

DEAR MR. PRESIDENT
EDWARD G. REITLER

*Re-opening
the SBA's
Public-
Private
Partnership
Investment
Program
would be a
valuable
addition to
the stimulus
program*

I am sure that my old law school classmate and current President of the United States doesn't remember me and wouldn't have time to respond to a question I have been meaning to ask him. So I will ask you. With a new Camelot in Washington, why aren't any of the new best and brightest talking about re-opening the Small Business Administration's (SBA) participating security program?

The economic headlines continue to be gloomy. Most economists are predicting that gross domestic product will contract again for the second quarter of 2009. As of June, national unemployment hit 9.5%, its highest level in 26 years. While equity markets are off their March lows, there is much discussion of a long-term cyclical bear market.

In order to combat these intransigent problems, Congress and President Obama have enacted a stimulus package consisting of \$787 billion of funds targeting a broad array of economic sectors and industries, including green energy initiatives and medical record-keeping technology. Another \$700 billion was set aside for the TARP program, most of which has been invested in commercial banks that continue to be restrictive in lending to businesses in an effort to prop up their battered capital ratios.

In the context of hundreds of billions of dollars being thrown at large institutions and programs, why not allocate a relatively small amount, on the order of \$5-10 billion, to professional investors in small businesses, i.e., venture funds? This would be a fraction of the \$30 billion allocated to private managers to invest federal money under the auspices of the Public-Private Partnership Investment Program and would arguably have a greater impact on spurring economic development and creating jobs. Approximately 50% of employees nationwide are employed in businesses of fewer than 500 workers. It is no surprise, therefore, that the nation's employment is inextricably tied to the fortunes of

small business. Small businesses drive our economy, and for the past 40 years, venture capital has been their primary source of equity financing.

Unfortunately for the venture industry, its funds have been caught up in the same liquidity crunch that has so impacted larger institutions. Venture funds closed on \$28 billion in new commitments in 2008, a 21.4% drop from 2007. The number of funds raising money in the second quarter of 2009 fell to 25, the lowest in 13 years, and the amount committed to these funds fell to \$1.7 billion, the lowest since 2003. Venture funds raised \$5.1 billion in the first six months of 2009 compared to \$13.6 billion over the same period last year. This marks the worst first-half total for venture capital commitments since 2003, when just \$2.2 billion was raised.

The amount of committed capital available to venture funds will continue to dramatically contract until some of the larger problems facing our economy are solved. While the venture community is not in need of a federal rescue, a well-timed and relatively modest amount of capital could have far-reaching impact on job creation. The federal government should address the decreasing availability of capital in the early stage private equity sphere.

The Small Business Act of 1953 established the SBA as an advocate for small business in this country. Five years later, the SBA created the Small Business Investment Company (SBIC) program to provide debenture financing to early stage business. Rather than creating an infrastructure of federal employees to administer these loans, the SBA relied on the invisible hand of capitalism to do its work more efficiently. It provided the capital commitments to fund teams (SBICs) that were

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DEADLOCK AND DISSOLUTION IN DELAWARE

CRAIG J. ALBERT

LLC's are creatures of contract, so they provide a flexible means of governance. But care must be taken in advance to negotiate over what happens in the case of deadlock.

Venture capitalists understandably demand a degree of control in exchange for their investment in a company. A variety of mechanisms, including board representation, voting agreements, vetoes, supermajority requirements, puts and calls, are among the tools that funds and their lawyers use to protect their investment. Those mechanisms are intended to effectuate decision-making when there is consensus, but they have a dark side: the absence of a consensus can cripple the company. Indeed, creating the possibility may be a rational and strategic choice. A recent case decided by the Delaware Chancery Court illustrates the danger of not providing a mechanism to make decisions when there is a lack of consensus.

Genitrix LLC was a fairly typical early stage biotech company. Its founder, Dr. Andrew Segal, conceived an idea for an innovative treatment of cancer and infectious diseases. Dr. Segal and obtained an exclusive license from MIT of rights to a patent related to Genitrix's core technology. Genitrix was to pay for prosecution of the patent and, in exchange, received the worldwide right to develop, sell and commercialize products and services derived from the patent rights. The license was not assignable, other than in connection with a sale of the business, so the Genitrix business model necessarily meant that the company could either exploit the patent or do nothing.

Enter venture capital. Fisk Ventures LLC became the first outside investor in Genitrix. It put up \$842,000 in cash (having valued Dr. Segal's contribution of patent rights at \$500,000 pre-money) and bargained for a four-person board split evenly between Dr. Segal's Series A Representatives and Fisk Venture's Series B. Shortly afterward, a Series C round raised another \$258,000 from a group of Series C investors. At this point, the cap table would have shown 16% of the equity in Series C, 53% in Series B, and 31% in Series A. The Board expanded to five (presumably to accommodate Series C), but with a twist: now board action required a 75% supermajority vote.

