

LOOKING FOR INVESTMENT?

Keep it clean and simple

Nothing can ruin a great day of fishing quite as quickly as twisted line. Just as you prepare to release the fly into the rings created by a feeding trout, a bizarre and inexplicable chain of events transforms your hopes of a trophy into a knotted bird's nest of fishing line 4 inches across. As you labour to undo the tangle, you wonder how all of these knots could possibly form in what seemed like a nanosecond. Many of these knots can, with patience, be untied, but it is often easier to cut away the tangled line and start with a fresh spool. In either case, you will be lucky if the trout is still there waiting for you when you are ready to cast the fly once more.

Unfortunately, a fledgling business can get out of control about as quickly as that knotted fishing line. A series of seemingly innocuous decisions can compound to create a situation so complex that potential investors will have to spend a lot of time and resources fixing the problem prior to investment. In the worst cases, it might just be simpler for the investor to cut bait and walk away. It is important to keep a young company as clean and free of baggage as possible. It may be necessary to introduce knots along the way, but keep track of how they formed so they can be untied subsequently, if necessary.

Resist Pressures to Complicate

Many technology-based opportunities that Foragen reviews began as a research project in a university or government research laboratory. Given the resource constraints of many researchers and the need to access different skill sets to solve scientific problems, it is not surprising that the technology is often the result of several years of development by multiple lead researchers across several institutions.

“Creating complex research webs and corporate structures and delaying licensing and ownership negotiations may save money and time in the short term, but can cost you dearly when seeking investment.”

This approach encompasses many of the fundamental tenets of good scientific research (including the use of open communication and the examination of individual research projects by peers) and can extend the amount of research that can be achieved on a finite budget. However, it can also introduce many complexities that impede, or in some cases actually jeopardize, the formation of a commercial entity for the future exploitation of the technology.

Protect Your I.P.

One of the most serious potential pitfalls of collaborative research is premature or unintentional disclosure of intellectual property (IP). Although publication and presentation of results at a conference are obvious examples of disclosure, simply talking about the idea with peers could destroy all possibility of obtaining patent protection in the future. The more people involved, the easier it is for information to be leaked unintentionally. Collaborators should ensure that they indicate the confidentiality of any verbal or written documentation that is shared with peers as the collaborative project is developed. Better yet, formal confidentiality agreements should be signed by all parties, including students, post-docs and technicians who will be working on the project. For obvious reasons, Investors will ask for personal guarantees that the IP has not been disclosed prior to patent filing. With the proper documentation in hand, these guarantees are easier to give.

Another common practice that can be costly is undertaking the collaborative research without first properly defining the ownership of the IP. Too frequently, collaborators elect to delay formal discussions of IP ownership until its potential value is known. Although this approach may seem friendly, it can lead to

serious disputes in the future—particularly when the collaboration involves different institutions, each with its own IP ownership policies. An actual example is a case where one researcher e-mailed a collaborator and promised him a 5% equity stake in a company that would commercialize the technology. At first glance, this might have seemed like a good idea, as it required no cash outlay to get the research performed, and promised a significant reward to the collaborator if the technology was eventually commercialized. The problem is that the promise of “5% equity in a company that commercializes the technology” was so vague that it led to a dispute. Did it mean 5% of the company at incorporation of a new company? After it has raised \$100 Million? If the technology was licensed to a large corporation, was the researcher promising to buy the collaborator 5% of the large corporation? Of course, the intent of the researcher was 5% at incorporation of a new company, but the uncertainty led to a legal dispute that forced the new company into bankruptcy.

The lesson here is that appropriate licences and research contracts should be put in place at the outset. These agreements should outline how the IP will be owned, how revenues generated from it will be shared, and who will pay for the prosecution and defence of patents. Investors will likely need to see final, signed licences and research contracts prior to making an investment, so delays in their negotiation will only lead to further delays in securing financing. Worse yet, negotiations of licences could take longer and be more complex once an investor has demonstrated interest, since the “size of the pie” is now more realistic, and various parties may be guided by self-interest. Lawyers will likely be involved at this point, and costs can escalate quickly if negotiations stall.

