ISSUES TO CONSIDER IN A NEW VENTURE SPIN-OUT

Steven M. Cohen
Evan McGillin
Morgan, Lewis & Bockius LLP

January 31, 2022

I. Reasons for Spinning Out

A. Free the venture from parent's resource allocation and planning decisions and other constraints, which may not be consistent with health and growth of venture

B. Different risk profile from parent – hard to justify investment in target market compared with familiar, existing business

C. Liberate parent from funding responsibilities

D. Encourage entrepreneurial spirit; increase focus on target market by Newco

E. Recruit talent that might not be attracted to internal division or venture

F. Align interest and create incentive through employee ownership enhancing likelihood of employee retention and Newco business success

II. Technology Transfer Structure

A. Assignment vs. license

B. To the extent separatable, future investors, strategic alliance partners, IPO underwriters and Newco company buyers will prefer to maximize percentage of ownership at the Newco level

C. License

1. Exclusive vs. nonexclusive
2. Field of use
3. Assignment rights (including in connection with a change of control)
4. Sublicensable vs. non-sublicensable
5. Retention of rights by parent; License back to parent for certain uses
6. Infringement by third parties; Infringement on the rights of third parties
7. Improvements
8. Any residual government interest or academic institution interest if any prior grant funding

D. Ownership issues if continued joint development

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III. Economic Terms

A. Allocation of Founder shares among the Founders - individuals treated as Founders who invest nominal amount for founder shares can create capital gains tax treatment (more favorable than treatment of stock options)

B. Contributions by parent

  1. Intellectual Property

  2. Valuation of the Intellectual Property

     a. Function of R&D expense attributable to the technology

     b. Function of valuation of technology if sold currently to a third party

     c. Negotiation with outside investors

     d. Equity vs. Royalties. Create a "win-win" structure. Consider use of convertible preferred stock with liquidation preference equal to agreed upon current value to preserve cash in the venture

     e. Use of milestones to adjust consideration to parent (conversion ratio adjustment or issuance of Warrant) subsequently if value is ambiguous

  3. Other assets

     a. furniture, fixtures or equipment

     b. intangible/contracts

     c. infrastructure services (HR, accounting, etc.)

     d. temporary facility sharing

  4. Upfront cash (often to reimburse for past patent/development expenses). Consider use of convertible preferred stock with liquidation preference equal to agreed upon current value to preserve cash in the venture

  5. Ongoing financial support – seed financing; participate in initial outside funding round; commitment to participation in later outside financing round(s)

  6. Allocation of tax basis in assets

C. Contribution by new investors (generally cash for preferred stock). Could be in conjunction with strategic alliance deal for a strategic investor

D. Equity participation pool for non-Founder employees and future management

E. In the university context – consider impact of equity grant to the university and any anti-dilution protection requested by the university

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F. Continuing commercial relationship between parent and new venture

1. Vendor/Customer
2. Support services
3. Joint R&D

G. Competition between parent and new venture

1. For customers
2. For employees
3. Consider messaging to the marketplace during spin-out

IV. Governance

A. Composition of Board of Directors

1. Parent represented (consider perceived conflicts of interest)
   a. Director
   b. Observer
2. Management represented
3. Outside investors represented
4. Procedure for selecting independent directors

B. Protective Provisions (voting, special consent rights of parent, etc.)

1. Parent
2. Outside investors

V. Separation Logistics

A. Real Estate

B. Personnel

C. IT/ERP systems

D. Any required regulatory or operating permits

E. Any consents required to assign material contracts

F. Comingled contracts

G. Transfer of assigned registered intellectual property

H. Release of transferred assets from any parent liens

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VI. Conflicts of Interest

A. Parties:

1. The parent
2. The new venture
3. Outside investors
4. Management/founders
5. In the university context – add the academic institution and the faculty member/principal investigator – consider limitations in university government contracts or grants

B. Parent on both sides of transaction

1. Watching out for interests of new venture
2. Watching out for interests of management
3. Are interests naturally aligned?

C. Impact on employees of new venture

1. Can they effectively negotiate?
2. Potential negative impact on future success of venture?
3. Consider designating roles (i.e., founder/management to look out primarily for interests of Newco, even though still employed by parent, and parent executive to look out primarily for interests of parent)

VII. Human Issues

A. Who goes with Newco? Who stays with parent?

B. Can parent tolerate loss of talent?

Alternative arrangements (allowing parent to keep people)

1. Compensation/incentive issues
2. Accentuated conflicts of interest

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