECTUAL PROPERTY ASSETS**

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Venture Law Group is based in Menlo Park, CA. I was one of three lawyers who came to Seattle in 1996 to open an office here in order to work with entrepreneurs who are starting technology companies. It was biotech that brought us to this community. At that time, we had six clients here that were all in the biotech industry, including Cellpro and Corrixa. We also thought Seattle was an interesting market in other technology fields. This community had Microsoft, which was obviously going to lead to a lot of entrepreneurial activity in the software world; the McCaw family, which was already leading to several start-ups in the cellular, wireless world; Amazon, one of the strongest leaders in the emerging internet world; and a biotechnology industry consisting of Fred Hutchinson Cancer Research Center, UW and others. Because of the diversity of the technology here and the entrepreneurial culture, we thought Seattle was one of the most interesting markets we could enter.

My practice is focused on the business and finance side of law. I obviously come into contact with IP lawyers all the time, because IP is a fundamental asset of the companies with which we work. Over the years, I have gained enormous respect and reverence for IP assets.

I think Cellpro probably taught me as big a lesson as can be taught in the area of IP assets. The story of Cellpro is a good example of why IP assets should not be ignored. Cellpro was the darling of the start-up biotech world in the 1990s. Its technology originated from “the Fred Hutch” and was backed by Kleiner Perkins, the premier venture capital firm in the world. They had an approved product, a cell separation system for treatment of cancer. It was being sold in the U.S. and Europe and was the only product for that treatment on the market. They had a billion dollar market cap. They had everything that you could hope for in a biotech company, until one day they got embroiled in a patent dispute with Baxter Pharmaceuticals over a patent out of John Hopkins University. After many years and millions of dollars of litigation, the U.S. Court of Appeals ruled that Cellpro’s patent infringed Baxter’s. The company ended up selling its IP assets for \$3 million and everything else was written off. This example demonstrates that the best management,

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unlimited capital, and even an approved product with growing revenue and sales mean nothing if you don't have the patent rights that you need.

Notwithstanding that lesson, my focus today is on factors we look for in start-up companies that ultimately contribute to the start-up's success. I have a list of the top ten factors that are important for start-ups. This actually came from a venture capitalist.

The top two factors have always been technology and management. There has been a trade-off over the years about which one is more important. Previously, the management team was considered more important. The theory was, even if the technology does not work out, there are smart guys running this company and they will figure out something else to do with it. The lesson learned over the last year is that this is not necessarily true. Fundamentally, if there is no business or technology in a company, then the best management team in the world cannot extract any value from it. Today we are hearing exactly the opposite. Now the focus is on technology. That is an equally wrong position to take. What you really want is both. You want great technology and you want a great team that can commercialize that technology.

There are several sources from which companies get started; it usually occurs where the technology is coming from. In our world, we deal with three different sources of technology: (1) academic; (2) industry, such as a spin-off from a larger corporation where there is a separate piece of technology that they do not want to pursue, or decide to pursue in a separate entity; and (3) individual inventors, who come up with interesting technology.

Where that technology comes from is irrelevant. What matters is that the entity selected as the commercial vehicle has to control the technology. We may be indifferent about whether it is through pure ownership, by assignment of the technology, or if it is through a very tight exclusive license. But when we are negotiating with a university or with an industry parent company, we are concerned about making sure that the new entity gets the control it needs to commercialize that technology. We have very little problem getting to that result with academia. They recognize that that is how it needs to be. You might spend some time working out the details of which market you are going to pursue and what your field of use is going to be, but overall control is usually not a big obstacle.

Industry is where the big issue occurs. A spin-out technology from a large company will inevitably overlap with some of their own technology and commercial interests. It is difficult to find a way to obtain adequate control of that technology and not have some reversion right back to the parent at the point it becomes extremely valuable. The most contentious issue concerns what happens if you spin out a technology and that company ends up being potentially acquired by a competitor of the parent company. We would argue that the entity needs the flexibility to pursue that as an alternative strategy. It owes a duty to its shareholders to find a buyer for that technology at some point, if it can. A parent company, however, can be very threatened by the possibility of a competitor buying technology that is often very closely linked to their own technology. Some mechanisms used to overcome this issue are buy-back rights, matching offers, and auctions where the parent company has an opportunity to participate.

Start-ups generally have no cash. Although a start-up may have some initial seed money from an investor, it still views cash as its most precious asset. What it has to offer is long-term upside. We would try to structure something that involves low to no cash up

front. In return, we would give some downstream upside in terms of royalties, milestone payments when there are specific success events that are going to translate nicely into financing events, and equity. Equity is probably the most powerful form of economic value that the company can deliver.

One of the more interesting issues that will be confronted over the next few years involves conflicts of interest. Such issues are raised when scientists use academic public money to create technology and spin it out into a commercial entity. These founders often retain a significant equity participation in those companies and often join the companies. Sometimes they take on a dual role where they are both teaching or researching at an institution and working with the company. From our perspective, it is absolutely critical to encourage innovation by giving some equity incentive to the inventors as well as to the institution. It needs to be done in a way where there is public trust and confidence. We do not want to misuse or abuse the public contribution to that technology. There is much more brainstorming to be done in this area, and there is already litigation on the horizon. Hopefully, both will provide constructive results.

