COLLABORATIVE TRANSFORMATION

FOCUS ON INNOVATION CENTERS

UNDERSTANDING PATHWAYS FOR HOSPITALS AND HEALTH SYSTEMS TO INVEST IN START-UPS

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The United States has seen a significant trend of hospitals and health systems (HHSs) investing in start-up biotech, digital health and medical device companies. These burgeoning collaborations enable HHSs to develop relationships with innovative companies and ensure access to cutting-edge technologies.

Two typical scenarios present these investment opportunities: First, a physician affiliated with the hospital may develop an innovative device or software that she or he wants to put into a company to develop and bring to market, and comes to hospital management asking for an investment. The second scenario involves HHSs proactively going to the market and seeking out investment opportunities.

Regardless of the source of the investment, the manner of investing in innovative companies can vary widely based on the HHS's goals and tolerance for risk, as well as the opportunity presented by the innovator. In addition to the choice of investment form, HHSs investing in innovation must address a wide variety of complexities derived from the laws affecting health care providers (including the Stark Law and the Anti-Kickback Statute) and tax-exempt organizations. In order to successfully navigate these issues, hospitals should implement appropriate conflicts of interest management plans, determine the best corporate and tax form for the investment, and ensure that relationships with physician referral sources are at fair market value. Furthermore, these investments are typically coupled with complex research and collaboration agreements between the hospital and the company.

This article provides an overview of the typical funding mechanisms used by hospitals and health systems to invest in innovative companies. While this article addresses investments into start-ups that have already been formed, future installments in our Focus on Innovation Centers series will address choice of entity and issues related to contribution of HHS intellectual property to a start-up.

1. CONVERTIBLE NOTE

A convertible note is one of the most common investment instruments used by so-called "angel" investors and other investors in very early stage companies. Convertible notes are debt that operates as a loan to the start-up company. The key feature of a convertible note is the fact that the investor and the start-up company do not need to agree upon a valuation at the time of the investment. This defers a potentially contentious discussion to a later point, when a valuation will likely be more accurate in any case. The convertible note functions such that the debt converts into equity at the same valuation for the next qualifying financing round. When the company receives an equity investment of at least a minimum threshold (i.e., $5 million), the note converts into equity at the valuation used in the qualifying financing.

Another advantage to the use of a convertible note is that it puts the investor (in this case, the HHS) into the position of a debt holder. As a debt holder in the company, the HHS will be first in line to receive repayment in the event that the company does not execute a qualified financing or otherwise raise money to advance its development program. The assets of the company (including intellectual property in some cases) may revert to the HHS to secure payment of the note.

CONVERSION DISCOUNTS

To entice investors to participate, a convertible note typically offers a "conversion discount" of between 10% and 30% at the time of the conversion. For example, if a hospital makes a $500,000 convertible note that converts at 80% of the valuation in the next "qualifying financing," in a qualifying financing of $5 million, the note would convert into 12.5% of the equity issued in the qualified financing (i.e., $500,000 divided by $4 million) instead of t10% of the equity, taking into account the 20% conversion discount.

Convertible notes frequently contain covenants that govern operation of the company during the period that the note is outstanding and may contain other features that are implemented once the note converts into equity. For example, a convertible note may contain covenants that restrict the payment of dividends or raising corporate officer salaries during the period that the note is outstanding. A convertible note also may provide the noteholder the right to participate on a board of directors or as a board observer upon conversion. Upon conversion of the note, the HHS will typically be asked to execute a shareholders agreement, voting agreements and other related documentation in the same form as the documentation executed by other investors in the qualified financing round.

2. SIMPLE AGREEMENT FOR FUTURE EQUITY

The simple agreement for future equity (SAFE) was developed by angel and seed-stage investors in Silicon Valley to provide an even more streamlined approach to investing in start-ups. A SAFE functions much like a convertible note but does not take the form of debt. Instead, the SAFE is an agreement that the company will issue equity to the investor in an amount equal to the investor's cash investment if and when the company issues equity to a future investor. While the basic SAFE template does not apply any conversion discount (see sidebar on how conversion discounts work), such a feature can be negotiated into a SAFE if it is important to the investor. Similarly, the SAFE can be modified to include interim covenants and other aspects similar to a convertible note.

The hospital becomes the owner of equity in the company only upon the company's achievement of its next financing round, and at such time the SAFE is extinguished. Similar to the convertible note, upon issuance of equity to the hospital investor, the hospital will be required to execute a shareholders agreement, voting agreements and other related documentation that is in the same form as the documentation executed by other investors in the next financing round.

3. WARRANTS

Warrants are used less commonly for an initial early-stage investment. Under a warrant, the company gives a party the right to purchase stock in the company at a defined prices at a future time. The start-up company would receive the initial purchase price for the warrant, and in the future may receive a second investment if the warrant is exercised. Alternatively, if an initial public offering (IPO) or acquisition of the company occurs, a warrant may be "cashless exercised," and the holder of the warrant will receive the amount that it would have received had it exercised the warrant to purchase stock and then sold that stock in the IPO or transaction.

Warrants typically offer the least amount of control over a start-up company. They do not give the investor equity or debt interest in the company; they only give the right to obtain equity at a future date. Warrants are rarely used as a tool for investment of cash, and are more commonly used to compensate an HHS for providing development or clinical services, or in-kind contributions, to the start-up company.

4. PREFERRED STOCK

Preferred stock is the most common type of equity investment in a start-up venture that is used by HHSs and venture capital investors alike. A preferred stock investment requires the parties to agree upon a valuation of the company, and the stock is purchased in exchange for an equity investment in the company. Preferred stock is typically structured to accrue a preferred dividend (typically in the 6–8% range) on the amount of equity invested in the company. The dividend is a preferred obligation of the company, and in the event of a distribution, the dividend must be paid first, along with a return of the preferred investor's capital contributions. Preferred stock gives investors downside protection in case the company does not have a future liquidity event that has significant growth in value.

At the time of a preferred stock financing, the HHS will execute a stockholder agreement, voting agreement and other related shareholder documentation. Depending on the size of the investment and the involvement of other institutional investors, the HHS (either individually or along with other preferred stock investors) may be granted certain governance rights. These may include the right to appoint one or more board members and the right to approve certain actions, such as the issuance of additional equity, debt, creation of subsidiaries or sale of corporate assets, as well as related party transactions. The obligation to negotiate these governance features frequently drives hospitals and start-up innovators to choose convertible notes or SAFE investments over a preferred stock investment, since the latter entails all of the complexity and documentation of a full venture capital investment round.

5. COMMON STOCK

Lastly, an HHS may make an investment into common stock of an innovator company. A common stock investment is similar to a preferred stock investment but does not offer the hospital investor downside protection in the form of a preferred dividend and return of capital. As a result, the vast majority of venture investments are in preferred stock, and hospital investors are well advised to follow that path as well. One advantage of a common stock investment, however, is that it may not require the company to amend its articles of incorporation, and it puts the investor and the founders on the same footing with respect to their ownership. This gives comfort to many founders of innovative companies. A common stock investment contains all of the same documentation and negotiation requirements as a preferred stock investment.

CONCLUSION

Each of these investment forms features a wide variety of potential alterations and customizations to adapt the investment to the specific situation. HHS innovation departments are advised to cautiously negotiate the many legal and regulatory issues that apply if an investment is made. Choosing the appropriate investment vehicle, combined with thoughtful due diligence, can help HHSs mitigate risk in early-stage innovation investments.