It is also important to decide who will take the lead in commercializing the technology. In





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one case, a company exclusively licensed a technology from a university. A year later, the company received a notice from another university that was offering the same technology for sale. Even more disturbing, several large companies had shown an interest in licensing the technology from the second university. In this case, the first university legally owned the technology, but the second university felt that it had claims on the technology because one of its scientists had collaborated on the project a few years earlier. This example demonstrates why it is vital to sort out ownership and commercialization arrangements before the collaboration begins. Investors will also ask for personal guarantees that the company has the authority to commercialize the technology. They need to be assured that no one else can claim that authority.

Too Many Cooks ...

When the time comes to form a company around the IP, care should be taken in selecting who should be officially associated with it. Investors will look for continued commitment to the venture by the chief scientists, but that does not mean that everyone who was involved in the collaborative project has to hold a senior management or research position in the company. Fledgling companies frequently approach us with a CEO, CFO, CSO, President, VP Research, VP Business Development and an extensive Board of Directors already in place. Filling these positions from day one greatly increases the expenses and cash requirements of the company, and will make it difficult to add additional staff with new skills in the future. It is often better to start with the key scientists involved in research capacities, and add necessary administrative and management personnel once finances have been secured and the company and investors have agreed on a business strategy. Reward collaborators with equity (properly documented, of course)—not with jobs that could disappear soon after the company gets started.

Similarly, corporate structures should be kept as simple as possible. A new company probably doesn't need multiple divisions with separate sales forces to pursue different market segments from day one. As with human resources, it is often better to start with a simple structure and build as you attract investment. At the corporate governance level, care should be taken in deciding whom to bring in as board members. Aunt Hilda might have been a great dentist, but that doesn't necessarily mean she would be a good board member of your plant biotechnology company, even if she has invested \$50,000 in a friends-and-family round of financing. The more shareholders involved, the greater the potential for disagreements on how to develop the company. At the extreme, internal

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disagreements among initial shareholders can be so bad that an investor will simply walk away from the deal, even if the technology has great potential.

Look Hard at Future Obligations

One final caution concerns the use of consultants, mentoring services, and other resources during the development of your business concept. For the most part, these services are valuable resources that can help entrepreneurs develop strategies, prepare business plans, and introduce you to potential investors or corporate partners. However, they are not all equal in their capabilities, or in their methods of compensation. Often, they are rewarded through some success fee after a deal is closed. While this is a good strategy to keep costs low in the early days, you must keep in mind that your commitment is now a cost being carried by the company and it has to be paid for by the investors or corporate partner. Consequently, founders should ensure that the

terms of compensation are viewed fairly by potential investors. One method of checking is to speak to other clients that the service provider has represented. In some cases, the terms are so outlandish that the investors will insist that the compensation package be changed, or the investment will not be made.

And finally, remember that any owed cash amounts will decrease the value of the company to an investor. The result is that the portion of equity held by the founders will be diluted more severely to compensate for the loss in value. There is nothing wrong with this, as long as the founders understand upfront that they will be diluted, and are satisfied with the amount of dilution that the investors propose.

In summary, it is important to keep the following points in mind during the development of technology into a commercial enterprise:

- 1) IP Development and Management: A balance must be found between the size of the research network necessary to complete the project and the complexities that increased size will introduce. Proper paperwork and planning for potential commercial opportunities is essential, regardless of the number of parties involved.
- 2) Corporate Structuring: Founders should be aware of the eventual costs of any services that they choose to access, and be extremely selective in the choice of employees and shareholders for their young companies.

Keeping things as straightforward as possible is often preferable, but if things need to get more complex, be sure to document each party's contributions and how they will be rewarded for them. If you keep these suggestions in mind, then, as with a day spent fishing, you should not be plagued with images of the big investor (or trout) that got away. **B**

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