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PERSPECTIVE

Strategic investors pose unique issues for startups

By John Rafferty

While venture capital firms are still the most active investors in the startup community, more large corporations are investing in early stage startups through separate investment divisions. These corporations have their own existing commercial businesses, but they also seek to make strategic investments in startups in order to capitalize on new technologies in the future.

However, strategic investors pose unique issues for startups that are not present with investments by traditional venture capital firms. When representing a startup considering an investment from a strategic investor, counsel must carefully advise the startup on the potential pitfalls relating to such an investment. There are distinct issues that counsel should be prepared to navigate when a startup client is considering an investment from a strategic investor.

Why does a Strategic Investor Pose Unique Issues?

When a strategic investor invests in a startup, it often results in an immediate and fundamental conflict of interest. This is because at the time of the strategic investor's initial investment in the startup, the startup's business plans already likely overlap with the strategic investor's existing business or business plans to some degree. This dynamic is not present when a venture capital firm invests in a startup.

Specific Issues for Counsel Advising Startups

Board representation and confidentiality. As part of its investment in the startup, a strategic investor will typically negotiate to have the right to designate a director on the startup's board of directors. Special care should be taken to confirm that the director will not inadvertently share confidential or proprietary information about the startup with others within the strategic investor's management team. There may also be occasions when it is appropriate to exclude the strategic investor's director from a portion of the board meeting in light of business conflicts between the startup's business and the strategic investor's commercial business. Counsel should consider, therefore, whether a separate confidentiality agreement should be entered into between the startup company and both the strategic investor and its director representative in order to address these topics.

Investment rights. Strategic investors often negotiate for special investment rights as part of any future equity financing round by the startup. The most commonly requested special right is that the strategic investor be provided with a preemptive right to invest in future financings on the same terms presented by any third party. This preemptive right is different from the more common participation right negotiated by venture capital firms, which simply permits the venture capital firm to participate in future equity financing rounds on a pro rata basis in order to maintain the venture capital firm's existing ownership stake in the company. A preemptive right, on the other hand, allows the strategic investor to subscribe for the entire proposed investment amount, supplanting any third-party investment proposal. Such a right can actually discourage third-party investors from even making a financing proposal to the company in the first instance, because a potential investor will be reluctant to spend resources to evaluate the startup as a potential investment if the strategic investor can simply elect to displace the potential investor by investing on the same terms proposed by the third-party investor. Accordingly, any special investment rights granted to the strategic investor need to be carefully considered and negotiated by the startup.

Rights in future sale of startup. A similar issue can arise with respect to a strategic investor's rights upon a sale of the startup. In particular, strategic investors often negotiate for a right of first refusal in the event of a potential sale of the startup. A right of first refusal provides the strategic investor with the right to acquire the startup on any terms proposed by a third party before the startup may be sold to the third party. But a potential acquiror may be reluctant to evaluate the startup as a potential acquisition target and perform the requisite due diligence if the strategic investor has a right of first refusal and therefore can simply supersede any acquisition offer provided by the third party. Negotiating what special rights, if any, a strategic investor will have in the acquisition context may be the most critical issue facing a startup considering an investment from a strategic investor.

Effect on commercial dealings with third parties. Another issue to consider is the impact, if any, that the affiliation between the strategic investor and the startup will have on potential customers of the startup in the future. It is not uncommon for the startup's potential customers to be competitors of the strategic investor. Accordingly, a startup company will want to carefully consider how its potential future customer base may view the strategic investor's investment in the startup.

Intellectual property considerations. Strategic investors often pair their investments in early stage startups with commercial arrangements between the parties. Great care needs to be used in crafting these commercial arrangements to ensure that intellectual property rights are carefully allocated between the parties in a manner that provides the startup with sufficient rights over intellectual property that the startup will need to succeed on its own.

But even absent such a commercial arrangement, if the strategic investor has the right to designate a director on the startup's board of directors as discussed above, this can create its own intellectual property ownership issues for the startup if the strategic investor's director subsequently provides valuable business ideas to the startup. A startup therefore may want to consider addressing in advance ownership rights over ideas and contributions provided by the strategic investor's director representative.

Conclusion

Entering into a financing transaction with a strategic investor poses a unique set of issues for a startup due to the business conflicts inherent in such an investment. However, with careful planning and knowledge of the particular issues involved, counsel can help a startup client successfully navigate through the potential pitfalls of a strategic investor's investment.


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