Case Study:

Life Cycle of a Successful VC-Funded Global High-Tech Venture

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or

How a small, privately owned company grew from start-up to expansion to maturity and finally to exit

Background. This case study follows the development of a new venture from the point of business plan to the sale of the company to a strategic acquirer. It involved information technology and Internet-based delivery of business services, global entrepreneurship, venture capital and corporate and commercial transactions. This journey, lasting over six years, ultimately led to a sale of about 85% of the company at a total company valuation of multi-millions to a buyer.

Our Role. The founders and their company, based in France, came to Bierce & Kenerson, P.C. when they chose to expand their operations outside of their home country. Acting as "in-house" general counsel, we advised on, structured and assisted in transactions and its related documentation for intellectual property licensing, venture capital investment, incorporating the company in the U.S., governance, operations and risk management, employment and exit planning and strategies.

In each of these aspects, the company had to make decisions and overcome evolving threats to its success.

The Business Plan. The five original founders, joined by four "co-founders," prepared a business plan, which defined the company's products, technologies and business model. These founders comprised an experienced management team with a range of skills that covered research and development (the senior technologists), marketing and sales, service delivery, finance and capital management and organizational development.

Intellectual Property ("IP"). The company developed a new technology for rendering high-quality video images and broadcast television and movies on portable electronic devices, such as mobile telephones and other portable electronic devices.

- *Patent Applications.* They filed for, and obtained, European and U.S. patents.
- *Licensing.* The company licensed its software to global companies, both in the field of telephony and entertainment. Bierce & Kenerson, P.C. advised the company on the terms and documentation of intellectual property licensing terms into the company's software licenses and master services agreements for ongoing Internet-based information technology services (mobile streaming of Internet TV and entertainment).

Changing Mission. As the company grew, business conditions became increasingly competitive. Like all new ventures, the company initially adapted by shifting target markets, raising capital, diversifying products, then by selling one of its non-core patents and, ultimately, by selling itself.

Raising Capital . The company had to raise money in order to expand outside of its home country and adapt to changing market conditions in an increasing competitive environment. Bierce & Kenerson, P.C.

assisted in negotiating and documenting a venture capital ("VC") investment, providing corporate records and information in the "e-room" for due diligence.

Venture Capital . The VC'S term sheet specified that the foreign company could not receive the funding directly, but that the funding would be paid to a U.S. parent company.

- *Initial Financing and Tax-Free Conversion from Foreign to U.S. Corporation.* To resolve this requirement, Bierce & Kenerson, P.C. recommended and implemented a tax-free procedure for reincorporation in the United States:
    - A new Delaware corporation became the parent of the foreign operating company and, after the completion of the transaction, of a new Asian sales subsidiary.
    - The use of tax treaties, including foreign tax credits, enabled a tax-free transfer of foreign company shares to the U. S. corporation.
    - Working with foreign local counsel, we managed the process of transfers of share certificates and compliance with the conditions of capital contribution by the founders to the foreign entity.
    - We also consulted with foreign lawyers on preservation of foreign tax credits for research done in the foreign offices.

- *Additional Financing: Series "A" Add-On.* We also negotiated and documented a Series "A" financing for several million dollars, which was added about 18 months after the initial financing.

Secured Loan. The company also obtained a $2.0 million bridge loan. Bierce & Kenerson, P.C. documented the transaction with a UCC lien search, a loan and security agreement, financing statements, a perfection certificate for the security interest, a credit facility support agreement, a guarantee agreement, the issuance of warrants and shareholder consent.

Sale of a Software technology to a Strategic Buyer. About three years after the company was founded, it decided to sell a valuable software technology that it had developed. It identified the primary potential competitor for such software and sold it to this competitor. We negotiated the sale of the software, the intellectual property and related know-how. This generated several million dollars, which was used to pay for other costs of developing core software and services products.

Operations and Risk Management. As operational legal counsel, we advised the company on legal risk management, employment policies, compliance policies and risk issues in operations and contracting with third parties.

Insurance and Risk Management. We assisted management in obtaining insurance for e-risks, infringement liability, directors' and officers' liability, and employment practices liability insurance.

Intercompany Transactions. The foreign local company was the center of operations. It needed to centralize and harmonize its administrative functions at the headquarters to support the foreign local company, the U.S. parent and its subsidiaries in Europe and Asia. We established intercompany agreements covering the administrative services, licensing and loans among the various affiliates. This involved U.S. and foreign "transfer pricing" analysis, which was done by the company's accountants.

