Morgan Lewis

VENTURE CAPITAL & PRIVATE EQUITY FUNDS
DESKBOOK SERIES

Accommodating Strategic Investors

As more and more large companies in fields driven by innovation, research, and development, such as life sciences, high technology, telecommunications, clean technology, energy, and applied materials, look for ways to gain insight into and access to new technologies and other innovations within their own markets, they are finding a welcoming home with early stage venture capital funds looking to raise smart capital. The proliferation of these types of investors has resulted in greater formalization of the category of "strategic partner" or "strategic investor." As the name implies, the investment by a strategic investor is motivated to a greater degree by the strategic business concerns of the corporate investor and to a lesser degree by the desire for a high return on invested capital.

Strategic investors want to have a window into changes in their market and early access to partnership or acquisition opportunities with portfolio companies that can benefit the strategic investor's primary line of business. These are typically investments made directly off of the strategic investor's balance sheet and managed by business development professionals— and not investments made by their pension plans. With these goals in mind, strategic investors are finding that their capital can reap greater benefits being invested at the fund level rather than being invested directly into portfolio companies. This is due to the greater exposure to multiple portfolio companies obtained through a single fund commitment plus the market insights provided by a partnership with experienced fund managers compared to the limited exposure to a couple of direct investments for the same amount of capital. Another factor favoring strategic investments in early stage funds is that portfolio companies have been and continue to be reluctant to accept capital directly from a corporate strategic investor for fear of limiting their options for partnering in the future with such investor's competitors. A fund with access to multiple strategic investors, however, may make a very attractive investor for a portfolio company. Venture capital fund managers are equally attracted to strategic investors for their knowledge of the markets, specific due diligence expertise in their field, and their ability to provide strategic support and value to portfolio companies.

Should My Fund Have Strategic Investors?

Before taking the step to fully integrate strategic investors into a fund-raising plan and investment process, fund managers should carefully consider the impact that the inclusion of strategic investors may have on their own operations as well as the reaction of financial investors and potential portfolio companies.

- *Financial Investor Concerns:* Financial investors may raise concerns that one or more strategic investors may exert undue influence on the investment decisions of the fund managers in order to achieve their own strategic needs to the possible detriment of financial returns to the fund. Financial investors may object to the increased access afforded to strategic investors or the time commitment of fund managers to address the needs of strategic investors. Contrary to the views of some financial investors, strategic investors tend to support terms that increase the number of investments made by a fund, including retention and recycling of investment proceeds and longer investment periods. Financial investors may object to the financial incentives sometimes offered to strategic investors that provide significant time and attention, such as reduced carry or management fees or consulting fees.
- *Portfolio Company Concerns:* As noted above, portfolio companies are concerned that strategic investors may narrow their options and may take competitive advantage of their knowledge of their products or strategies. While having strategic investors only investing indirectly through a

fund mitigates these concerns, a portfolio company may still raise them, particularly in the context of sharing confidential information that may flow to strategic investors.

- *Fund Manager Concerns:* Fund managers must be ready to address the concerns of financial investors and portfolio companies described above. Fund managers must be willing to take on any extra reporting or time commitments that may be required by strategic investors in common side-letter terms that are more fully described below. New strategic investors may be unfamiliar with typical fund terms or industry practice and therefore may require additional time and effort in negotiating. Strategic investors may be subject to internal corporate policies, compliance, and reporting that could impose further burdens on fund managers. These may include covenants for FCPA and AML compliance or adherence to corporate ethical guidelines. In addition, strategic investors may seek to impose tight investment restrictions that seek to optimize the strategic investor's objectives. Fund managers should also be concerned with whether a strategic investor will have a long-term commitment to its fund program, regardless of the fund manager's performance, because a strategic investor's strategic business objectives may change with changes in the markets or the personnel of the strategic investor.

Planning for Strategic Investors

Once the decision is made to attract and accommodate strategic investors, fund managers should take some basic planning steps. Generally, this should be done by implementing a strategic investor program that would include specific terms (discussed below) and be fully disclosed in marketing materials and legal documentation.

- *Clearly Define a Strategic Investor*: Specific criteria should be set forth to be eligible for status as a strategic investor and the benefits such status confers. This might include a minimum or specific threshold of investment and a designation by the fund manager at its discretion.
- *Most Favored Nations Carve-Out*: Probably the most significant factor determining the ability to accommodate strategic investors is to make sure that any additional terms and benefits for strategic investors are carved out of any most favored nations clauses offered to financial investors. If this is done from the start of marketing and presented to financial investors as a benefit to the fund in order to attract such investors and their insights and expertise, then the process should be smoother.

