WEB INCUBATORS

Formation, Funding, and Operations
Thomas C. Carey, Esq.
Bromberg & Sunstein LLP

I. Definition

A web incubator, for purposes of this material, is an entity that seeks to encourage the development of web-related businesses by providing them with capital and substantial additional resources. First and foremost among those resources is office space in a collective environment that allows web entrepreneurs frequent interaction with each other. Incubators also offer industry contacts, finance and administrative support, and assistance in filling gaps in the client company's management structure.

Incubators vary in the extent to which they rely on internally-generated ideas for the formation of business ventures, or, alternatively, view their mission as primarily fostering entrepreneurs whom they select much as a VC firm would. The nature of the agreements between the incubator and its clients may vary depending upon how and where the business idea originated.

A common characteristic, although not a defining one, is that many web incubators put their client companies on a very short leash. They give them a limited amount of time – as short as three months – in the incubator's physical space, after which the client must move out. It is also common for

incubators to require client companies to move out once they attain a threshold number of employees.

II. 1940 Act Concerns

A successful incubator will want to guard against the possibility that too large a portion of its assets may one day consist of "investment securities", thus potentially requiring registration under the Investment Company Act of 1940, 1SUSC § 80a-1 et.sq. (the "1940 Act"). Such a result would have a serious effect on the ability of the incubator to function. For example, the incubator would be forbidden from issuing stock options to employees; and would make it very difficult to issue either debt or preferred stock. See sections 18(a) and (d) of the 1940 Act. The regulatory concerns presented by the 1940 Act require incubators not only to safeguard against becoming investment companies themselves, but also to ensure that their investors and client companies do not become investment companies.

A. What is an Investment Company?

The definition of an "investment company" under the 1940 Act is fairly involved. Generally, it is designed to capture widely-held companies that primarily engage in investing in securities. To do so, the 1940 Act establishes a broad definition of "investment company," and then provides an exception for closely held companies. In particular, the 1940 Act defines investment companies to include (A) companies which are or hold themselves out as primarily engaged in investing, reinvesting or

trading in securities and (B) companies that (i) are engaged or propose to be engaged in the business of investing, reinvesting, owning, holding or trading of securities, and (ii) have more than 40% of the total value of their assets (other than Governmental securities and cash items) in investment securities other than (a) securities of majority-owned subsidiaries (which are not investment companies themselves) (b) Governmental securities and (c) securities issued by employee's securities companies. (1940 Act, Section 3(a).)

Section 3(c)(1) of the 1940 Act excludes from that definition any company that has fewer than 100 holders of its debt and equity securities and "is not making and does not presently propose to make a public offering of its securities". For purposes of counting security holders, beneficial ownership by a "company" is generally treated as beneficial ownership by one person. If, however, the "company" is itself an investment company (or would have been but for an exception for companies owned by "qualified purchasers"), beneficial ownership is deemed to be that of each of the holders of the investing company's securities.

B. Certain Prima-Facie Investment Companies

SEC regulations (17 CFR 270 3a-1) provide that an issuer shall not be deemed to be an investment company if no more than **45%** of the issuer's total assets (other than cash and Governmental securities) consists of and no more than **45%** of the issuer's total net income is derived from certain types of

securities. These exclude securities like those excluded from the 40% threshold of investment assets described in Section 3(a) (*i.e.*, securities of majority-owned subsidiaries which are not investment companies themselves, Governmental securities and securities issued by employee's securities companies), but also securities issued by a company "controlled" primarily by the issuer.

The 1940 Act presumes "control" to exist when one person beneficially owns more than 25% of the voting securities of another, and is presumed not to exist otherwise, but allows persons to apply for orders from the SEC to rebut these presumptions. Safeguard Scientifics, Inc. ("Safeguard") recently applied for and received an order from the SEC declaring that it controlled Internet Capital Group ("ICG") despite the fact that it only held about 14% of ICG's common stock. In its application, it stated that it was the largest single shareholder in ICG, that its officers and directors held three of the eight Board seats on ICG, and that a Safeguard director on the ICG Board served as president and CEO of ICG. (SEC Notice, 65 FR 11616) Presumably, Safeguard's interest in this order was to be able to count ICG securities and the revenues received from ICG to the 45% test under Rule 3a-1.

