Davis Division Academic Senate

Request for Consultation Responses

AFS - Equity in Return for Access to University Facilities and/or Services

April 30, 2015

UC Academic Senate has initiated review of draft guidelines for a pilot program whereby UC would be able to accept equity from companies in return for access to facilities and services associated with incubators and accelerators around the UC system. The guideline draft was developed by staff within the Office of Research and Graduate Studies and the Office of General Counsel in consultation with representatives from the UC Berkeley and UC Davis programs that will be the first participants in the pilot.

Council of School & College Faculty Chairs (MANAGEMENT)

April 29, 2015 10:58 AM

Response continued on next 2 pages.

Response to RFC
April 29, 2015
AFS – Equity in Return for Access to University Facilities and/or Services

As FEC chair for the Graduate School of Management, I received comments from three faculty members with deep expertise in entrepreneurship, organizational theory, and venture capital, respectively. Though not my direct areas of expertise, I am familiar with research in these areas and have concluded that the comments of these scholars should be addressed if possible. The two main issues raised in the comments below are:

(1) The uncertain valuations associated with startups create several issues that require careful consideration.

(2) University funding of startups raises several potential conflicts of interest, particularly since the document makes clear that the objective is not to make money, but rather funding (p.7) "… shall be based upon the educational, research, and public service missions of the University over financial or individual personal gain." While this is a laudable goal, one wonders how the educational, research, and public service missions of a start-up will be evaluated. Would the university allocate funding if the startup helped to recruit a top-notch faculty member, create jobs or alleviate poverty in California, but was not financially viable?

The comments of each faculty member are provided below, but most build on these two main issues.

The faculty member with expertise in venture capital provided the following detailed comments.

Main Comment

The document is written with the assumption that equity is the common form of security to be issued as compensation for the companies' use of university facilities and/or services. While this is a reasonable assumption for publicly traded companies, it is not the case for young start-up companies that are yet to receive a VC round of funding. Such companies often issue convertible debt or convertible note to angel and seed investors to avoid setting an equity valuation. It is difficult for the University in such cases to determine a fair value of equity for the companies.

Appendix F, Part 2 (Private Benefit), discusses several methods to come up with equity values. Using the price at which options are issued is reasonable for common stock, since options are convertible to common stock, but it is not appropriate as the price for preferred stock, since (convertible) preferred stock has different and typically higher value per share than common stock. Determining the value of preferred stock using the option exercise price requires more advanced financial modeling that takes into account the liquidation preference, participation rights, etc. features of the particular preferred stock. See Metrick and Yasuda (2010) for details.

Generally, I think that taking common stock or convertible preferred stock in a company at "fair value" that has yet to receive VC funding is fraught with valuation challenges, which then exposes the university to various compliance issues with its obligation as a public entity. I cannot therefore recommend delegating such decision-making responsibility to various campus DCMs.

I am much more in favor of the "potential financing options" described in some of the bullet points on page 34 and 35. In particular, use of a note or convertible note (second bullet), and similarly use of a convertible security that would "convert at a later time upon a triggering event" (third bullet). Charging cash for the most part and reduce the cash amount by the par value of equity received also seems reasonable (first bullet) in some cases. Flat percentages is also an interesting idea, as that is used by private incubators in some cases, but setting the appropriate percentage will require further work.

Other comments

I was surprised that Section D of IV. Equity Guidelines prohibits University employees from serving on the board of directors in a Company in which the University has a equity position through this program. It seems highly likely that some of the best candidates for university incubation programs are founded by University affiliates (employees, professors, students), and the whole point of setting up such incubation programs is to contribute to the overall entrepreneurial ecosystem in the local economic region, with the university serving as one of the hubs. I understand this rule is motivated by the need for compliance, but this seems to handcuff the program too much and undermine its potential for success. This is a sensitive timing issue.

Perhaps one solution is to allow university affiliates to serve on the board (e.g., as the founder/CEO) for a limited period of time, so that they can keep their university positions ("day job") while the company is still in its infancy, but require that such board members either (1) severe ties with the university ("quit the day job and dedicate themselves full time to the company") once the company is in a more developed stage, or (2) resign from the board and play a limited role as a scientific advisor.

