

Entrepreneur-in-Residence Programs

Key Legal Issues

July 2004

Introduction

- Informal entrepreneur-in-residence ("EIR") programs are a traditional feature of the private equity industry
- Recently, some private equity organizations ("PEOs") have formalized and expanded EIR programs as an alternative to traditional methods of attracting and compensating talented individuals
- Expanded EIR programs offer PEOs new opportunities to capture value for investors
- However, increasing complexity of EIR programs and applicable laws expose PEOs to additional potential liability

What is an EIR Program?

"EIR" and "EIR Program" are terms used to describe a flexible set of relationships that represent:

- A PEO's formal efforts
- To attract and capture value from
- Individuals with substantial expertise
 - Operating expertise
 - ▶ e.g., former CEOs of successful start-ups
 - Domain expertise
 - ▶ e.g., scholars or researchers in PEO's area of investment interest
 - Other expertise relevant to PEO's mission
- Who work closely with PEO personnel for limited periods of time
 - Normally six to 12 months
- For purposes including
 - Exploring, evaluating, and developing new investment opportunities
 - ▶ Includes preparing business plans for new ventures that the PEO will fund and the EIR will lead
 - Serving as interim directors or executives of PEO portfolio companies
 - Helping PEO fund managers to evaluate and prepare term sheets for "hot" companies
 - ▶ Especially where due diligence time and access to senior company management are limited
 - Working with portfolio company founders to further develop business plans and operations
 - Permitting the PEO to evaluate the EIR's suitability for a partner position

Distinguishing an EIR from a "Venture Partner"

Entrepreneur-in-Residence

- Short-term relationship
- Duties to PEO are normally principal business activity
- PEO normally owns rights to ideas, business plans, and other relevant work product generated in the course of the relationship
- Rarely compensated with equity in PEO or portfolio companies
- Participates in PEO internal meetings
- Often provided with PEO office space

Venture Partner

- Relationship may extend for term of fund
- Normally interacts with PEO only when presenting new investment opportunities
- Sometimes obligated to share deal flow with PEO first, but normally no other obligations to PEO
- Typically compensated with share of carried interest in deals brought to PEO
- Normally excluded from PEO internal meetings
- Normally maintains own office space

Announcing an EIR Program

- PEO may derive significant benefit from publicizing involvement of a prominent EIR, including:
 - Enhanced reputation in the private equity community
 - Additional deal flow from entrepreneurs and others in the EIR's area of expertise
- "Right of publicity" may limit PEO's ability to do so
 - Right of individuals to prevent unauthorized use of their names for commercial purposes
 - Protected under Federal law and in most States
 - ▶ Especially strong protection in California

Announcing the EIR Program (cont.)

- At a minimum, EIR should permit PEO to highlight EIR's affiliation for promotional purposes
- Consider agreeing in advance to form of press release and scope of permissible PEO publicity activities

EIR Status

- Relationship of EIR to PEO has important consequences for rights and obligations of PEO
- PEOs typically retain EIRs as independent contractors. Advantages include:
 - Tax and administrative savings
 - Greater flexibility in structuring incentive compensation
 - ▶ State labor laws may limit ability to implement incentive compensation for employee EIRs
 - Clawback for carried interest compensation
 - Vesting schemes involving forfeiture of previously paid compensation

EIR Status (cont.)

- Other relationships (e.g., employee, agent, attorney-in-fact) may be appropriate in some circumstances
 - However, lack of flexibility limits usefulness for comprehensive EIR programs
- This presentation assumes the EIR is an independent contractor

EIR Status (cont.)

- Recently, regulators and private plaintiffs have focused on "misclassification" of workers by employers
 - Most common instance of misclassification: "Contractor" agreements with workers who are effectively employees
 - Investigations by Federal and State authorities of companies that retain full-time consultants
 - ▶ Microsoft
 - Litigation by private plaintiffs (e.g., terminated fund managers) alleging PEO employment and labor law violations
- Penalties for misclassification of an EIR can include PEO liability for:
 - Payment of overtime EIR would have earned as an employee
 - Health, vacation, and other employee benefits
 - Not withholding state and federal payroll taxes

EIR Status (cont.)

