Corporate Venture Capital: A Value-Add Proposition for In-House Counsel

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Established companies are increasingly turning to corporate venture capital – equity investments in startups by company-affiliated venture capital units – to bolster innovation and achieve financial returns.

According to a recent study by tech market intelligence platform CB Insights, global corporate venture capital participated in almost $53 billion of funding across 2,740 transactions in 2018, which represented 23% of all venture capital-backed transactions in that year.[1] While the report found that the most active corporate venture capital investors in 2018 were the usual suspects – GV (Google Ventures), Salesforce Ventures, and Intel Capital, to name a few – the data also indicates a 35% increase in new corporate venture capital entities making their first investment in 2018.[2] Further, the recent growth in corporate venture capital investment is not isolated to the tech industry. Companies in many industries, including consumer goods, energy, financial services, and health care are exploring partnerships with innovative startups.

Given their specialized transactional skills, experience, and perspective, in-house counsel can be a significant asset to their organizations in entering the corporate venture capital space.

Corporate Investment in Startups

There are several means by which established companies make investments in new and innovative startups, including:

- establishing corporate venture capital units;
- forming an incubator (an innovation environment within the parent company);
- joint development programs such as corporate accelerators (an environment separate from the parent company that provides the startup with workspace, funding contacts, and potential partnership opportunities); and
- platform-based programs through which the established company provides a startup with a technology platform in which it can build its innovations, thus expanding the market for the established company's products (e.g. Paypal or Apple's App Store).[3]

Companies use different structures depending on their individual goals. Whether or not the investment includes equity participation depends on the structure. Corporate venture capital and internal incubators almost always include an equity investment in the startup by the established company, while joint development and platform-based programs may not involve a direct equity investment.[4]

As an example, we assisted a client in creating a public-private accelerator partnership intended to develop innovative solutions to produce cleaner energy and make the energy grid smarter. Selected startups each receive $100,000 in seed capital to participate in the 12-week accelerator program. As part of the program, each startup also receives focused mentoring and technical assistance, as well as facilities and networking connections from accelerator partners.

At the conclusion of the program, participants showcase their efforts to mentoring teams, potential third-party investors, corporate executives, entrepreneurs, students, and the general public during an accelerator demo day. Ideally, successful startups are selected for ongoing mentoring and engagement beyond the accelerator program, and our client gains significant insight into next generation clean energy and smart grid technology.

Process and Structure

Companies opting to invest in startups through corporate venture capital typically establish a separate corporate venture capital unit, operating autonomously from the company's other established departments evaluating mergers and acquisitions and other investment opportunities.[5] The corporate venture capital unit, ideally staffed by seasoned venture capital dealmakers, reviews potential investment targets, negotiates transaction terms and structure, conducts business due diligence, and manages the company's investment in the startup.

How In-House Counsel Can Add Value

Once the corporate venture capital unit has identified a target startup, in-house counsel can be very valuable to the company's venture capital efforts. In-house counsel can take the lead in the negotiation and drafting of the term sheet, which may cover familiar concepts such as investment structure (e.g. convertible debt, preferred stock, etc.) and rights of the company in connection with the investment (e.g. board seats, liquidation preferences or dividends, anti-dilution, voting rights, conversion and redemption rights, registration rights, preemptive rights, rights of first refusal, protective provisions, exclusivity, etc.). In these early stages of the transaction, in-house counsel can also add value by drafting and negotiating confidentiality agreements and nonsolicitation agreements with the target.

Once the term sheet, confidentiality agreement, and nonsolicitation agreement are in place, in-house counsel can conduct the legal due diligence review of the target while the corporate venture capital unit performs the business and technical due diligence. Typical legal diligence includes reviewing the target's corporate and capital structure, organizational and governing documents, employment and employee benefits matters, previous equity issuances, contracts with material suppliers and vendors and other commercial contracts, intellectual property registrations, and liens and indebtedness for borrowed money. If issues are spotted during the legal due diligence review, in-house counsel can advise the corporate venture capital unit on any risks presented by those issues and potential steps to mitigate risk.

In tandem with the legal due diligence review, in-house counsel can also participate in the drafting and negotiation of the principal transaction documents. Depending on the corporate form of the target startup and the transaction structure sought by the parties, these documents may include a stock purchase agreement or membership interest/unit purchase agreement, convertible notes, simple agreements for future equity, shareholders' or unitholders' rights agreement, registration rights agreement, voting agreement, and ancillary transaction documents such as side letter agreements containing additional affirmative or restrictive covenants of the parties, authorizing resolutions, and other closing deliverables.

In-house counsel will also add value by advising their company's corporate venture capital unit on legal issues that arise in the management of the company's active portfolio of startup investments and exits from those investments. This may include attending board meetings of the startup, ensuring compliance with the transaction documents that govern the investment, representing the company in connection with key milestones such as debt conversions or securities registrations, and ensuring the company's interests are represented in connection with the company's exit from the investment. Additionally, it should be noted that, given the low survival rate of venture-backed startups, in-house counsel may also be called upon to ensure the company's interests are protected in connection with the wind-down of an investment.

Conclusion

The role and expectations of in-house counsel are constantly evolving, providing new opportunities to add value across various departments and functions. By taking a proactive approach and ensuring key decision makers are aware of the efficiencies that can be gained by involving in-house counsel in corporate venture capital initiatives early on, in-house counsel can position themselves to drive efficiency throughout the process and offer invaluable insight that ultimately impacts innovation, growth, and bottom line results.

Notes

[1] CB Insights, The 2018 CVC Report 7 (2019), 7, https://www.cbinsights.com/research/report/corporate-venture-capital-trends-2018/ (last visited Nov 15, 2019).
[2] Id. at 12.
[3] Tobias Weiblen & Henry W. Chesbrough, Engaging with Startups to Enhance Corporate Innovation, 57 California Management Review 66-90, 77 (2015).
[4] Id. at 81.
[5] Id. at 70.