STANFORD BUSINESS GRADUATE SCHOOL OF

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MED DEVICE SYSTEMS, INC.

Andrew, Robert, and Ellen sat in together on a Zoom call, discussing the plans for their new company Med Device Systems, Inc. (MDSI). It was March 15, 2020, and the group had been actively working towards the start-up for several months. Now, things seemed to be coming together, but there were still many issues to be dealt with. They hoped that tonight's meeting would help them make these important decisions.

BACKGROUND

Andrew Reed, Ellen Carlton and Robert Baker were all friends who intended to leave their current employment and form a new business. Reed, Carlton, and Baker had been classmates in their undergraduate days at Stanford University. After their graduation, they each took different paths, but met in late 2019 to start a new business. Their business, organized as a Delaware corporation under the name Med Device Systems, Inc. (MDSI), was formed to develop, manufacture, and market an innovative and low-cost inhalator(1) to be marketed and sold in the USA and, eventually, internationally.

Reed received his MBA in 2013 and had been enormously successful working at a large manufacturer of scientific equipment. In only a few years, he rose to become assistant to the chief financial officer and had been recently promoted to become their youngest chief financial officer ever. Carlton graduated from Stanford with a bachelor's degree in chemical engineering and then received her M.D. from UCSF. After her residency, she decided to pursue her love for developing medical devices and spent two years in the New Products Division of Guidant Corporation. Baker received a master's degree in sociology, spent three years as a district salesperson for General Electric, and then spent four years as a vice president of sales and marketing for a small manufacturer of low-tech medical instruments with sales offices in San Francisco, Boston and Shanghai.

The group's first serious organizational meeting took place in December 2019. Most of the meeting was spent talking about their visions for the company and what they hoped to achieve. They became increasingly excited as they realized that they did indeed share common ambitions for the firm and their skills were complementary. Near the conclusion of the meeting, Reed mentioned that he would like the three of them to be "equal partners" and that they should share the ownership of the company equally. Baker and Carlton agreed without discussion and they ended the meeting.

Since early January 2020, Reed had been actively working (night and weekends) on the development of a business plan for MDSI. While Reed's experience in establishing new companies was limited, he had studied that topic in business school and kept up with new venture activities in the business press. As a result of his efforts, he had prepared a preliminary draft of a business plan, contacted two friends in the venture capital business, talked with medical device expert and GSB lecturer Howie Rosen, and spoken with a regional investment banker who knew healthcare investors. In addition, he had discussed the proposed business venture with his father-in-law, who was the president of a medium-sized bank in Minneapolis. His two venture capital friends were Lambert Woo, a general partner of International Ventures Partners (IVP), and Anthony Wallace, a general partner of Medical Venture Associates (MVA). The local investment banker was Pincus, Greene & Co.

Carleton had a gift for designing innovative medical devices and had a well-equipped development shop in the basement of her home. For two years Carleton had worked evenings and weekends on the development of a low-cost portable inhalator that would replace many mechanical functions of current inhalators with advanced and unique software and electronics. This inhalator would not only greatly reduce the cost, but it also made the system easier to use by medical professionals. In view of the COVAD-19 pandemic disease that had overwhelmed the world starting in January 2020, the timing could not be better to introduce a new inhalator into the global market. On January 15, 2020, Carleton, after consulting with her personal patent attorney, filed a patent application for her invention.

In addition, Carleton had identified three friends at Guidant who wanted to leave that company and join MDSI. These three individuals were engaged in engineering and development work in Guidant's New Products Division. They were well compensated and did not want to leave Guidant until MDSI had raised its initial capital and was in a position to compensate them with a competitive salary and equity participation.

Baker had just completed a very successful year with his employer and was awarded a substantial bonus for organizing a new marketing approach for two recently introduced products. Baker's immediate boss, however, was fifty years old, and Baker believed it was unlikely that he would replace his boss in the near future. He was eager to leave and try his hand at running a marketing organization for a medical devices company with an innovative product.

THE MARCH 15 MEETING

After their first meeting in late 2019, Reed, Baker and Carlton had several meetings at Reed's home to plan the formation and financing of their new venture. At the Zoom call on March 15, 2020, the preliminary business plan and financing alternatives were reviewed.

Relationship with Former Employers

Reed reported that he had resigned his position with his former employer effective March 1, 2020. Carlton indicated her plans to resign April 1, 2020. Baker expressed his desire to remain with his employer until September 1, 2020, at which time he would resign. Baker's partner was recovering from a major surgery and he desired both the insurance coverage and his salary to be intact until his partner was fully recovered.

