Corporate Venture Capital

Rise Amid the Changing Venture Capital Market and Lessons in Making and Structuring Corporate Venture Capital Investments

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Rise in Corporate Venture Capital Investments

The ecosystem that provides the funding necessary to finance the development and growth of startups and early-stage companies has traditionally been dominated by venture capitalists with funds dedicated to taking risky bets. These venture capitalists source investments in hopes of spurring rapid growth in portfolio companies, scaling them and putting those companies on the trajectory to successful exits. Corporations, considered slow and bureaucratic, generally took a backseat and did not pose a serious challenge to venture capitalists.[1] The funding landscape, however, is changing. In recent years, venture capital investors have pulled back from startup funding amid market turmoil caused, in part, by high interest rates and inflation.[2]

Given the slowdown in financing from traditional venture capitalists, corporations are slowly rising from their shadows to establish themselves as dominant players in the venture sphere. By 2019, corporate venture capital (CVC) participation in startup

funding reached a record high. That year, CVCs participated in 25% of all venture capital-backed deals, and CVCs invested alone, without venture capitalists as co-investors, in 10% of their deals.[3] By the second quarter of 2023, global CVC funding rose by 4% to $14.6 billion, even as overall venture funding for the same period fell 13% to $60.5 billion, the lowest level in three years.[4]

A growing number of large corporations have created separate venture capital arms specifically dedicated to sourcing and investing in startups focused on innovative solutions within their industries. These CVC units operate independently from their parent corporation, acting more like a venture capitalist but with financial support from the parent.[5] Through strategic investments in early-stage companies, corporations see value in being able to "get in on the action" without changing their core business, and view strategic investments as an essential part of their corporate development efforts.[6]

This article will discuss the upswing in CVC investment activity, including the benefits and challenges of strategic investments. It will also address structuring considerations in making those investments, and highlight corporations, particularly in New Jersey, that are capitalizing on the momentum to augment corporate development efforts by engaging in CVC investments.

The Benefits and Challenges of Strategic Investments

While traditional venture investors singularly pursue financial return for their limited partners, CVCs often have broader strategic goals.[7] These corporations tend to be motivated by the strategic and commercial synergies realized by investing in companies focused on products or services that are often complimentary, and sometimes competitive, to their operating businesses.[8]

From a financial perspective, a corporation can capture significant financial upside if it funds a successful venture.[9] From a strategic perspective, however, exposure to an emerging or competing technology or product can serve as a hedge against a competitive threat or disruption to the corporation's existing business.[10] A CVC can gain advantages for its parent corporation by surveying the landscape of what startups are doing.[11] This informational advantage can be critical in determining whether to pursue acquisition opportunities. Through this exposure, the corporate investor can observe how the startup operates, build relationships with its founders, and decide whether to pursue a more significant transaction.[12] Even if acquisition is not the main driver, the strategic investment can boost a corporation's research and development initiatives and enhance the opportunity for the corporation to penetrate growth markets.[13]

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For the startup, in addition to getting access to the capital it needs to scale, CVCs offer key value-added services. Their established distribution networks, relationships with strategic partners and entrenched domain intelligence are consequential for the startup. Through corporations, startups gain invaluable introductions to important industry contacts and access to an experienced sales force, among other benefits.[14] Moreover, since the companies with CVC arms are generally some of the biggest and most significant industry players, their investments also validate and provide credibility to the startup's products and services.[15]

Startups also appreciate the patience that comes with a strategic investment. Traditional venture capital funds with limited life spans face pressure to exit early and return funds to their limited partners.[16] Corporate venture capital units, by contrast, are not bound by limited partnership agreements that have defined terms of seven to 10 years and, given the proliferation of CVC units within large corporations in recent years, corporations have demonstrated a commitment to investing in startups for longer terms.[17] The strategic investor's ability to stay the course is even more acute during down cycles when those corporate investors are willing to support startups in spite of lower valuations. As the president of one CVC unit put it, "If the company continues to deliver on what we are looking for from an innovation perspective, and if they continue to progress against those milestones, absolutely, we want to continue to help them. We want that company to be successful."[18] This longer horizon is attractive to startups

that wish to stay private longer and sidestep a premature acquisition or initial public offering.[19]