- Documents establishing the EIR relationship (collectively, the "EIR Agreement") are persuasive evidence as to the intent of the parties
 - Scrutinize EIR Agreement and internal records to ensure they support desired classification of EIR
- However, "contractor" or "consultant" labels cannot change substance of EIR/PEO relationship
 - Classification in EIR Agreement not binding on regulators or courts
 - Will be disregarded if employment relationship in fact exists

EIR Status (cont.)

- In general, an employment relationship between the PEO and the EIR would be considered to exist if:
 - PEO has the right to control and direct EIR in the performance of EIR's services
 - EIR is economically dependent upon the PEO
- Sample factors tending to indicate employee status:
 - Right to terminate EIR at will without cause or without notice
 - EIR commits to a long, continuous term of service
 - EIR prohibited from delegating work
 - EIR has no time to perform other work or no right to work for others
 - EIR is reimbursed for business expenses
- Sample factors tending to indicate independent contractor status:
 - EIR entitled to control the manner and means of performance
 - No direct supervision of EIR by PEO personnel
 - EIR's services not essential/integral to the PEO's business

EIR Status (cont.)

- EIR should be retained by PEO management company
 - Centralize administrative tasks associated with EIR program
 - Reduce exposure of carry-bearing entities (normally, PEO general partner entities) in event of a dispute with EIR
- Any EIR carry compensation should be "walled off" from independent contractor relationship
 - PEO documentation and internal procedures should distinguish:
 - ▶ Service relationship between PEO management company and EIR from
 - ▶ Profit participation by EIR in a PEO general partner entity
 - Consider a separate agreement designating EIR as a member or assignee of appropriate PEO general partner entity
- See Fund Services Group presentation "Fund Managers as Employees—Employment Law Issues for Venture Capital and Other Private Equity Firms" for more information

Office Space and Office Services

- Typical office lease prohibits "occupancy" of leased space by non-employees without landlord consent
 - EIRs who regularly occupy space at PEO offices may cause PEO default under lease
 - Landlord consent should normally include a “waiver of subrogation”
 - ▶ A waiver of the landlord’s insurer’s right to recover from EIR any payout on account of damage to the PEO offices caused by EIR
- EIR access to PEO email, voicemail, and other office services
 - Benefits:
 - ▶ Aids integration of EIR with PEO “team”
 - ▶ Boost EIR productivity and incentive to work on PEO projects
 - Risks
 - ▶ May compromise ability to maintain confidentiality of sensitive information
 - ▶ May increase chances that third parties perceive EIR as having implied authority to act for PEO
 - ▶ Excessive EIR use of office resources may hinder PEO fund managers and staff from completing their work

Intellectual Property—Protecting Sensitive Information

- Strongest protection of PEO, portfolio company, and other third party information combines contractual protection with internal controls
- EIR Agreement should contractually obligate EIR to maintain confidentiality of all such information
 - EIR, as a contractor, is not covered by confidentiality provisions of PEO employee handbook
 - Any fiduciary duties imposed on EIR by membership in a PEO general partner entity are likely to be limited to that entity and its funds
- Limit EIR access to sensitive information outside EIR's scope of work
 - Formal internal procedures assist PEO and portfolio companies in
 - ▶ Maintaining "trade secret" protection of such information
 - ▶ "Building a case" if needed for prosecution under Economic Espionage Act

Intellectual Property—Protecting Sensitive Information (cont.)

- **Special issue: Track Record**
 - EIR may wish to disclose his or her activities and results to future employers or investors
 - Typical PEO confidentiality policies prohibit such disclosures
 - EIR Agreement should specify nature and extent of track record information, if any, that EIR may disclose
- **Special issue: Securities Trading Policy**
 - PEO should have or develop policy restricting trading by fund managers, employees, and others associated with PEO when in possession of material, non-public information
 - Ensure that policy covers EIRs and that EIR Agreement obligates EIR to abide by it
 - Review and revise internal procedures as needed to support and monitor compliance by EIR

Intellectual Property—Capturing Value

- PEO should obtain and protect rights to intellectual property produced by the EIR so that PEO may:
 - Pursue profitable ideas developed by EIR
 - Prevent EIR from disseminating protected ideas to third parties
- Typical EIR work product may be copyrighted
 - Examples: business plans, analyses of investment opportunities and market sectors
 - In general, any original work expressed in a tangible medium
 - ▶ Includes electronic files
- "Author" of a work is normally the copyright owner
 - Employees' "work for hire" is normally owned by the employer
 - EIR's work as an contractor does not normally entitle PEO to automatic ownership of the copyright

Intellectual Property—Capturing Value (cont.)