Reed reported that he met twice with Woo at IVP and once with Wallace at MVA to discuss MDSI and to determine whether they had any interest in investing. In the meantime, over Christmas, he had several discussions with his father-in-law, who indicated that he and several of his friends and banking clients would like the opportunity to invest in MDSI. They believed that innovative medical devices, and the inhalator product in particular, had enormous market potential.

Reed prepared an extensive agenda for the March 15 meeting, including a summary of the tentative financing proposals submitted by IVP, MVA, his father-in-law, and Pincus, Greene. The March 15 Zoom call was held to consider the advantages and disadvantages of the various alternatives and how they might be modified.

It was agreed that Carlton's three friends at Guidant would join their next meeting to discuss their future roles in MDSI, although none of them were expected to join MDSI until the initial financing was completed.

At the meeting, Carlton exhibited considerable uneasiness about leaving Guidant. She had heard that Guidant had a very formal "exit" procedure which she would undergo when she announced her resignation. She reported that she had signed a standard Guidant form of invention and nondisclosure agreement and there might be some question as to the rights of ownership in her invention and the patent application. Reed reported that he had no contracts with his employer. Baker, on the other hand, had signed an agreement which prohibited him from soliciting or otherwise inducing any employees of his employer from leaving the company for other employment. After further discussion, it was decided that Reed would select, to represent MDSI, employment and intellectual property attorneys who, as a first order of business, would review each of their obligations to their former and current employers and the possible legal obstacles to the commencement of the new business.

Initial "Pre-Seed" Capital

They then discussed the need for some initial funds that would be required to retain attorneys and pay the initial start-up expenses which would be incurred before the financing was consummated. Reed had been making a sizable salary for the last few years and had been able to save a good portion of it. Carlton, on the other hand, had no money to contribute to the new venture, but was willing to contribute her invention and patent application to MDSI. Carlton also asked whether it would be proper for her to seek a royalty from MDSI in exchange for the transfer of all rights to her invention. Baker indicated that he could only contribute $1,000 to the venture at this time.

The three decided that the company needed $25,000 in initial capital. Since the other two were unable to contribute significantly, Reed offered to put in the $25,000 to the venture out of his personal funds.

Ownership

Next, Reed wanted to revisit the question of equity split among the founding team. He apologized for bringing this up again, but he had reconsidered his position based on conversations he had with his friends in the venture capital industry. At the first meeting, he explained, he had been naive and now, would like to propose that the equity distribution for Reed, Baker, and Carlton should be 50%, 25%, 25% respectively. He argued that he had considerably more relevant business experience and he was contributing all the initial capital. According to his venture capital friends, he stressed, this was a very fair arrangement.

Baker and Carlton objected immediately. First, they felt that this split did not adequately value their contributions of technology and commitment. Also, they both thought it best for the working relationship that they all be equal partners. If the equity split was unequal as Reed proposed, Baker and Carlton would feel like second-class citizens.

However, Baker and Carlton did want to compensate Reed for his $25,000 investment. Carlton proposed that Reed could loan the money to the company until the initial financing was complete. Then, the company could pay him back and all the founders could still have equal equity positions. Reed said that he would have to think about that, so they postponed the discussion till later.

“Sweat Equity”

At that point, Baker shifted the discussion to his personal arrangements with the new company. Baker indicated that he wanted a two-year employment contract with fixed minimum salary and an annual bonus award if he met certain agreed-upon goals. Reed stated that he was not interested in an employment agreement, but he did want to be sure that each founder remained with MDSI for at least five years. A means of securing that commitment was a “golden handcuff’ agreement. He was fearful that one of the founders might leave the company in a year or so, and walk away with his or her share of common stock. He suggested that each founder agree that his or her stock would be forfeited if he or she did not remain in the employment of MDSI for five years. Carlton disagreed, but was willing to agree on a compromise approach: a portion of the stock (for example 20%) would vest and be nonforfeitable for each year during which a founder remained in the employment of MDSI. Reed thought that was a reasonable compromise.

Class Discussion

1. If you were one of the VCs or the banker considering investing in MDSI, does the idea behind MDSI sound solid? What further information would you want before you moved forward on an investment? Provide a list of key pieces of information you would like to review.

2. How do you think the partnership deal between the three founders of MDSI is coming together? Suggest improvements to their process to facilitate a win-win-win negotiation.

3. For class participation, we interrupt our Zoom call and divide the students into teams in a few breakout rooms for 20 minutes. We will ask the teams to (1) provide recommendations for ownership positions for each of the founders and (2) any other considerations your team recommends to get to a fair and long-lasting agreement. We will reconvene and have the teams share their conclusions. Creativity is encouraged!