



Company Formation and Incubation

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Case Western Reserve University

Office of Research & Technology Management

I. Current Working Model of University Support for Company Formation and Incubation

A. The Business Strategy

It is a prerequisite for a start-up company (“NewCo”) to have a viable business strategy. The best way for the University to determine this is for the intended Founders of the NewCo to provide a Business Plan that defines the many critical steps required for taking a technology to its commercial implementation.

Typically, such a Business Plan should systematically describe the critical elements, characteristics and expected results of NewCo, including:

1. NewCo’s technology and its status;
2. Expected NewCo products and/or services;
3. Targeted market(s), customers, distribution channels; size of targeted market(s); competition;
4. Competition, both technical and commercial (*a very important element!*);
5. Marketing and sales strategy of NewCo;
6. Unique advantages of NewCo, compared to competition;
7. Economics of the business, starting with expected gross margins, i.e., the difference between selling price and product (or service) cost;
8. Organization and key people involved, including CEO, key officers;
9. Key staff and consultants, other key employees;
10. Operating plans that align with financial assumptions;
11. Financial forecasts;
12. Financing objectives and/or plans, including valuations, financing sources and expected NewCo ownership and governance;
13. Development plan for the technology along with associated cost/budget for each step in said plan
14. Delineation of the IP that NewCo seeks to license and develop (i.e., which invention disclosures, which patents, and who owns what).
15. Current status of NewCo and expected schedule of actions, events, and accomplishments.

An effective and plausible Business Plan must be created by the prospective CEO and the other key leaders of the business who will be responsible for accomplishing the Plan. It should be developed as much for 'internal' as for 'external' purposes and should essentially become a 'set of instructions which NewCo writes for itself'. Assistance by competent consultants or advisors can often be helpful, but must not take the place of the personal involvement and commitment of the prospective key leaders of NewCo.

The existence of a plausible business strategy is one of the requirements of the Tech Transfer Office for establishing that a NewCo is a qualified licensee, and a prerequisite to engaging in serious Licensing and NewCo-formation discussions with Creators and potential Founders.

If uncertainties related to the technology, business status or market inherently preclude the drafting of, or commitment to, a Business Plan, then the NewCo and University may consider establishing an option to the technology. Under such an agreement, some of the requisite elements of the Business Plan outlined in Section 1(a) may be waived prior to execution of an option, but would be retained as ultimate prerequisites to the execution and receipt of an ultimate license agreement.

B. License Terms

Transfer of University technology will always involve a technology license from University to NewCo; such a license, unless it is a very broad platform technology, normally will be exclusive for a period of time if the NewCo meets certain standards within a particular field of use, minimum performance requirements, minimum annual payments, etc. This needs to be negotiated by the Creators / Founders with the Technology Transfer Office.

C. University Incubation Support

University Incubation Support to a NewCo, if requested by the Founders, will be considered by University concurrently with its review of all pertinent facts and circumstances of the business strategy. Incubation Support is offered at University's discretion and potentially may include the following services:

- 1) **Start-Up Documentation Package:** Includes License Agreement, Split Agreement, Corporate Bylaws, Shareholders' Agreement, and other key documents and legal services that are required for the formal start-up of the NewCo. Such documents will be based on mutually agreed terms. Legal expenses up to an agreed amount for such work will be paid by University as a Docket Expense. Expenses, if any, beyond this agreed amount, will be charged to NewCo.

- 2) **University Financial Support:** Contingent upon availability of University resources, University may offer NewCo financial support in a range of \$50,000 to \$250,000, in two forms:
 - a) **Cash to NewCo** – which may be drawn by NewCo upon execution of the License and the other NewCo formation documents, for NewCo’s initial start-up expenses, plus
 - b) **Credit Line for NewCo** – which may be drawn by NewCo only against charges for Incubation Services provided by University.

Such Financial Support may be constructed by mutual agreement, by structuring it as:

A convertible debt note from University to NewCo, with an established principal and a multiplier of 1.5, interest-bearing at prime-plus-two percent, with the accumulated interest to be credited toward the principal at the time of the repayment or conversion of the Loan; Loan and interest to be repayable to or converted to preferred equity by the University at the time of NewCo’s first major investor financing, or at a default date stated in the note, or when NewCo has developed adequate cash resources, or at the time of certain corporate transactions such as an IPO, merger, or corporate acquisition, whichever occurs sooner;

If, however, no agreement on University Incubation Support is reached between the Founders and University, and the University does not provide some or all of these services to the NewCo, the University will continue to help the Founders, if desired by them, to identify and connect with other sources of cash and incubation services. Additionally, as appropriate, the University will work to introduce NewCo to the Northeast Ohio Innovation Network comprised of the University and affiliated institutions that include BioEnterprise and JumpStart, Inc.