The CVC model is not without its challenges. Given that CVC investments are often negotiated alongside commercial agreements (see the discussion below) that may include rights of first refusal on future sales or other exclusivity provisions, these investments may limit the fundraising or financing alternatives for startups, as well as a startup's ability to pursue opportunities with other strategic partners.

Structuring Corporate Venture Capital Investments

Initial Structuring Considerations

A corporation's investments into early-stage companies are largely driven by strategic and commercial motivations. Whether it's obtaining a license to the startup's technology, cooperating on a research and development initiative, securing a commitment from the startup to supply a product or technology, or the opportunity to evaluate the startup with an eye toward acquisition, the key drivers of CVC investments are often strategic objectives the corporation wishes to address.[20]

The CVC structure can take a few forms. For one, corporations can join an existing venture capital fund as a limited partner.[21] Alternatively, corporations can use current operating business units and task them with venture capital investing.[22] Another option would be for dedicated funds to be co-managed by a venture capital fund and the corporation.[23] Most commonly, however, a corporation creates a wholly-owned subsidiary, and that subsidiary operates exclusively to make venture capital investments and retains employees to manage those investment activities.[24]

Type of Equity Investments and Special Terms in Legal Documents

Like traditional venture capitalists, corporate investors prefer to invest in preferred equity rather than common equity. Preferred equity offers the holder downside protection in the form of a liquidated preference or the right to receive, in preference to any distributions to holders of common equity, on a sale, liquidation or winding up of the issuer, some multiple (often 1x) of their invested capital.[25] Corporate investors also seek preferred equity that is convertible[26] into shares of common equity based on a conversion price per share that is typically tied to the purchase price paid by the investor at funding and, thereafter, subject to anti-dilution protection. That anti-dilution protection is intended to protect the strategic investor (who is often a minority investor in the startup) from its ownership percentages being diluted upon the occurrence of certain dilutive events like a stock split, stock dividend or down-round funding, over which the corporate investor as a minority investor may not have a veto right.[27]

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To address their commercial and strategic objectives, corporations tend to negotiate special terms in investment documents or craft stand-alone agreements that align with those objectives. For instance, in addition to the traditional investment documents for venture capital financing,[28] corporate investors typically negotiate a separate business, commercial or intellectual property agreement addressing their commercial needs. If the strategic investor's interest in the startup is as a prospective acquisition target, it should consider negotiating a right to be provided with notice of the startup's receipt or solicitation of an acquisition offer, and the opportunity to make a competing offer if the corporate investor desires, generally on the same terms and conditions as the acquisition offer.[29] Finally, a strategic investor should consider entering into a side letter with the startup that provides the investor with certain financial and reporting information, particularly if the corporate investor does not have a seat on the startup's board of directors. These informational rights will grant the strategic investor access to financial statements (quarterly and annual) and annual budgets to enable the investor to monitor its investment.[30] The side letter form will also ensure that the strategic investor's informational rights cannot be eliminated without the investor's approval.[31]

Additional Legal Considerations: Disclosure Obligations and Conflicts of Interest

Corporations interested in pursuing strategic investments in startups should keep some key legal considerations in mind. While CVC investments are generally not made in amounts that trigger disclosure requirements, particularly for public companies,[32] corporations should be mindful that startups will likely disclose their investment by publicizing the list of investors participating in capital raising rounds.[33] These disclosures "[serve] an important market signaling function" for the startup but can have other consequences for the corporate investor.[34] Disclosing a corporation as an investor can signal that corporation's strategies concerning future acquisition areas or specific targets.[35] For corporations in highly competitive industries, this information may incite competition among other industry players, so corporations should be prepared and negotiate tighter confidentiality restrictions, if necessary, within their investment documents.