I thought it was unrealistic and too rigid to require that "No consideration shall be given to Company information uniquely available to the University through its AFS pilot" (p.14, top paragraph). This rule seems financially reckless for the sake of compliance and if enforced could jeopardize the interests of university stakeholders.

I was also surprised to see in Appendix D that dispositions of stock have to follow a predetermined schedule (50% upon expiration of lock-ups, another 25% 6 months later, and the remaining 25% 6 months after that). This strikes me as unreasonably rigid for the sake of compliance, and jeopardizes the interests of University stakeholders too much. One could imagine a scenario where the university will be forced to leave a lot of money on the table and dispose the stock at an inopportune time, or conversely miss an opportunity to sell stock before it precipitously loses its value.

It was also not clear who is the beneficiary of the stock once it is issued – does it belong to the office that runs the incubation program, the Campus at which such program is located, or the Regents? The document refers to "[Campus'] portion of an cash proceeds" in Section C.3 of VI. Chief Investment Officer's Management of Equity (p.15), but it is not clear how the various portions are allocated to different UC entities.

Reference:
Andrew Metrick and Ayako Yasuda, 2010, Venture Capital and the Finance of Innovation, Hoboken, NJ: John Wiley & Sons.

The faculty member with expertise in organizational theory provided the following comments.

1. Overall, the guidelines seem quite comprehensive and clearly presented.

2. With this said, the guidelines (like any set of guidelines) leave grey areas within which university personnel will be afforded considerable discretion. For this reason, I suspect that problems of an unpredictable sort are bound to arise. This leaves me to believe that this program carries some risk.

3. Further, there is some research that suggests that guidelines such as this can generate counterintuitive negative consequences. On a general level, any set of guidelines tends to cause the individuals subject to them to perceive the decision context as a game to be played and won. A number of studies show that individuals subject to guidelines tend to peruse the guidelines in an effort to identify gaps that allow them to pursue their self-interest. I am not saying that organizations should not establish guidelines. I am just saying that their effect is not universally salutatory.

4. On a more specific level, there is some research that suggests that guidelines calling for people to disclose conflicts of interest can generate counterintuitive negative consequences. A number of studies show that people have an idealized ethical identity around which their concrete ethical behavior vacillates. When people do something that is less ethical than their idealized identity, they tend to do something more ethical than their ethical identity to bring their "average" behavior in line with their idealized identity. Conversely, when people do something that is more ethical than their idealized identity, they tend to do something less ethical than their idealized identity, again to bring their "average" behavior in line with their identity. This tendency is sometimes referred to as "compensatory ethics." Thus, ironically, when people disclose conflicts of interest, they are more likely to let those conflicts of interest influence their behavior. I am not saying that organizations should eschew guidelines requiring their personnel to reveal conflicts of interest. I am just saying that the effect of disclosure guidelines is not universally salutatory.

5. I think that a central element of the guidelines might be problematic. As I stated above, I am not an investment professional. With that caveat, it seems to me that the requirement to calculate the value of the enterprises in question might be quite difficult, insofar as most will be start-up enterprises, the value of which generally will be highly uncertain. Thus, it seems to me that any attempt to balance the value transferred to the enterprises by the university and the value transferred to the university by the enterprises will be fraught with error.

6. Finally, I was unsure what the phrase "acting in their capacity as University employees" in the first sentence of section D meant (page 9). Does this phrase refer to the state of mind of university employees when they serve on the board of directors of an enterprise receiving value from the University and surrendering equity to the University? More specifically, does this mean that University employees can serve on an enterprise's board of directors, as long as they do not represent their service as provided on behalf of (or with the approval of) the University? If so, this provision seems to be entirely unenforceable.

A faculty member with expertise in entrepreneurship provided the following comments:

1. Fundamentally, why is the equity exchange for accelerator space and services? Why is it not in lieu of patenting costs or licensing royalties as these are often the more burdensome constraints for new ventures (and clearly shared risk for the UC system). Space (specifically lab space and equipment) may also be valuable, but also possibly available outside.

   Moreover, business support services, particularly from administrative staff based on UC Campuses, rarely has the requisite disciplinary, industry, and entrepreneurial experiences to be of significant value to new ventures.

