

**Strategic Investments for Corporate
Investors
VC Task Force Presentation, Palo Alto**

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Overview

Equity Investment Considerations

- Introduction to Strategic Investing
- Two primary equity considerations:
 - Governance
 - Exit/Liquidity
- Other issues (antitrust, bankruptcy preference, antitakeover measures, employee benefits, due diligence and social issues (including existence of labor unrest, ethics concerns, EHS considerations etc.))
- IP Rights
- Accounting Impact (cost/equity)
- U.S. Tax Issues

Introduction

- **Introduction to Strategic Investing**

- Financial investments are typically made by venture capital funds, investment banks or other institutional investors seeking to earn a favorable return on their investment. Strategic investments are typically made by companies in complementary business seeking to enhance a broader relationship.
- corporate investor is generally a strategic investor, although the scope and
- terms of the investment are influenced by financial opportunities.
- Strategic investments are usually coupled with other agreements (licensing agreements, product purchase commitments, etc.). It may be the first step in an acquisition plan; may be a way to gain access to technology/products; influence technology development.

Corporate Objectives

Objectives

Principal Considerations

Company

Need for financing
Governance
(loss of control)
Positioning for future
Access to markets
Access to technology

Financial
Investor

Return on investment
Governance
(preserve value)
Exit/Liquidity

Strategic
Investor

Strategic relationship
Governance
(relationship)
Exit/Liquidity
Access to markets
Access to technology

Issues Checklist

Principal Considerations

Governance Issues

Exit/Liquidity Issues

Issues Checklist

Governance Issues -- Board of Directors

Board seats – are they worth it?

- Provide visibility to the Company's activities
- Provide opportunity to vote on certain matters

Companies may welcome a corporate designated member on the board, however consider the following:

Accounting Impact

Who is the most appropriate corporate investor representative to serve? VC's would like someone senior who can add "leadership" and "marketability" to the investment.

Does any senior corporate investor representative have the time to carry out their duties on the board?

Duties include being informed of matters coming up for a vote, reading board materials, asking questions of management, accountants and other advisors.

In some instances the director can be personally liable (under certain securities laws)

Directors, including corporate investor's nominees, do get named in securities lawsuits and may be deposed in litigation proceedings.

Issues Checklist

Governance Issues -- Board of Directors (cont'd)

Voting Rights

- charter (business direction)
- board size
- debt
- mergers/acquisitions/substantial asset sale
- material joint ventures or partnerships
- equity based compensation
- bankruptcy
- affiliate transactions
- liens
- dividend
- commitments/capital expenditure
- approval of business plan
- licensing

In terms of voting rights, a director may be compelled not to vote for a matter involving corporate investor in any event.

Shareholder voting rights can be adjusted to cover the matters corporate investor most cares about and shareholders are, generally, not bound by the same duties (exceptions usually arise in the context of the sale of the company itself).

In most circumstances "visibility" to the affairs of a company can be accomplished through board observer rights.

Issues Checklist

Governance Issues -- Management Issues

Key Management Retention/Succession

Employment agreements (non-compete)/Insurance

Employee benefits agreements

Stock option schemes etc.

Consider effect for corporate investor if corporate investor acquires remaining or controlling interest

Management agreements

Issues Checklist

Exit/Liquidity Rights

Sale Rights -- when/how does corporate investor want to sell

Co-Sale Rights (Tag-along/Bring-Along) -- does corporate investor want to participate in sales by other shareholders or force the sale of the company to a third party?

Registration Rights -- under what circumstances should a company be obligated to go public or register corporate investor shares for sale? Who pays?

Redemption in certain circumstances -- are there any circumstances in which corporate investor should be bought out?

Liquidation events -- what is corporate investor's desired position upon a bankruptcy or liquidation event?

Issues Checklist

Other considerations

Antitrust

HSR/European commission filings may be necessary as in any acquisition if certain size tests are met.

Do not assume that because it is not a full acquisition the transaction will not come under antitrust scrutiny.

Also note that other simultaneous transactions (such as exclusive licensing) may itself be a reviewable event for certain antitrust authorities.

Essential to have good business reason for transaction (e.g. complementary nature of the companies as opposed to elimination of a competitor).

Minority ownership does not justify anticompetitive agreements.

Issues Checklist

Antitrust (cont'd)

U.S. Hart-Scott-Rodino Notification (“HSR”)

JV formations may need to be notified to the government.

- *Notification must be done before closing.*
- *Requires a signed document summarizing the deal (may be a LOI/MOU).*
- *\$45,000 filing fee; takes generally two weeks to prepare a filing.*
- *Filings are confidential.*
- *30-day waiting period before deal can be closed.*
- *Waiting period does not start until both sides file.*
- *May request early termination (no guarantees); early termination is public.*
- *Waiting period can be extended by “second request” subpoena.*
- *Even if notification not required; government can still challenge deal.*

HSR Process

- *During 30-day period, government examines transaction.*
- *If government has questions or concerns, will contact the parties.*
- *Will ask for customer contacts to seek out any competitive concerns.*
- *At this stage deal may become public information.*
- *If government very concerned, it will issue “second request” requiring production of documents and answers to detailed questions.*
- *Cannot close deal until information is provided for the second request which can take several months.*
- *For filing, need to turn over 4C documents.*

Issues Checklist

Antitrust (cont'd)

4C Documents

- All studies, surveys, analyses and reports which were prepared by or for any officer(s) or director(s). . . for the purpose of evaluating or analyzing the acquisition with respect to:
 - *Market shares*
 - *Competition*
 - *Competitors*
 - *Markets*
 - *Potential for sales growth*
 - *Expansion into product or geographic markets . . .*
- Do not need to create these documents, but must file them if created.
- Most cases where government has taken an interest is because of bad 4C documents.

