INSIGHTS

"The single most important piece of information that investors need to understand is who owns the company. If there are any questions, that should raise a huge red flag."

Top 3 Due Diligence Concerns for Investors in Venture Capital Transactions

Q: WHAT SHOULD AN INVESTOR IN VENTURE CAPITAL DEALS THINK ABOUT BEFORE MOVING FORWARD?

JOSHUA E. FRENCH: It's a common scenario: a venture capital investor has identified an exciting new technology or innovation with the potential to become an industry game-changer and is ready to invest in the company at an early stage. Even after the investor has gone through the code and worked through the company's financial statements, there could still be certain legal aspects of the situation that should stop the investor's enthusiasm in its tracks. Investors need to scrutinize: 1) who owns the intellectual property, 2) who owns the company's stock, and 3) if there are any employment concerns. If there are issues in any of these three areas, the effect of these deficiencies may not be felt for years down the road—right when the investor is expecting a significant return when the company is sold.

Q: WHY IS IT SO IMPORTANT FOR AN INVESTOR TO DETERMINE WHO OWNS THE INTELLECTUAL PROPERTY?

JEF: Especially for an early stage technology company, ownership of the intellectual property is, if not the only, far and away the most critical asset. If a company doesn't actually own the intellectual property, then the investor's dollars could be facing a major risk. Investors should ensure that each of the founders of the company and all of the company's employees and contractors have signed agreements which clearly assign all of the intellectual property developed in connection with the company's business to the company. This should include any intellectual property that is developed using the company's equipment, on the company's time, or even if it relates to the business itself. If there are registered patents, trademarks, or copyrights, the investor should ensure that there is a proper chain of title. It may also be valuable to engage intellectual property counsel to conduct a high-level search.

Q: HOW CAN AN INVESTOR SAFEGUARD THEIR FINANCIAL INTERESTS WHEN MAKING A DEAL?

JEF: The single most important piece of information that investors need to understand is who owns the company. If there are any questions, that should raise a huge red flag, particularly if there is any evidence of promises being made to individuals that they will receive a percentage of the company or a lack of documentation on stock ownership. An investor should be wary because if the company does well, someone could show up with a stock certificate not reflected in the company's capitalization table. This wrinkle would create significant issues at the time of the company's sale and would also have an effect on pricing of the financing round. The investor needs to know what is outstanding. If it's understated, the investor will pay a higher price than what they bargained for.

Additionally, the investor should review and ensure that the founders are properly incentivized to continue performing well after the round closes through vesting of their existing stock. Investors should review what the current vesting restrictions are on the founder's stock and negotiate as part of the transaction that the founder's shares will be subject to a vesting schedule that runs for at least two or three years following the closing of the financing round. Investors are investing just as much in the founding team as they are in the business itself and, as such, they need to ensure that the founders will continue to stay with the company to help it grow for a significant period of time following the closing of the financing.

Q: WHAT POTENTIAL EMPLOYMENT ISSUES SHOULD MAKE AN INVESTOR PAUSE?

JEF: Companies that make promises to employees and then don't follow through on them could create massive future liability. Careful attention should be paid to how companies are classifying individuals, whether as employees or independent contractors. If someone is misclassified as an individual contractor when they ought to be an employee, companies could open themselves up to damage at the federal and state levels.

Joshua E. French

OF COUNSEL
Corporate and Transactions
617.439.2099
jfrench@nutter.com

Joshua E. French is of counsel in Nutter's Corporate and Transactions Department. He focuses his practice on advising clients in mergers and acquisitions, debt and equity finance, corporate governance, and incorporation. Clients in all stages of their business life cycle engage Josh to serve as their outside general counsel. He has extensive experience advising privately-held emerging and middle-market companies on navigating corporate formation, fundraising, and liquidity events.

PRESS CONTACT:
Heather Merton
Senior Communications Manager
617.439.2166
hmerton@nutter.com