Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

What To Do When Seed Money Gets Personal

Law360, New York (December 3, 2010) -- Contrary to popular opinion that funding for medical device startups is dormant along with much of the current economy, many entrepreneurs are finding that sources such as friend and family and angel investor groups are rife with opportunity during this time. It is essential that the opportunity be supported by written agreements that accurately reflect the interests of the parties in this unique business partnership.

The individuals who comprise the friend and family and angel investor groups are determining where to allocate personal investments, and many do not see good options in traditional investments such as equity and debt markets. The stock market is highly unpredictable, and the debt markets are offering remarkably low rates of return. According to Michael Marasco, director of the Farley Center for Entrepreneurship and Innovation at Northwestern University, many individuals are frustrated with managed money accounts since the vast majority have lost money over the last few years. As an alternative, some people are choosing to put their personal wealth into products, projects or businesses that are "closer to home" than traditional investments and offer the potential for high return. In an age where investors are separated from their investments by highly complex financial instruments and numerous intermediaries, the notion of investing in something that provides the investor with an opportunity to get to know the product, and even company management, can be quite attractive. Moreover, an investor has the opportunity to profoundly impact an area of personal importance to him/her, like early diagnostic tests for a cancer that has affected his/her family or new diabetes treatments that may improve the quality of life for his/her child.

While these investments can be exciting opportunities for investors and entrepreneurs, it is important for all participants to understand the dynamics of such a partnership and set clear expectations.

First and foremost, it is important to understand who the investors are and what motivates them to invest. Marasco explains that friend and family investors are generally people who have personal relationships with the entrepreneur and want to help the entrepreneur achieve his/her personal goals, in addition to the standard desire to achieve a favorable return on investment. Angel investors are typically high-net-worth individuals (or groups of individuals referred to as angel investor groups or angel investor networks) with particular experience or expertise in the area in which they like to invest.

For example, Marasco mentioned Marc Andreessen, the founder of Netscape, as a prominent angel investor in the IT space who invests based on the principal belief that he can help parlay his experience and achievements with Netscape into success for his portfolio companies. Another common example of experience-based angel investors includes medical doctors who tend to invest in medical technology because they have an intimate understanding of the nuances of reimbursement, regulation and patient treatment. Moreover, angel investors also may be motivated by a humanistic element such as developing a technology to improve the quality of life for patients, investing in an entrepreneur who appears to have a lot to contribute to society, and so forth.

The trend has shown that typically, neither friend and family investors nor angel investors are motivated purely by financial gain and usually (but not always) have a good understanding as to the risk associated with investing in startup enterprises. However, personal relationships are typically being leveraged to create a business partnership, and this is a situation fraught with peril if proper precautions are not taken.

In one common situation, for example, the founder of a medical device company attracted a $250,000 investment from his uncle as part of the company's "seed round." The uncle was well aware of the high-risk nature of the investment and assigned a low probability of receiving any return on the investment. Against the odds, the company developed a successful product and was approached by a large competitor regarding an acquisition. Much to the uncle's dissatisfaction, however, his $250,000 share in the company had been diluted significantly through stock option grants to the company's founders, advisers and employees. Additionally, the company had incurred substantial debts that required repayment before any of the shareholders could receive any distribution from the acquisition price. Although the uncle did not realistically expect a return, he felt that his nephew had taken advantage of his generosity by diluting his share in the upside. The nephew, on the other hand, maintained that he had been explicitly clear with his uncle at the time of investment about using stock options as a form of compensation. This unanticipated dilution turned what would have been a success story into one of broken relationships and mistrust between an uncle and his nephew. Sadly, this could have been prevented with proper planning and attention to details.

For example, in this situation, the uncle and nephew should have at least reviewed and negotiated:

- The company's stock option plan to define the possible recipients and total number of grants eligible under the plan.
- The shareholder's agreement to define the terms and amounts of loans that are permissible.
- Anti-dilution provisions for the earliest investors (i.e., the uncle and other seed-round investors).

In addition, both parties to any investment deal should always pay particularly close attention to the offering documents, subscription agreement, shareholder's agreement, company bylaws, charter documents, and federal and state registration compliance.

In another scenario, a recently retired physician made a $125,000 angel investment in a medical device diagnostic company that was focused on early diagnosis of colon cancer — an area of particular expertise to the physician. The physician believed that his involvement in the company would go beyond the investment and hoped the company would utilize his expertise in the development of its diagnostics. The company had initially stated its intent to keep the physician involved through periodic updates and was happy to field his suggestions, but they never held true to that promise. Instead, the company relied on its advisory board for technical expertise and its communication to its shareholders was more infrequent than anticipated. When the company sought to raise more money in a subsequent round of financing, the physician was not interested in partaking given his disappointment over the lack of opportunity for him to contribute his expertise.

As shown above, it is essential that the company and investor discuss and document the essential terms and underlying interests of the relationship. In this situation, the parties could have:

- Agreed to add the physician to the advisory board in exchange for the investment.
- Included a provision about communication to shareholders in the shareholders' agreement or subscription agreement.

By proactively developing unambiguous documentation that addresses a wide range of potential scenarios and memorializes the parties' explicit intentions, the investor and company/entrepreneur will dramatically increase the odds of a successful business and personal relationship together, regardless of the ultimate outcome with the investment. In a time when investing in startups can be particularly exciting, it is essential for all parties involved to protect themselves and their relationships at the outset of any arrangement when it is relatively easier to address the important issues that can and will arise throughout the investment phase in any business.

--By Jacob D. Babcock, Foley & Lardner LLP

Jacob Babcock (jbabcock@foley.com) is an associate in Foley's Chicago office.