C. "Transient" Investment Companies

17 CFR 270.3a-2 provides a window period of one year for companies that have a bona fide intent to be engaged, as soon as possible, primarily in a business other than investing in securities. The intent of the

company must be evidenced by its activities and a resolution of the board of directors. This exemption may not be relied on more than once every three years. It is routinely relied upon by companies that raise significant cash in an IPO, and invest that money temporarily in securities.

D. SEC Orders

A company may also apply for an order from the SEC under Section 3(b)(2) of the 1940 Act declaring that the company is "primarily engaged in a business other than investing, reinvesting, owning, holding or trading securities" and exempting the company from being treated as an investment company for a certain period of time.

In considering these applications, the SEC considers the following factors: (i) historical development; (ii) public representations of policy by the applicant; (iii) the activities of applicant's officers and directors; (iv) the nature of the applicant's present assets; and (v) the sources of the applicant's present income. See *Tonopah Mining Company of Nevada*, 26 SEC 426,427 (1947).

Several Incubators have applied for these orders. Idealabs! and Yahoo! have recently received temporary orders under Section 3(2)(b) in connection with applications for permanent orders.

Internet Capital Group received a permanent order in August 1999. The facts put forward by ICG to support its application included that: (i) ICG

considered itself to be an operating company engaged in business-to-business electronic commerce, and has consistently held itself out as such, and not as an investment company; (ii) its officers and directors dedicated about 27% of their time to internal operations, 56% of their time to partner company operations and only 17% of their time to acquisitions; (iii) at least 60% of its assets would continue to be invested in partner companies that ICG actually controlled within the meaning of the 1940 Act, and (iv) that over 68% of its current revenues were attributable to companies it actually controlled. See 70 S.E.C. Docket 514, Release No. IC-23923.

Not all companies at risk of being classified as an investment company apply for such an order, which can be difficult to obtain. CMGI chose to sell some of its client companies and obtain a controlling interest in others so as to avoid being characterized as an investment company.

III. Choice of Entity

A. LLC versus C Corporation

1. Advantages of LLC

LLC offers tax pass-through status. Unlike an S corporation, it can have corporations as equity holders. An LLC also offers customizable features not typically found in the corporate form, such as ability to vary the allocation of profits depending upon a variety

of factors. LLC operating agreements can differentiate between different types of contributed capital (cash, intellectual property, equipment), and provide for different means of distributing them upon a liquidation of the entity. See the LLC Operating Agreement attached as Exhibit 5.

2. Advantages of Corporation

C Corporations can adopt incentive stock option plans, while LLCs cannot. C Corporations are the expected vehicle for an initial public offering, in part because Delaware corporate law is preferred by the investment community. Thus, while Internet Capital Group began life as an LLC (see Exhibit 5), it incorporated prior to its IPO.

B. Other Possibilities

1. Mass Business Trust

May offers tax pass-through characteristics of LLC. Massachusetts law offers somewhat less flexibility in governance, because of need to preserve the "trust"-like quality of the entity.

2. Joint Venture

This form of entity may be appropriate for managing ownership shares in a single entity (see Exhibit 4 for an example), but may not work well for a true incubator.

IV. Agreements Among Founders/Investors

A. Customary Provisions Common in Many New Entities

1. Right of First Refusal on Sale of Shares

   (A) In Favor of Company
   (B) In Favor of other Equity Holders

2. Co-Sale Rights

   These rights are often used to provide outside investors to share in liquidity opportunities that may become available to the founders.

3. Registration Rights – Demand, Piggyback

   These rights permit the incubator to demand, or participate in, a 1933 Act registered offering. See, e.g., the Investor Rights Agreement between CMGI and Engage, Inc. (Exhibit 8).