2. How is the equity stake to be determined (i.e. how is the nascent venture valued)? Is it anchored at the discretion of the administrative units of the technology transfer offices, and how does this office claim the ability or experience in making such determinations?

3. There is a significant power imbalance between researchers negotiating the license for their intellectual property and university administrators negotiating on behalf of the university. If the same individuals and offices are also negotiating for an equity stake based on space and business services, this creates an equally significant potential for conflict of interest and coercion on the part of administrators and pressure to accept unfair terms on the part of the researchers (who have no recourse without the rights to the IP).

   This concern is not about COIs based on personal gain, but rather "bureaucratic" gain in terms of the performance of administrative units judged on the revenue they generate from licensing and equity in conflict with the interests of the researchers as well as the interests of the new venture. I would recommend separating, on the administrative side, the valuations and negotiations of the IP licensing from the valuations and negotiations of the space and services as well as of the value of the venture.

4. Related to (3), there is a stated preference for fully paid securities when often the seed stage investors take a convertible note that is valued by subsequent professional investors in a later investment round. Why not avoid the conflict by placing a cash value on the space and services but not the venture, and have a professional investor set the valuation in a subsequent round (with a scheduled discount).

   Additionally, an arbitrary (and completely reasonable) "expectation of dilution" enables an administrator to bypass any limitations (i.e. >10%) on the equity stake it may claim as fair.

5. The independent auditing of these arrangements needs to be truly independent, which will be difficult as the Office of Patenting and Licensing typically reports to the OVCR, which reports to the Chancellor. Moreover, the revenues generated from licensing become discretionary funding for the Chancellor.

Faculty Welfare

April 13, 2015 1:48 PM

While the Faculty Welfare Committee (FWC) is supportive of this initiative, it was concerned that other faculty, not part of this program, would be displaced. Therefore, it is important that "access" for all faculty be protected and that the campus is conscious of any adverse effects on other faculty and their research pursuits. In addition, the FWC requests that there be a meaningful 5-year system-wide review of this program to determine its cost-effectiveness and actual benefit to the University. Detailed data, such as financials, space, usage, etc., should be collected from the program onset in order for the Academic Senate to fairly evaluate this program in the future.

Graduate Council

April 29, 2015 2:10 PM

Response continued on next page.

UC DAVIS: ACADEMIC SENATE
GRADUATE COUNCIL

April 29, 2015

RFC: AFS – Equity in Return for Access to University Facilities and/or Services

The Graduate Council, based on a memo from its APD Committee, forwards their recommendations for the aforementioned RFC.

The Academic Planning and Development (APD) Committee met on April 7, 2015, and considered the proposal for equity in commercial entities in return for access to campus facilities. APD identified both positive aspects and negative concerns.

Graduate education could be enhanced by partnership with start-up companies, including those initiated by graduate student entrepreneurs and their mentor faculty. There would also be a potential for increased internship and permanent job opportunities, so the trading of equity in those companies for usage of university resources could create a positive outcome.

However, serious concerns were raised that the University's academic independence could be compromised with the acquisition of equity in such companies. It is entirely possible that at times, the University's financial interests linked to such equity could conflict with its primary mission of academic freedom for faculty and students. For example, if a company with whom the University had acquired significant equity marketed a product with claimed attributes, and subsequent independent academic discoveries invalidated these claims, the University's financial interests might align with pressure to suppress the new academic information that would decrease the equity value. In a similar manner, there could be pressure financially to exaggerate the utility of a product or service developed by such companies, when a more objective academic study would find only limited utility or none at all.

Sincerely,

Kyaw Tha Paw U, Chair
Graduate Council

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C: Gina Anderson, Academic Senate Executive Director

Planning & Budget

April 29, 2015 5:18 PM

Response continued on next page.

CPB has reviewed the pilot program regarding Equity in Return for Access to University Facilities and/or Services (AFS). The majority of CPB members are in broad support of the program. If this program works as intended, it would result in a true win-win for all concerned. CPB also recognizes that this program grows out of a longstanding arrangement by which the University has licensed technology. Furthermore, CPB knows that there are many related programs at many other universities. In addition, the proposal is clear and addresses all of the major areas of possible concern, particularly conflicts of interest. Finally, CPB understands that this is a pilot program and thus is specifically designed to be a test case.