At each stage of financing, each of which followed the preceding in rapid succession, the parties had effectively bound themselves to operate by unanimous consent. When Dr. Segal was alone, he acted as his own master. When Fisk Ventures arrived, likely votes were 4-0 or an unbreakable tie. And when Series C entered, any coalition that they formed with either Series A or Series B was powerless against the

other; Series C was at the mercy of an A/B block, but incapable of breaking an A/B deadlock.

How did the parties deal with the issue of deadlock? In only the crudest of ways, by giving Fisk Ventures a put, exercisable at any time after the fourth anniversary of its investment, exercisable for any reason or for no reason. The put price was to be based on a neutral valuation, but it was onerous. If the price was less than 50% of the company's total assets (that's *total*, and not net), then the company was obligated to pay it right away; if more, then it could pay in equal annual installments over three years. The consequences of a default in payment? One of the Series A seats shifts to Series B. Thus, with a default (a likely scenario in a development stage company lacking little in the way of tangible assets), the venture fund ends up with 60% of a board that requires 75% to act, so its only hope of influencing policy is to appease Series C.

The case does not explain how Dr. Segal and Fisk Ventures came to be at odds with one another, but the relationship obviously deteriorated. Five years into the relationship, in 2006, Dr. Segal and the other Series A board member stopped attending the company's infrequent board meetings, demanding instead that the board conduct its business by electronic mail. At most, therefore, a properly called board meeting would have been attended by a quorum of 60% who lacked the 75% power required to act.

After five years of discord, the company had no money, no office, no revenue and no grant income. Dr. Segal wanted to raise new capital, while Fisk Ventures would not do so without significant anti-dilution protections. Dr. Segal *wanted* Fisk Ventures to exercise the put: at a low valuation, the company could buy Fisk Ventures out, perhaps with money contributed by Dr. Segal or a Series D investor in a down round. For the same reasons, Fisk Ventures did not want to exercise its put. The LLC Agreement said that the company could be dissolved either with 75% consent, or upon an order of judicial dissolution. Since the parties did not agree to dissolve, what was to happen?

The Chancery Court ordered dissolution of Genitrix because it was not "reasonably practicable" to carry on the business of the firm, rejecting the notion that the standard ought instead to be "impossibility". The dis-

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DEADLOCK AND DISSOLUTION IN DELAWARE

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tion is important because it was not, and probably never would be “impossible”; minds could change, circumstances could change, and a moribund business without debts could, one day, rise Phoenix-like from the ash-heap. But on this day, given these personalities and the current set of financial and business conditions, continuing was not reasonably practical. (Although unstated, that rationale expresses a preference for operating companies over moribund holding companies. The licensor of the patent at issue, which was not a party to the litigation, has an interest in having the patent exploited, and the public at large would be better off under those circumstances as well.) One possible outcome is that the license terminates and, with no assets, Genitrix disappears, with a possible future fight between the equity owners over what happens to the intellectual property originally contributed by Dr. Segal.

It was a problem that could have been avoided. In their desire to design a mechanism that would ensure that each party checked the power of the other, the parties neglected to create a mechanism to break deadlocks, which can oc-

cur just as easily with an evenly-divided board as they can with a supermajority requirement. In designing a mechanism to break deadlocks, the parties need to realize that the company can only act when its board has the ability to say “yes” to a designated affirmative question. If the question is, “Shall we adopt Program X?”, and the answer is “No,” then unless the status quo is working well for the company, then the board must continue to consider alternatives until they reach the answer “Yes.” Genitrix did not have that mechanism: there was no outside expert to whom they could turn, no neutral board member to cast a deciding vote, and no Solomonesque mandatory buy-out proposal with which the parties could part ways. The Chancery Court noted that the LLC structure is, at its core, a creature of contract, so the parties have tremendous flexibility in controlling their own fate. When they did not take the care to exercise that flexibility at the outset, they saw their value disappear at the end.

calbert@reitlerbrown.com

DEAR MR. PRESIDENT

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licensed by the SBA. SBICs had to raise at least \$5 million on a private basis from investors and would then be eligible for leverage from the federal government of up to 300%.

However, as most of us who work in the venture industry know, debt capital is not appropriate for many early stage enterprises. Seed and Series A stage businesses often are not developed enough to have the cash flow to service debt. By limiting its investments in SBICs to debenture securities, the SBA, intentionally or otherwise, turned its back on early stage businesses—the companies most in need of financing and arguably holding the most promise for job growth.