II. Deal Types and Compensation of University

A. General Objectives

In providing Incubation Support, University’s basic objectives are:

1. To provide a favorable environment for successful University Tech Transfer and Spin-Offs,
2. To help achieve the numerous potential benefits of enterprise creation as enumerated in Section 1,
3. To minimize, to the extent possible, exposure to unacceptable risks to both the Creators and to University as an institution,

4. To be fair, reasonable, and consistent in the terms expected and negotiated in each Deal,
5. To structure each Deal for best possible likelihood of overall success.

Some of these objectives will, at times, be in conflict with one another. The University will aim to keep all objectives in reasonable balance with one another, with the overriding goals of fairness to the key participants, of creating the best odds of overall success, and of establishing a portfolio of companies spawned from University technology.

B. Development of Specific Deals

Each Invention Disclosure, new Technology, License, and proposed NewCo formation has unique characteristics and must be considered on its own merits and under its own set of circumstances.

On the other hand, University has during the last several years evolved several “Deal Types” for the formation of NewCo’s which may serve as guidelines to potential NewCo Founders and investors, and offer them as an indication of the options which may be available.

The Deal Type and its specific implementation and numbers depend on:

1. the nature of the technology,
2. external circumstances, and
3. internal circumstances, including the desires of the Founders and University’s appraisal of the situation.

It must be understood, however, that the University’s decision to offer a specific deal in any situation remains at University’s sole discretion. Deals for specific situations may differ from one another in some of the details since there are many distinct characteristics to each specific NewCo. It is always the University’s objective to maintain high standards of consistency and even-handedness in overall valuations and general contract terms, but the University also wants to take into account the critical details of each situation in designing specific Tech Transfer arrangements.

In any case, however, all matters relating to intellectual property ownership rights and related subjects are subject to the provisions of the University Intellectual Property Policy contained in the University Faculty Handbook.

Deal Type A – Equity Participation and Royalties

Deal Type A is the preferred arrangement. It normally involves the situation whereby the Creators will be participating as Founders and shareholders of the NewCo. It combines equity and royalties and thereby offers the best balance of opportunities and risks to the parties. The arrangement will normally include among other things:

- a. **Royalties at Full Market Rates to be shared with Creators (unless mutually agreed upon by Creators and University that the Creators will NOT share in financial return to University);** in the case where all Creators do NOT share in financial return, then royalties and equity (below) are halved;
- b. **Minority Equity ownership in NewCo by the University, 15% of the founding common stock; this percentage will be protected against dilution as defined below.** If the license rights are desired to be non-exclusive, then the University equity stake will be 10% with the same anti-dilution protection employed.
- c. **Board Representation and Veto Mechanism.** CASE shall have the right to appoint a director of the Company's board. CWRU's right to appoint a board representative shall remain until University and creators holding stock through the University collectively hold less than 5% of NewCo or NewCo conducts an IPO or sale at respective levels set in the license ("Qualified IPO and Qualified Sale"). This board representative's consent must be given for material changes to the NewCo that include, but are not limited to, changes in capital structure, corporate governance, and sales, acquisitions or mergers of the company.
- d. **"Deferment of Royalties and Intellectual Property-related Reimbursements":** Cash payments for royalties and IP reimbursements may be deferred by NewCo for up to two years after the start of NewCo, or until NewCo has adequate cash flow available, whichever occurs sooner; deferred payments will then have to be paid off through amortizing payments during the following twelve months. If the majority of NewCo ownership or assets should be sold to another party or in case of an IPO, deferred royalties will have to be paid off to University at the time of such a transaction.
- e. **"Royalty Split":** Net Revenues received by University will be split between the CREATORS, College(s) in which the Licensed Technology was created, and ADMINISTRATION in accordance with University Intellectual Property Policy; in accord with said Policy, a specific Split Agreement must be executed prior to receipt of revenues that will define a CREATOR(s) personal compensation arrangements with University. A portion of the College's split, per decision of the respective Dean, may be allocated to the University Department and/or Center in which the Licensed Technology was created.

- f. **“Equity Ownership Protection”**: The equity ownership agreement must provide (a) Anti-dilution Protection for University’s initial percentage of ownership until cash equity infusions into NewCo have reached a level agreed upon in the license, and (b) Preemptive Rights for University to purchase additional NewCo shares under certain defined conditions until a Qualified Sale or Qualified IPO of NewCo.
- g. **University may offer Incubation Support** as described above.

All other Normal University General Terms and Conditions will apply, to be covered in the License Agreement and other agreements required for the startup of NewCo (“Closing”)

Deal Type B – Where All Creators Waive Their Share

This is a possible variation on Deal Type A. If all Creators waive their share, the equity and royalties will be reduced by 50%. Creators will make their own compensation arrangements with NewCo as Founders.

Deal Type C – Where the University Elects to Function as the Organizer

In certain situations, the University may desire to undertake the role of the organizer (i.e., “Founder”) of the new company. In that situation, the University would receive a larger percentage of the stock ownership than in Deal Type A, and there may be variations in other provisions as well. The precise nature of such terms will depend upon the circumstances of the situation and cannot be delineated in advance.