- Federal Copyright Act offers limited protection to PEO
 - PEO will be copyright owner under the Act automatically only if EIR's work is:
 - ▶ "Specially ordered or commissioned"
 - ▶ Within one of nine categories that are unlikely to cover typical EIR assignments
 - Examples: motion pictures, atlases, answers to tests
- EIR Agreement should require EIR to execute separate assignments of copyright to PEO as necessary to cover works not automatically protected under the Copyright Act
 - Additional effort needed to obtain foreign copyright protection or protection of intellectual property developed by foreign EIRs
 - Consult foreign counsel
- Whether and how to register copyrighted works and to enforce those copyrights is beyond the scope of this presentation

Intellectual Property—Miscellaneous Issues

- Protect third party intellectual property to avoid:
 - Infringement claims
 - Prosecution under Economic Espionage Act
- EIR Agreement should require EIR to:
 - Use third-party intellectual property only with PEO's consent
 - Represent that any such use is:
 - ▶ Non-infringing
 - ▶ Otherwise authorized and lawful
 - Pay royalties or similar fees for use of such property

Noncompetition, Nonsolicitation, and Similar Restrictions

- Consider whether noncompete is needed
 - Confidentiality and copyright protection may be sufficient to prevent disclosure and use of sensitive information
- "Noncompetes" generally unenforceable in California
 - Limited exceptions to general policy are not normally applicable to EIR programs. Examples include:
 - ▶ In connection with the sale of a business
 - ▶ In connection with the dissolution of a partnership
 - California courts *may* enforce narrow restrictions designed to prevent EIR from competing through use of PEO's confidential information

Noncompetition, Nonsolicitation, and Similar Restrictions (cont.)

- Other states' rules are generally more flexible
 - May enforce noncompetes under a "rule of reason"
 - ▶ When reasonably limited by time, scope, and geography
- However, attempts to limit EIR's work for competing PEOs may tend to undermine classification of EIR as an independent contractor

Noncompetition, Nonsolicitation, and Similar Restrictions (cont.)

- Agreement by EIR to refrain from soliciting PEO personnel should be enforceable in California
 - Must have reasonable geographical and time limitations
 - ▶ California courts have in some cases enforced limitations of up to one year
 - PEO with offices in multiple states may not be able to prevent a California EIR from soliciting personnel in other offices
 - PEO's ability to prohibit EIR from soliciting portfolio company personnel is less clear
- PEO may be able to restrain EIR from soliciting specific PEO investors
 - Difficult to enforce restrictions against soliciting unnamed and potential investors

Indemnification and Insurance

- Review indemnification provisions of governing documents for relevant PEO funds and general partner entities
 - Typically, these provisions extend to fund personnel and fund entities, as well as their agents and representatives
 - Independent contractors are neither agents nor representatives of the PEO
 - ▶ EIR not indemnifiable under typical PEO indemnification provisions

Indemnification and Insurance (cont.)

- Review relevant insurance policies to determine scope and limits of coverage
 - Umbrella/premises liability policy, if EIR will have office space in PEO headquarters
 - D&O insurance, if EIR will be asked to serve as a director or interim executive of a portfolio company
 - Other
- Assess potential liability to PEO in setting scope of EIR's duties
 - EIR unlikely to carry (or want to carry) appropriate insurance sufficient to cover potential liability for EIR program activities
 - EIR Agreement may include contractual indemnification of PEO by EIR
 - ▶ Value of indemnity depends on EIR creditworthiness

Summary

- Sponsoring an EIR program entails significant but manageable potential legal liability
- Review scope and nature of EIRs' duties to assess risks to PEO and its portfolio companies
- Review and adjust internal controls to assist in comprehensive risk and expectation management

This presentation is intended only as a general discussion and should not be regarded as legal advice. For more information, please contact your Fund Services Group attorney.

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