There is also a “people side” to the equation. Entrepreneurs want to know if they are going to get fired once venture capital financing is acquired: “Are they going to ship me out of the company and hire a new management team that will come in and take this technology forward?” The answer is: usually not, unless over time, it is realized that the entrepreneur’s role is not going to ultimately provide success to the company. Often the entrepreneur is shifted to a more scientific technology role while a more experienced businessperson will come in as CEO.

On the other hand, there are many great examples of scientific founders who’ve made great business leaders in their companies. This is because nobody understands their technology better than they do. It can be a disaster to bring in a CEO who does not understand the technology – he cannot get the respect of the scientific team and even that of the outside world. Such a CEO is unable to tell the story and express the enthusiasm and passion needed when raising money or speaking with the community at large or customers. Many scientific founders often possess a very critical skill that is not easy to get from the outside world. So it should be presumed that scientific founders bring something to the table that is unique and valuable to the company.

Where scientific founders often struggle is in having the people skills necessary to be a leader. It may not be in their background, and they may not understand the psychological and cultural issues that surround the top executive position. They may not be able to lift themselves out of the nuts and bolts of the science and tell the story effectively to laymen. This is very important because you do not raise money from other scientists; you raise money from venture capitalists who have little scientific knowledge and who get lost in the details. The focus must be on market opportunity and how to make money with the technology, because venture capitalists are not interested in nifty technology unless it is going to make them a lot of money.

As the company grows, you need to have people focused separately on science and business. It becomes impossible for one person to do both well; you cannot run both the science and technology development and the company itself. It is something that every company has to figure out for itself. You do not, however, automatically kick out the

founders and bring in the new team. Most successful companies have a continuing role for their founders, should they choose to stick around and fill that role.

What should you look for in a management team? A successful track record in the particular market is the only thing that will cut the mustard. The single factor that can eliminate risk for investors is somebody that has been successful before, because they are more likely to do it again than somebody who is doing it for the first time.

An entrepreneurial attitude is another important factor. Some of the best examples are in the dot-com world, where they hired people out of old industries. Some of those guys had a really hard time adjusting to a cash-starved venture that had to prove itself to the world without having a long track record and billions of dollars of investment capital. Therefore, being an entrepreneur at heart is important. Leadership capability and credibility, both internally and externally, are also very important.

What distinguishes start-up companies from those in other more mature sectors is the need to effectively leverage equity. That is, you need to be able to deliver equity to founders, employees, business partners, academia, and whoever you need to work with in order to build your company. In a world where you have to treat your cash as extremely scarce and precious, your equity is something that is also precious but it is not scarce. So you have to be able to use equity as a substitute for cash to create value.

In order to do that effectively, you need to be focused on delivering equity cheaply, with respect to your employees and your founders. Their contribution for that stock is in the form of sweat and loyalty to the company. Their hard work and/or initial investment of IP is not intended to be a fund-raising vehicle; you are not trying to raise your capital from your employees. Instead you are trying to get them motivated to work really hard to see that stock price go up. This is especially important in today's market of descending stock prices. Many companies are trapped because they priced their equity too high for employees. As a result, there is no motivation in having stock. So, the cheaper the stock, the better.

Additionally, keep it simple. Otherwise, you'll lose people. If people do not understand why they should be excited about your stock, if it is not obvious to them, then you have already lost the battle. You should not be spending lots of time trying to educate people about why they should view this as a valuable benefit.

Equity has been a useful tool in start-ups because it keeps people focused on the liquidity objective. A critical milestone for the company is reached when that value is monetized in either a public offering or a sale to a public company.

From the employer's standpoint, or the company's standpoint, one of the most interesting aspects of equity is that you can make it performance based – you can make it contingent on the employees sticking around in the company. The most standard form of equity that is used in this community is the four-year vesting schedule, in which options are renewed every few years to make sure that people continue to have some unvested stock. You can tie it to a specific performance event, such as getting financing raised, getting a product shipped, or hitting a revenue benchmark. Linking equity with performance gets people very focused on achieving results.

One of the problems with performance based stock incentives is that they are really only effective if you have an appreciating stock value. One of the dilemmas companies are

facing right now is: what do you do when you have relied on equity as a handcuff to keep people around, and now the perception is that equity is worth nothing to them because of the declining stock prices and the underwater options? There is a whole myriad of potential solutions we can try. However, it is not easy from an accounting, tax, or legal perspective to cancel out those options and put new, cheaper options in employees' hands. This is an issue for a lot of companies right now.

One observation I have about the new start-up and technology companies is that they focus on retaining people with rewards instead of penalties. This has been one of the contributions they have made toward creating a satisfied employee base. They are delivering on innovation and fostering entrepreneurial culture by focusing on the upside rewards rather than penalizing people for things. However, there are some penalties; it is not without restriction.

There are ways we keep employees aligned with the company and provide some incentive for them to stick with it long-term. First, it is important that founders who have contributed their IP do not get it back – if they walk away, they leave their technology and science. Many who have developed IP are passionate about it, so it is a huge downside risk for them to leave it in the hands of others. Second, impose non-competition and non-solicitation agreements on people. If they leave, it may block them off for a year from doing anything in the field that the company was doing. That provides some incentive to stay with the vehicle they need to use to exploit their technology. Finally, there is the loss of options. We try to grab back the equity on the way out the door.

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