Another important consideration is the conflict of interest that may arise when corporate investors appoint individuals to a startup's board of directors.[36] In connection with their investments, investors often negotiate the right to appoint a director to the startup's board and often designate one of their employees to fill that role.[37] The corporate investor generally expects that its board designee will protect the investor's interests by consulting with the investor on major company decisions and reporting to the investor on non-public financial results.[38] However, the question that often arises is whether the board designee's obligations to their designating investor conflicts with their duty of loyalty to the startup on whose board the designee sits. While the board designee owes an "uncompromising duty of loyalty" as a director in the startup,[39] disclosures to their designating investors are generally permitted; provided that the corporate investor does not cause harm to the startup by, for example, using that information to compete with the startup or to divert business opportunities away from the startup.[40]

Corporate Venture Capital Activity Within New Jersey

New Jersey is home to several corporations with robust CVC activity. Johnson & Johnson (J&J) has been a leader on this front, boasting a 50-year old CVC practice that has had many successes, including launching and establishing J&J as a significant player within the HIV-treatment market.[41] Like J&J, many New Jersey companies are embracing the opportunity to gain visibility into emerging markets within their respective industries through strategic investments in innovative, early stage companies. ■

Endnotes

1. Darian M. Ibrahim, *Corporate Venture Capital*, 24 U. PA. J. BUS. L. 209 (2021).
2. Kaloyan Andonov, *Corporate Investors Hold Steady as VCs Retreat*, Globalventuring.com (Jan. 15, 2023) *available at* globalventuring.com/corporate/corporate-investors-2022-deal-numbers/.
3. Darian M. Ibrahim, *Corporate Venture Capital*, 24 U. PA. J. BUS. L. 209 (2021).
4. *Global Corporate Venture Capital-Backed Funding Ticks Up for the First Time in Nearly 2 Years*, CB Insights (August 3, 2023) *available at* cbinsights.com/research/report/corporate-venture-capital-trends-q2-2023/.
5. Darian M. Ibrahim, *Corporate Venture Capital*, 24 U. PA. J. BUS. L. 209 (2021).
6. *Ibid.*
7. Steven Rosenbush, *Pro Take: Corporate Venture Capital Provides Path for Long-Term Tech Strategy*, wsj.com (August 25, 2023) *available at* wsj.com/articles/pro-take-corporate-venture-capital-provides-path-for-long-term-tech-strategy-6f75eb75.
8. Darian M. Ibrahim, *Corporate Venture Capital*, 24 U. PA. J. BUS. L. 209 (2021).
9. It is often cheaper to invest at early stages in an emerging company, scale it and acquire the business, than to buy out a mature company when it poses a competitive challenge. *Ibid.*
10. *Strategic Equity Investments in Startups* (Practical Law 2023); Darian M. Ibrahim, *Corporate Venture Capital*, 24 U. PA. J. BUS. L. 209 (2021) (A corporation that has no ownership in disruptive technologies may fall victim to one.).
11. *Ibid.*
12. *Ibid.*
13. *Ibid* (While internal research and development within corporations generally focuses on enhancing existing lines of business, engaging with startups can supplement internal R&D efforts).
14. Jennifer S. Fan, Catching Disruption: Regulating Corporate Venture Capital, 2018 COLUM. BUS. L. REV. 341 (2018).
15. Evan Kipperman and Paul Hughes, *Practice Tips For Structuring Corporate Venture Capital Deals, Law360.com* (June 13, 2023) *available at* law360.com/articles/1687275/print?section=capitalmarkets.
16. Darian M. Ibrahim, *Corporate Venture Capital*, 24 U. PA. J. BUS. L. 209 (2021); Jennifer S. Fan, Catching Disruption: Regulating Corporate Venture Capital, 2018 COLUM. BUS. L. REV. 341 (2018) (Limited partnership agreements that govern the operation of the venture capital fund have terms of between seven to 10 years).