Employment. The company sought to identify, recruit and hire good talent, but encountered problems.

- *Employment Agreements.* All employees were required to sign employment agreements and other documents granting ownership of their inventions to the company. There was disparity in local state laws where some states, like California, prohibit certain restrictive employment practices such as non-competition covenants. With associated of counsel, we structured and negotiated state specific employment agreements for employees in California and other U.S.

states. Foreign legal counsel did the same for foreign employees.

- *Employee Stock Option Plan.* We established a qualifying stock option plan under U.S. income tax rules for U.S. employees. At management's instruction, we acted as agents to issue stock option awards to U.S. and foreign shareholders. Unlike foreign employees, in the U.S., no tax is imposed on the employee's receipt of the qualifying stock options in consideration of services.

Governance among the Stakeholders. Initially, the nine founders were cohesive and agreed on key issues including their ownership percentages and their roles and responsibilities for operation and growth. As business conditions changed, target markets shifted from mobile to internet and executive management realized that existing resources would need a significant reorganization and new financing structure to meet these new challenges. Over time, internal conflicts of interest arose within the executive management team and, towards the implementation of the exit strategy, between the executive management and the senior technologists.

Early Exit by a Founder. One of the co-founders decided to move on to other business activities. To prevent him from getting a "free-ride" on future value creation by the other founders, the company exercised its right, under the shareholders' agreement, to buy back that founder's shares. We helped to structure and document that buy-back.

Turnover at the highest level. We negotiated and implemented the unwinding of the employment agreement for the Co-President of U.S. operations, after he failed to deliver expected sales performance. This included buy-back of vested stock options and forfeiture of unvested stock options. The company's cost of this failed hiring can be estimated at about $350,000 or $400,000. In addition, the Chief Operating Officer, a co-founder, was terminated as COO, but remained as a board member. In the interim, the CEO assumed his responsibilities until a new SVP of Operations was hired. During this time, the company became increasingly reliant on sales to a key customer.

Tensions among the Founders who were executive management and senior technologists. The inability to build a steady revenue base beyond a key customer led to cash flow delays, increased dependence on a key customer for cash flow as the senior technologists focused more on the needs of the key customer rather than other potential software development.

Exit: Plans, Steps and Stages.

Final Exit in Two Steps: Majority Sale of the Company to a Strategic Buyer, with Retention of Key Personnel and Delayed Sale of Some of their Shares. After five years, the company was facing significant competition from well-financed, well-established companies. Any increase in market share and the full roll-out of the Internet platform product would require substantially more capital investment, and growth in fixed expenses, than the founders considered worth the effort, considering the substantial risks involved. The founders concluded that a sale would be advantageous and the VC's agreed. So it was decided to sell the company. We advised the company's management in the negotiation of the sell-side investment banking engagement letter.

Terms of Sale. The buyer wanted to buy the company in two stages. In the first stage, the exiting founders and VC's would be paid cash, and some of the core founders would remain but would sell most of their shares. (The cash sale avoided concerns about valuation of both companies and any dilutive impact of the transaction on the buyer's shareholders.) In a second stage, the "core founders" (three key software engineers or senior technologists) would sell the remainder of their shares.

Tax Planning for Foreign Owners. In conjunction with foreign tax lawyers, we advised and assisted major foreign shareholders in mitigation of local income taxes on the sale of their shares in the company. This required intra-family transfers to reduce marginal income tax rates on the entire family. It also required establishment and capitalization of foreign private investment companies for the selling shareholders to use as vehicles for future venture capital investments, including payment of deductible business operating expenses for such investment activities.

Representing the Interests of Different Classes of Sellers. At the end, the selling shareholders consisted of several different interest groups:

- the VC's, who owned preferred stock and warrants, both of which were convertible to common stock;
- the founders owning common stock who would cash out entirely;
- three founders owning common stock who would be paid for most of their shares but who, as part of the buyer's "retention program," required them to continue as "key employees" after closing and to sell their remaining shares to the buyer under terms to be negotiated six months after the initial closing with the other shareholders; and
- the employees who had been awarded common stock options, whether vested or unvested.

Shareholder Representatives. To simplify the roles and avoid delays and potential vetoes by individual sellers, we recommended and obtained unanimous consent to have all selling shareholders (other than the three remaining founders and the VC's) give powers of attorney to the CEO in his individual capacity as seller. His role as a "sellers' representative" accelerated decision-making and closing procedures. The venture capital firm chose to have our firm represent it, but would not give a power of attorney to anyone. The "key employees" appointed their own legal counsel.