Strategic Investor Terms

Strategic investors are generally looking for one or more of the following terms to be offered in a side letter when investing in order to document and reflect the strategic nature of their investment. Fund managers that are marketing to strategic investors should be prepared to address these requests and may consider providing from the outset a term sheet and/or form of strategic investor agreement or side letter that contains one or more of these terms:

- *Additional Meetings and Access to Fund Managers*: Strategic investors are seeking more knowledge of their markets through regular communication with the fund managers. Consequently, they typically seek a commitment from fund managers to make themselves available on a periodic basis to meet with strategic investors and discuss their business objectives, areas of technology interest, business development initiatives, as well as their views of market trends and developments and portfolio company opportunities.
- *Additional Reporting*: Strategic investors seek additional reporting for the same reasons stated above. This may mean more in-depth reporting or more frequent reporting, generally regarding deal flow, investment opportunities, and portfolio company developments.
- *Access to Deal Flow*: Strategic investors are generally interested in all the deals that a fund manager may see and not just the ones ultimately made. Many deals that were not appropriate for other reasons to the fund manager building a balanced portfolio may still be attractive to a strategic investor.
- *Strategic Advisory Board*: Often fund managers will invite strategic investors to participate on a Strategic Advisory Board as a way of formalizing their interaction. These boards are not to be

confused with Limited Partner Advisory Boards that handle conflict issues relating to the management of funds. Strategic Advisory Boards are intended to provide business advice to the fund manager that is relevant to the fund's objectives and those of its portfolio companies and, in addition to representatives of strategic investors, may also include executives from relevant industries or leading researchers in a relevant field. In some cases, depending on the level of time commitment involved and services to be rendered, members of a Strategic Advisory Board may be compensated or receive other financial incentives.

- *Portfolio Company Introductions*: Strategic investors seek access to portfolio companies as a business development objective. Consequently, they may seek assurances that fund managers will make introductions to portfolio company managers to facilitate business development introductions and opportunities, such as development agreements, R&D alliances, licensing, and acquisition agreements.
- *Co-Investment Opportunities*: Co-investment opportunities are always a hot topic, even among financial investors. Strategic investors want as much assurance as possible that they will be offered such opportunities, in some cases even ahead of other investors if warranted.
- *Exclusion of Competitors*: As the name implies, strategic investors are seeking a strategic business advantage over their competitors and tend to view the relationship with fund managers as an outgrowth of their own business development team. As such, they do not want to find their own competitors at the same table at a strategic investor meeting with a fund manager. Accordingly, strategic investors may request a commitment from fund managers to exclude, either by category or by specific list, the competitors of such strategic investor.
- *Limitation in Number of Strategic Investors*: Similar to the exclusion of competitors and the reasons therefor, strategic investors may seek to limit the number of strategic investors. Fund managers also may have reason to limit the number of strategic investors in order to foster competition among potential strategic investors, to ensure exclusivity, and to minimize the administrative burdens of partnering with multiple strategic investors.
- *Participation in Subsequent Fund*: Depending on the depth of the relationship being developed with a particular fund manager and the amount of effort anticipated in developing such a relationship, a strategic investor may want some assurance that when the next fund rolls around that the relationship will stay intact on substantially the same terms.
- *Obligations of Strategic Investors*: As relationships with strategic investors are intended to be mutually beneficial, in exchange for the above benefits that may be provided to strategic investors, fund managers may consider imposing some obligations or conditions on providing such benefits.
    - *Meeting attendance*: Repeated failure to attend Strategic Advisory Board meetings may result in loss of benefits.
    - *Investment opportunities (e.g., spin-outs)*: To the extent that a strategic investor has a corporate reorganization that includes an investment opportunity of interest for the fund managers, the strategic investor may be required to notify the fund managers of such opportunity.
    - *Market analysis and corporate strategic direction*: Fund managers may request that strategic investors similarly share their own strategic goals and objectives and direction with the fund managers for the benefit of the fund.
    - *Senior executive sponsorship*: Fund managers may require that the strategic relationship be supported by specifically named senior executives of the strategic investor in order to ensure that the fund gets the most out of the relationship. The fund manager may require that representatives attending meetings be either such senior executives or experts in the relevant field.
    - *Stand-still*: As strategic investors are interested in making investments in portfolio companies, depending on the content and timing of the reporting, it may be appropriate for a fund manager to seek covenants from strategic investors to refrain from

independently pursuing an investment opportunity that the fund manager has identified to the strategic investor.

Confidentiality Issues

Maintaining and abiding by confidentiality obligations is perhaps the thorniest issue raised by strategic investor relationships and must be navigated with care. Strategic investors want as much information as possible, and they want to use it to their business advantage beyond the scope of their investment in a fund. Fund managers, on the other hand, must be mindful of their own contractual and fiduciary obligations to portfolio companies regarding disclosure of proprietary information. Only if both parties are sensitive to this issue can an effective balance be reached.

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For more information on the issues discussed here, please contact your Morgan Lewis Private Investment Funds Practice attorney.

About Morgan Lewis's Private Investment Funds Practice
Morgan Lewis has one of the nation's largest private investment fund practices and is consistently ranked as the "#1 Most Active Law Firm" globally based on the number of funds worked on for limited partners by *Dow Jones Private Equity Analyst*.

About Morgan, Lewis & Bockius LLP
Morgan Lewis provides comprehensive transactional, litigation, labor and employment, and intellectual property legal services to clients of all sizes—from global Fortune 100 companies to just-conceived startups—across all major industries. Our regulatory and industry-focused practices help clients craft and execute strategies to successfully address legal, government, and policy challenges in today's rapidly changing economic and regulatory environment.

Founded in 1873, Morgan Lewis comprises some 4,000 professionals—attorneys, patent agents, employee benefits advisors, regulatory scientists, and other specialists—in offices across the United States, Europe, Asia, and the Middle East. The firm is unified in its long-held service philosophy that every action of our attorneys, in every representation, is driven first and foremost by the immediate and long-term concerns of each client. For more information about Morgan Lewis or its practices, please visit us online at www.morganlewis.com.