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The Importance of Venture Capital in Promoting Entrepreneurship - Discussion Following the Remarks of Brad D. Chernjak and Cathy Horton-Panzica

Discussion

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up as a global industry. That's where Canada can make a mark. I mean, Canada can make a mark by using its asset base to petition for venture funds, and maybe that's why this is skewed.

MR. SANDLER: Part of the reason why it is skewed is because there is no breakdown between labor-sponsored funds and private venture funds.⁸¹ I think the labor-sponsored funds return certain rollups.

MR. CHERNIAK: Yeah, absolutely. I did sort of a rough calculation on the fly when I was in the business and, absolutely, the overall return for the labor-sponsored returns is fairly dismal.⁸²

MR. SANDLER: Negative in many cases.

MR. CHERNIAK: Yeah. In some cases, they were specially focused funds that had shackles that American funds or other sort of generalist venture capital funds didn't have.⁸³ The one, which I worked with, their charter was to invest in small, capital intensive, labor intensive businesses in the province of Ontario. And that was right around the time that the Indian and Chinese offshore manufacturing assault was hitting its peak. You did the best you could, but when your focus is that specialized and tragically flawed, frankly, let's just say that chunk of capital didn't do very well.

MR. SANDLER: That's labor.

MR. CHERNIAK: Yeah.

DISCUSSION FOLLOWING THE REMARKS OF BRAD D. CHERNIAK AND CATHY HORTON-PANZICA

MR. SANDLER: Aren't there a couple of questions or comments?

DR. KING: Yeah. I had a question. It seems to me the ultimate source of success or failure is technology, and I would like to ask Cathy and also Brad about technology reviews.

Do you have somebody on your staff – or do you have a group that reviews it before you take the plunge or before you take – or do take the entrepreneur's word for it?

MS. HORTON-PANZICA: It is interesting because my partner, he and I between us probably have 40 years of tech or technology experience. So we actually are very deep technologists. Between us, he covers very much

⁸¹ See generally Cumming, *supra* note 77 (arguing that labor sponsored funds "have become the dominant source of venture capital" in fact, "government tax subsidies to LSVCCs may crowd out private venture investment.").

⁸² *Id.* ("[E]vidence suggests LSVCCs are inefficient investment vehicles, charging high fees and yielding disappointing results: very few funds generate positive returns.").

⁸³ *Id.* (explaining that statutory constraints on labor-sponsored venture funds "include limits on the geographical range of investment opportunities to within the sponsoring jurisdiction, [and] constraints on the size and nature of investment in any given entrepreneurial company.").

healthcare and bio and the alternative energy field, and I cover really systems.

I worked for a leading vendor for about ten years as a lead outside counsel, and they taught me everything to do with systems. I understand everything having to do with information technology and how systems can be improved and driven. Between us we can really hit the analytics and hit the patent world and really understand there is a place.

What is the patent world, and how do you analyze it? It is just like real estate: I think the easiest way to explain it for me as an investor is that it is just virtual real estate, and there is only so much of it.⁸⁴

And do they have a parcel that is going to be worth something, or is it a parcel that is not situated well and doesn't have any beach view and doesn't have any sand? What are the amenities, and what is the possibility of this little piece of real estate they own, which is called intellectual property?

If you are blessed enough to be able to look at that intellectual property and say, "Oh, my gosh, I want to buy that," I think the people that understand intellectual property are just like real estate moguls. They get the property they are looking at, and they understand what it can be.

If for some reason I don't have the skill set in-house to determine whether that's a good investment because it is something that is really a specialty area, then, yes, I have outside people I retain. They will scrub it down for me and give me a response.

MR. CHERNIAK: Yeah. In Canada, it can be very difficult just given the size and lack of depth of investments in any specific vertical to have in-house expertise. For technology-related deals or IP-related deals, you tend to bring in a third party. However, you tend to lose something with that method.

They issue a report, and then it is not quite the same thing as having the sort of in-house talent, fully motivated to be right.⁸⁵ And that is what has driven so much of the specialization in the U.S., of funds that bring on software developers and bring in veteran entrepreneurs from specific companies that fit with their charter.⁸⁶

⁸⁴ Mario W. Cardullo, *Intellectual Property – The Basis for Venture Capital Investments*, WORLD INTELLECTUAL PROPERTY ORGANIZATION, available at http://www.wipo.int/export/sites/www/sme/en/documents/pdf/venture_capital_investments.pdf (explaining that venture capitalists should carefully analyze the economic value of a patent, a trademark, software, a domain name, and any intellectual property in order to determine when and whether to invest).

⁸⁵ See generally, Canadian Venture Capital Activity: An Analysis of Trends and Gaps (1996-2002), SME Financing Data Initiative, http://strategis.ic.gc.ca/epic/site/sme_fdi-prf_pme.nsf/en/01182e.html (last visited Nov. 23, 2007) (arguing that in order for the Canadian venture capital industry to grow, the country needs skilled and experienced VC fund managers that can evaluate and identify potential high growth investment opportunities on their own).