To address this capital gap, the SBA expanded the scope of SBICs when it launched its participating securities program in 1994. This allowed qualified SBICs that had raised a minimum of \$10 million of private capital to receive 300% leverage while investing in the equity of small businesses. The program made equity capital more accessible to businesses previously overlooked because of more modest capital needs, particularly early-stage companies seeking funds in the \$500,000 to \$5 million range. While all venture capital investments fell 83% during the last recession which began in 2000, investments made by these funds fell just 23%. Since the program’s inception, participating securities SBICs have invested approximately \$14 billion, generating 385,000 new jobs and \$65 billion in revenue.

Despite this impressive track record, the SBA discontinued the participating securities program in 2004 after the Office of Management and Budget and the Congressional Budget Office determined that preferred stock did not qualify for the credit subsidy program under the Credit

Reform Act. This determination required dollar-for-dollar appropriations to the participating securities program in the annual budgeting process. Another problem facing the program was lackluster returns.

The Obama administration should direct the SBA to review the old participating securities program. It would be easy to rectify the legislative problem. An analysis of the existing portfolio companies to assess the cash on cash returns as well as the continuing employment tax revenue numbers from those companies would be illuminating. The companies receiving financing from SBICs during the eight year window of the participating securities program have had an opportunity to mature and many have reached or passed the harvest stage. We have a great deal more information to assess the efficacy of the program and to consider whether re-opening it, at least for a period of time, would be beneficial.

The SBA may even want to go further. Rather than the onerous SBIC licensing process to determine eligibility for federal financing, it might model its fund selection process on the due diligence procedures utilized by venture funds of funds and state and sovereign funds to choose alternative asset managers. Eligibility for the new SBIC status should be limited to old SBIC teams that performed well and to venture funds that have not traditionally been SBICs, yet have impressive track records.

On second thought, maybe I will send a letter asking the President about the participating securities program. If enough of us start talking about it, perhaps it will become a subject of conversation in Camelot, or at the very least, the SBA. I would love to hear your thoughts—*ereitler@reitlerbrown.com*.

RECENT TRANSACTIONS AND LITIGATION

◆ Represented **LexisNexis**, a division of Reed Elsevier, in its investment in the Series B Preferred Stock of, and co-branding and marketing relationship with, Rocket Lawyer Incorporated, an internet-based legal services company offering an online directory of legal forms and self-help software to customers through its website, RocketLawyer.com.

◆ Represented the venture capital funds, **Milestone Venture Partners**, **Silicon Alley Venture Partners** and **GlobalNet Partners LP**, as selling stockholders in connection with the \$88,000,000 initial public offering by **Medidata Solutions, Inc.** (Nasdaq:MDSO), a leading global provider of hosted clinical development solutions.

◆ Represented **Chart Venture Partners, LP**, a \$100M early stage venture capital fund investing in security related technologies with government and commercial applications and **Acadia Woods Partners, LLC**, a New York based investment partnership that focuses primarily on early stage technology companies in connection with a Series C Preferred Stock investment in WiSpry, Inc., a leader in programmable radio frequency (RF) semiconductor products for the wireless industry, based in Irvine, CA.

◆ Represented **Zelkova Ventures, LLC**, an early-stage venture investor in technology enabled services and consumer products companies, in connection with its investment in the Series A Preferred Stock of Nutshell Mail, Inc, a developer of technology for email and social networking accounts.

◆ Represented **Osage Venture**, a Pennsylvania-based venture capital fund, in connection with its investment in Series A-1 Preferred Stock of SevOne Inc., a Delaware-based provider of application and network performance management software delivered as an integrated appliance.

◆ Represented the shareholders of **Media Storm, LLC**, an entertainment industry advertising and marketing agency, in connection with a \$45 million recapitalization effected through the sale of membership interests to Shamrock Capital Growth Fund II, L.P., a private equity fund focusing on media, entertainment and communications businesses, with financing provided by NewStar Financial, Inc., a Boston-based commercial finance company, and City National Bank.

◆ Represented **Lockheed Martin (NYSE: LMT)**, a large multinational aerospace manufacturer and advanced technology company, in the successful defense of a multi-million dollar, multi-year case involving the ownership of and payment for two cutting-edge sea vessels built by Lockheed Martin.

◆ Represented **NIC Holding Corp. (Northville)**, a New York based petroleum supply, distribution and trading company, and a major market maker in the gasoline and heating oil markets in the Northeast and Gulf Coast, in connection with its claim for lost profits and hedging losses incurred due to a late delivery of a gasoline cargo to the Gulf Coast in October 2005. After the trial commenced, the case was settled with NIC Holding receiving a multimillion dollar payment.

Reitler Kailas & Rosenblatt LLC
800 Third Avenue, 21st Floor
New York, NY 10022
Tel: 212.209.3050
Fax: 212.371.5500
www.reitlerbrown.com

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