Nevertheless, CPB does have some questions and concerns:

- This project is in some sense based on a theory about the needs of startups. CPB understands the general reason why they might need the help this program can provide, but is there academic or other evidence that startups require these services?
- Another way to approach this first question is: how have the incubators at other campuses – and other universities, if any – fared?
- To the extent there is information out there, it is likely not all of equal value, and so which experts, at UC or elsewhere, have been consulted about the design of our program?
- The various legal rules implicated by this program are not only complicated, but they are in some cases cumulative. Both aspects of the rules can be a problem. Take the rules concerning private use of facilities financed with tax-exempt bonds. Will the campus representative estimating private use be a bond lawyer or consulting a bond lawyer? If not, how can we be certain the estimates are sound? If so, then this might be a considerable expense.   Also, to the extent that a single bond issue might be used to fund many projects on many campuses, is there a system to track the cumulative use? If so, this also seems like it could be a significant expense – assuming that the program is successful.
- At UC Davis we have lots of conflicts around space. What is our plan for providing space to these startups and how should we manage conflicts with other priorities?
- In general, CPB also wonders to what extent the proposed rules about conflicts of interest are “state of the art.” The committee is not suggesting otherwise, but, for instance, a seemingly unrelated question about the use of a lab might in fact pose a conflict with making space available to a startup. Does there need to be training? A campus conflict officer?
- Has student participation been considered? To be sure, the startups are business enterprises first, but, given that, for instance, we have business and law students who would benefit from experience with a startup, is there any way that some educational component can be incorporated?

Research

April 30, 2015 2:35 PM

Response continued on next page.

AFS - Equity in Return for Access to University Facilities and/or Services

COR discussed the AFS – Equity in Return for Access to University Facilities and/or Services proposal. Although the committee agrees that such a service could be valuable to the campus; several members expressed the following concerns:

- Receiving equity in a company could be risky- would it be better to just receive payment? How can we truly know which companies have less risk without enormous training and experience? The document states “Note that each participating campus and the Laboratory is expected to designate a DCM who has the relevant experience with and knowledge of startup equity transactions, complex financial instruments and University policy so as to be able to develop its own procedures by ways of standard templates …” Is such experience and knowledge available to us?

- There are 5 areas of assistance for startups. The letter focuses on just the "incubation" part of things. It talks about the DRIVE program in return for equity, which is only one of the 5 areas. There is a much bigger question here that has not been touched on in the documents: How are they managing the conflict of interest with UC Davis? To be sympathetic to faculty members attempting this: They're offering "blurred services". What is the "space" offered? Is it the researcher's lab space? The same lab? A new lab? Do they need two separate computers? Are there guidelines to relieve the stress of faculty wanting to do things correctly? It is not even clear if meetings and other activities can be done on campus. How do you reconcile the conflict of interest? Startups are fairly all consuming; what is the tradeoff for teaching? Mentoring? Is that a conflict of interest? Is there relief offered for that otherwise 100% commitment?

- Given long-standing faculty concerns about how slow the Contracts and Grants process is; how some faculty have literally lost contracts with companies due to slow response, are we as a campus ready to support such a program?

- The document states “For example, University inventions should be made available for licensing to appropriate companies and should not automatically be made exclusively available to Companies in which the University has taken Equity under this pilot.” Are there exceptions to this where exclusive licenses would occur? That would seem problematic.

- Exactly what is the “A campus-designated conflict of interest committee” in terms of faculty, staff, administration, students, and who designates it?

- This statement seems vague: The Campus or Laboratory’s subsequent use and distribution of its portion of any cash proceeds shall be handled in accordance with the schedules, formulas, and practices established by the Campus or Laboratory. There is no timeline or clear responsibility.

- The operational considerations appear enormous to me. UC resources must be protected for the current benefit of UC faculty and students. How can we protect them against overspending or mis-use, keeping them available and in good functioning order? Equity may not be available, especially if it is a failing start-up, to pay to repair or replace equipment and then the UC Davis unit incurs a financial cost.

Although the document reports that the President will analyze the program after 3 years, there are no guidelines or metrics as to what would be considered success. Again, how will real and potential cost to UC faculty and students be quantified and guarded against?