17. *Ibid.*
18. Steven Rosenbush, *Pro Take: Corporate Venture Capital Provides Path for Long-Term Tech Strategy*, wsj.com (August 25, 2023) *available at* wsj.com/articles/pro-take-corporate-venture-capital-provides-path-for-long-term-tech-strategy-6f75eb75.
19. Darian M. Ibrahim, *Corporate Venture Capital*, 24 U. PA. J. BUS. L. 209 (2021).
20. *Strategic Equity Investments in Startups* (Practical Law 2023).
21. Jennifer S. Fan, Catching Disruption: Regulating Corporate Venture Capital, 2018 COLUM. BUS. L. REV. 341 (2018).
22. *Ibid.*
23. *Ibid.*
24. *Ibid.*
25. *Startup Venture Finance: Overview* (Practical Law 2023).
26. The right to convert is triggered by certain specified events, such as a qualified public offering, or the sale or liquidation of the startup. *Startup Venture Finance: Overview* (Practical Law 2023).
27. *Strategic Equity Investments in Startups* (Practical Law 2023). To protect itself in the case of a subsequent down round, the CVC generally negotiates a price-based anti-dilution provision which is designed to reduce the conversion price of the preferred equity, thereby increasing the number of common equity issuable to the investor on conversion in proportion to the relative reduction in the conversion price. The anti-dilution provision generally takes the form of either (i) weighted average anti-dilution, which is more commonly used in typical institutional venture capital financing, or (ii) full ratchet anti-dilution, which is less commonly used but more favorable to the investor. *Ibid.*
28. The five main documents of a venture capital financing are: the Certificate of Incorporation, the Stock Purchase Agreement, the Investors' Rights Agreement, the Right of First Refusal and Co-Sale Agreement and the Voting Agreement. Jennifer S. Fan, Catching Disruption: Regulating Corporate Venture Capital, 2018 COLUM. BUS. L. REV. 341 (2018).
29. *Strategic Equity Investments in Startups* (Practical Law 2023).
30. *Ibid.*
31. *Ibid.*
32. Public corporations must disclose "significant subsidiaries" in a 10-K filing; however, the corporate venture capital arms of corporations do not often meet the threshold of a significant subsidiary given the size of those subsidiaries in relation the larger parent corporation's operations, cash flows and financial position. Darian M. Ibrahim, *Corporate Venture Capital*, 24 U. PA. J. BUS. L. 209 (2021).
33. Following a capital raise, startups routinely disclose, through industry trade publications, company press releases, website and social media, the investors who participated in a funding round, how much was raised during that round, which investors led the round and what stage the company is in. *Ibid.*
34. *Ibid.*
35. *Ibid.*
36. Corporate law imposes duties of care and loyalty on directors of corporations. To meet the duty of loyalty, in particular, a director must serve the corporation on whose board such director sits rather than the interests of such director, and, by extension, the interests of their designating corporate investor. *Ibid.*
37. David M. Morris, Lois Herzeca and Julie E. Kamps, *Designated Directors and Designating Investors: Early Planning is Key*, The Corporate Governance Advisor (May/June 2008).
38. *Ibid.*
39. Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (directors owe an "uncompromising duty of loyalty").
40. David M. Morris, Lois Herzeca and Julie E. Kamps, *Designated Directors and Designating Investors: Early Planning is Key*, The Corporate Governance Advisor (May/June 2008).
41. Steven Rosenbush, *Pro Take: Corporate Venture Capital Provides Path for Long-Term Tech Strategy*, wsj.com (August 25, 2023) *available at* wsj.com/articles/pro-take-corporate-venture-capital-provides-path-for-long-term-tech-strategy-6f75eb75 (J&J's investment in Tibotec-Virco provided it with entry into the HIV-treatment market).