Troublesome 4C Documents

- Documents characterizing the transaction as anticompetitive such as, it will eliminate a competitor; we will be able to raise prices; we will dominate market;
- Documents attributing high market share or market position to the parties; and
- Documents stating that the transaction will raise barriers to entry or allow us to control a key resource that our competitors need to have to compete.
- Also, do not use "market." It has specific implications in the antitrust area. Use the term "product line."

Issues Checklist

Other considerations (cont'd)

Bankruptcy

At 20% or greater interest there are concerns that if the company becomes insolvent and is involved in bankruptcy proceeding payments made to us within one year of the bankruptcy filing may be voided. This means payments between us and the company (i.e. payments for the corporate investor's products sold to the Company, license fees, royalties, debt payments, dividends) may be reclaimed by the trustee of the bankruptcy estate and corporate investor may have to return such funds to be paid to all creditors of the company (of which the corporate investor may be one of many).

Issues Checklist

Other considerations (cont'd)

Business Control Statutes

Business control statutes (the share acquisitions statutes and the business combination statutes) restrict the activities of an owner of 20% or more of the stock of another company. Some statutes apply at lower ownership levels. The purpose behind these statutes is to thwart hostile takeovers not approved by the disinterested shareholders or disinterested directors. However, these statutes have the collateral affect of also limiting the exit strategies of significant shareholders.

Example: if corporate investor held an investment in a company and it is approached by another bidder for a possible merger or consolidation and the board of the company does not agree to the terms of the transaction, corporate investor may be limited in its ability to sell its shares to the third party directly (the shares would become non-voting in certain circumstances and worthless to the third party).

Issues Checklist

Other considerations (cont'd)

Due diligence

Even though corporate investor's interest may be small, its association with another company through ownership is significant. Issues such as ethics, labor policies, EHS policies and other matters must be scrutinized carefully, in order to assess the perception of a corporate investor's involvement.

If a corporate investor is obtaining an option to acquire additional shares (such as a controlling interest or remaining interest) the initial due diligence should be comprehensive enough to facilitate a later transaction.

Matters discovered in due diligence should form the basis for actions taken by the company to prepare for sale to a corporate investor or a third party (i.e. disaster recovery programs, employee service agreements or compensation programs etc.)

Issues Checklist

Other considerations (cont'd)

Employee Benefits

At 80% ownership of another entity, corporate investor will become obligated for certain employee benefits liabilities of a company under ERISA. This means that if the company has under-funded pension liabilities; withdrawal liabilities and the like, corporate investor may be obligated as a member of its “affiliate group”.

Environmental Issues

At 50% ownership or more controlling person liability for use, occupancy, ownership, storage (on-site or offsite) may be imposed. Some statutes (state and federal) are very stringent and impose strict liability on owners and controlling persons.

Issues Checklist

Other considerations (cont'd)

Securities Issues

If the Investment is made in a public company, or a company which is likely to become public, the following levels of ownership have significance: 5%; 10%; and 50%

At 5% an investor is a “significant” shareholder for purposes of the exchange act and obligated to publicly disclose ownership from time to time. Further, corporate investor would be listed in the disclosure statements of the investment company and certain of its relationships or transactions with that company will need to be disclosed.

At 10% an investor is obligated to file statement of ownership and disclose intent with respect to the management of the company under Regulation 13d.

At 50% the entity will be consolidated as a subsidiary and may be deemed a co-registrant in the issuance of its securities.

Ownership percentage may affect sale options

“Affiliates” cannot sell as freely as non-affiliates. 10% ownership triggers rules restricting sales.

Access to insider information may limit ability to sell

Issues Checklist

Other considerations (cont'd)

Social Issues

Labor policy -- consider effect of investing in company with poor labor policies, labor unrest, collective bargaining

Code of conduct -- consider whether the company has a code of conduct similar to the corporate investor's (high ethical principles etc..). There may be an adverse effect on the corporate investor generally if the corporate investor is perceived to be an owner of a company with compromised principles.

EHS policy -- in addition to legal environmental liability the policies carried out by a company with respect to health and safety issues may have an impact on the corporate investor's perceived policies and corporate character as a part-owner of the company

Issues Checklist

Summary of issues associated with ownership levels

- 5% -- Securities (public company investment): Public disclosure of ownership
- 10% -- Accounting: Equity method may be presumed if there are indicia of influence
Securities (public company investment): Public disclosure of ownership with notice of intention to acquire additional securities. Triggers rules restricting sales. Control person liability may be presumed (could be presumed with less ownership if other factors present such as board seat)
- 20% -- Bankruptcy: Insider preference risk
Business control statutes: takeover strategies may be limited
- 50% -- Accounting: consolidation presumed if control exists
Securities (public company investment): co-registrant liability
Corporate investor policies with respect to subsidiaries: labor, code of conduct, EHS, security, corporate identity etc.
Environmental: controlling person liability under certain environmental laws (may be presumed at less than 50% if other indicia of control are present).