Potential Conflicts of Interest among Sellers. We had a conflict of interest to the extent that we were representing both the company and the majority of the selling shareholders (excluding only the three remaining shareholders). We identified this issue with the CEO and were careful not to recommend any action by the company adverse to the interests of the three remaining founders without consulting with their special counsel.

Conversion of Options and Warrants upon Sale. The qualifying stock option plan only had value to the U.S. employee. We advised on the special U.S. income tax rules governing the cashless exercise of qualifying stock options.

Escrow for Contingencies. The buyer required an escrow of 10% of the purchase price as security for potential breaches by the sellers

Escrow for Patent Infringement Claims. Shortly before the sale, a third party asserted a claim of patent infringement. The sale could not be completed until the buyers and sellers adopted two separate limitations of liability: a cap on general liability (for breach of warranties, representations, agreements and covenants) and a cap on specific infringement liability (for losses that might be payable to the patent-holding plaintiff who ultimately sued both the company and the buyer). Before negotiating this specific liability cap for infringement, Bierce & Kenerson, P.C. reviewed the facts and discovered that the buyer had some potential liability for its own actions, independent of its license from the company, for patent infringement. The cap for infringement liability was a very small percentage of the purchase price. As part of the escrow documentation, we drafted a clause requiring the buyer to report to the sellers (by their representatives under powers of attorney) on a quarterly basis to disclose the status of the patent infringement litigation. Based on a report by the buyer, it appears that the cap for infringement liability was very prudent for the sellers, and the buyer may incur damages far in excess of such cap.

Law Firms' Roles.

- *Multinational Collaborations among Small (and Large) Law Firms.* Throughout the growth and exit periods, the company relied on the legal advice of Bierce & Kenerson, P.C. in coordination with small law firms in foreign countries. For this transaction, the buyer hired three separate law firms (a very large multinational firm in the U.S., a smaller firm in Asia and a large multinational firm in Europe) to perform due diligence across borders. In the Purchase and Sale Agreement, the separate jurisdictional limitations of all law firms were carefully identified. We worked with both large and small law firms to resolve cross-border legal issues.

- *Potential Conflicts of Interest for the Sellers' Law Firm and Accounting Firm.* As the law firm representing the company on various ongoing operations, Bierce & Kenerson, P.C. eventually had a potential conflict of interest in representing the sellers. This conflict disappeared once the Board of Directors adopted the plan to seek the highest value for the shareholders by positioning the company for a sale. The lawyers and accountants billed the company for their services in connection with the sale, and the company paid the fees. By agreement, the buyer discounted the purchase price by the amount of our fees that had been paid after the purchase price was agreed. In short, our fees therefore came out of the pockets of the sellers, not the company or the buyer, but were financed by the company with the consent of the board.

Post-Closing Transactions.

- Administration for Sellers after Closing. We recommended to the CEO that the sellers withhold an amount to be used for administration of the escrow and other dealings with the buyer after the closing. We prepared an agreement appointing a shareholder representative and a process for accounting to the selling shareholders. In the end, this was abandoned, but the former CEO decided to establish his own personal credit balance with our law firm to handle such items, and this has worked efficiently since he continued to be a client. This has worked well, and no conflicts have arisen.

- *Post-Closing Claims; Indemnification.* The wisdom of planning for post-closing administration became evident when another third-party patent holder asserted an infringement claim against the buyer by reason of the company's operations. This particular claimant was a "patent troll," or "non-practicing entity" ("NPE"), that had purchased someone's patents and intended to generate revenues by threatening lawsuits. The patent troll's demands were vague and did not specify how any infringement might be occurring. The sellers had to address strategic issues, including how to respond to the buyer's demand for indemnification, exploring litigation scenarios, defenses and counterclaims, and the impact of their assuming any litigation defense upon their limitation of liability. We advised the former CEO and other sellers on managing the patent troll's claims, the buyer's demand for indemnification and the impact on the escrow for post-closing claims.

Outcome. This case study offers an example of the life-cycle of a successful VC-funded new venture. Through superior technology and insightful management, this new venture succeeded despite adversity, changing market conditions, evolving product design, re-targeting of the business plan, financial shortfalls, performance shortfalls, internal tensions, turnover among senior executives and difficulties with technology, customers and competitors, culminating in a successful sale of the company.