B. Provisions Peculiar to Incubators

1. 1940 Act Contractual Safeguards

1940 Act concerns sprout up in a number of contracts. For example, Article XIV of the

LLC operating agreement of Internet Capital Group LLC (Exhibit 6) provides that any member owning more than 9% of ICG that is or becomes and investment company shall be partially expelled from the LLC (in an amount sufficient to bring the investment company's ownership interest down to 9%).

The purpose of this provision is to insure that the number of beneficial owners of securities in ICG is under 100 persons so as to be escape being deemed an investment company. As described above, if one of the members is or becomes an investment company and owns more than 10% of the securities of ICG, the holders of ICG's securities will be deemed to include all of the holders of the investor's securities.

The ICG LLC operating agreement also carved out, as an exception to the investors' right to co-invest in future deals, any investment that would cause the investor to be an investment company. See Exhibit 6, section 6.9.

In order to avoid 1940 Act problems, CMGI has required Engage to enter into an Investor Rights Agreement intended to insure that CMGI owns at least 50% of Engage. See Exhibit 8.

2. Investment Opportunities

Section 6.9 of the LLC Operating Agreement of Internet Capital Group (see Exhibit 6) gives each major investor in the LLC a right to participate directly in any internet-related investment opportunity presented to ICG.

V. Agreements Between Incubators and Client Companies

A. In General

The type of agreements that an incubator may enter into with client companies will depend on (i) what services the incubator is offering to the client, and (ii) whether the client company has a developed infrastructure, and if so, what its remaining needs are.

B. Specialized Agreements

1. Are They Necessary?

Sometimes the internet venture is so immature that the time, energy and money required for customized agreements may be lacking. The issues confronting the incubator and the client may be dealt with by having the incubator structured as and LLC and creating special classes of membership interests, one class for each venture. See the Duzmore LLC Operating Agreement, Exhibit 5.

(i) What Do They Look Like?

(a) Stock Purchase Agreements

If the client is a separate entity, then the incubator's investment in the client may be documented with a customary stock purchase agreement. The amount of equity required by the incubator may vary greatly. For example, Divine Interventures reports that its equity position in clients generally varies between 25% and 65%. See the Stock and Note Purchase Agreement dated of June 27, 1997 between eToys Inc. and idealab! inc. (Exhibit 7) giving idealab! a 63% ownership position in eToys. If the client company was germinated from within the incubator, the incubator's percentage ownership may be greater. Just prior to Engage Technologies Inc.'s IPO, it was 96% owned by CMGI.

(b) Facilities and Administrative Support

The incubator will generally make office space available in an area shared by other client companies. In doing so, the incubator is likely to provide administrative support, such as handling payroll, providing telephone

and computer resources, legal advice, and employee benefits. These matters may often be handled without a formal agreement, but there are formal agreements in place for publicly-held client companies. See the Facilities And Administrative Support Agreement dated July 23, 1999 between CMGI, Inc. and Engage Technologies, Inc.

(c) Tax Allocation Agreement

If the incubator and client are both C Corporations, and satisfy the Internal Revenue Code definition of an affiliated group of corporations under section 1504 (a), the incubator may file a consolidated tax returns covering the client (and possibly many other client companies). In that case, it may be necessary to properly allocate the responsibility for the tax payments, since the different client companies are likely to have different minority shareholders. See the Tax Allocation Agreement between CMGI and Engage Technologies, Inc. at Exhibit 3.

VI. Other Issues

A. Conflict of Interest

The web incubator model presents numerous potential conflicts of interest. Among them are:

- The extent to which companies under the same roof may be pressured to do business with one another, rather than to find a better match elsewhere.
- The incubator's 1940 Act concerns, which may require it to maintain majority control.
- The difficulty of apportioning tax.
- The proper allocation of shared costs, and equipment; and jointly developed intellectual property.

B. Piercing the Corporate Veil

Incubators and their client companies may be so intertwined -- sharing board members, office space, officers – that great care should be taken to ensure that the incubator is insulated from the liabilities of the client. While a detailed discussion of this issue is beyond the scope of this presentation, practitioners representing incubators should take care to minimize risk in this area.