⁸⁶ See, e.g., Paul Gompers et al., *Venture Capital Investment Cycles: The Role of*

You have companies in the U.S. who just do enterprise software or just marketing applications. And they bring in guys who have run those kind of companies and can assess the technology. In Canada, it is much more difficult. You are forced by the nature of the market to be more of a generalist.⁸⁷

MR. DELAY: I am an attorney. When small businesses are setup somewhere in the United States, counsel will tell the ambitious founder that they have to remember that a new business could take twice as much money and five times as much time as they originally estimated, and they'll discuss with the attorney at that time about reaching a profit.⁸⁸ They try to curb the enthusiasm of the curve and let them know it will take longer and twice as much money.

In your experience, is that still a good rule-of-thumb in the American experience with the VC's capital? Is that a good rule-of-thumb?

MR. CHERNIAK: Absolutely. It is one of the key reasons why we started Sapient Capital. Probably the biggest chunk of time we spend with a client is to model in detail what the business is going to look like and not just kind of blue sky, not just sort of soft and meaningless numbers. We nail it down to a single employee and here we also apply current market principles as to what that person is going to cost you.⁸⁹

So we spend a lot of time saying, "What do you really need to target the market you are going after?" and it is a detailed exercise because it often surprises them in terms of how much money they need. We help determine and prioritize strategic goals. We can help by using our experience to tell them how realistic is it to achieve, say, four of these goals within six months, or whatever.

You probably have to spread them over a longer period of time, be more conservative in terms of what it is going to cost you and what your sales ramp-up is going to be.⁹⁰

Experience and Specialization 24 (2004), available at <http://www.law.upenn.edu/ile/SeminarPapers/Gompers%2011.11.04.pdf>.

⁸⁷ Canadian Venture Capital Activity, *supra* note 85.

⁸⁸ See generally, Jeff Wuorio, *7 Good Reasons to Call a Lawyer*, MICROSOFT SMALL BUSINESS CTR., http://www.microsoft.com/smallbusiness/resources/finance/legal_expenses/7_good_reasons_to_call_a_lawyer.aspx (last visited Nov. 8, 2007) (explaining that attorneys are essential to any small business operation in reviewing the business structure, evaluating exit strategies and managing finances).

⁸⁹ *Id.*

⁹⁰ See generally Asheesh Advani, *How to Forecast Revenue and Growth*, ENTREPRENEUR, MAR. 7, 2005, <http://www.entrepreneur.com/money/financing/startupfinancingcolumnist/asheeshadvani/article76418.html> (explaining the need for business owners to "[f]orecast revenues using both a conservative case and an aggressive case.").

MS. HORTON-PANZICA: I think every investment is different. I like it when the venture capital world tailors investments to the circumstances. The investment we made in New York – and we were out in six months – was tragic. I wanted to be in that deal. It just depends, if the real estate is that hot, somebody is going to want it. I think about it like property. If you have got that corner lot sitting on the beach, somebody is going to buy it real fast. If you have one that is further down and a little bit back from the beach, it could be harder to sell.

Certainly, my specialty is technology companies. So I think it is a lot like that, and you have to look at how soon that property is going to be wanted in the marketplace. If you think about it like that, and analyze the IP like that, you actually can predict cash flow pretty well, and you can predict time to market pretty well.⁹¹ Think about it like real estate.

MR. JEFFERS: I had a question. You have talked a lot about getting into deals and about working with your entrepreneurs. What happens when things go south and you have a failure on your hands? One among you is a priest. You know, is there a possibility of absolution?

I am just wondering if either of you, in your experience, follows a sort of template where you perhaps sit down, and you conduct a sort of autopsy of what went wrong.

Are there occasions when you, perhaps, will look at the individual and say this just didn't work for one or other reasons? It doesn't mean that you are a bad person. In fact, you may be a very good person, and, maybe in the future we will deal with you again.

Have you come across situations like that?

MR. CHERNIAK: Yeah. From my own experience, I find that I have seen several that turned into restructurings and ultimately disasters. And really it is a slow motion train wreck. It doesn't happen so quickly that you don't see it coming and you can't talk with the entrepreneur in the trenches over weeks or months. So you tend to see it coming. I think it depends on how you deal with it as you are going through it.

There is no need for a forensic post-event assessment, because you have gone through it live in terms of making sure everyone understands there is no fault here, that everyone has tried their best, but that in some cases you are dealing with exogenous factors, like the India/China manufacturing phenomenon, that simply eviscerates domestic manufacturers on cost. It is not that the failed entrepreneur is an idiot. And you just make that clear during the process.

MS. HORTON-PANZICA: That's a really interesting question because I have had a couple of entrepreneurs who, because they are so disappointed in

⁹¹ See generally Cardullo, *supra* note 84.

themselves, they just sort of exude that across everybody that has anything to do with them. And I tend to just take it.

There are a couple of young chaps I was thinking about in my London investment days where I sat down and really tried to help them see why they failed and why we failed. One in particular I am thinking about just didn't get the market position right. Today I am a different investor.

I think I very rarely just invest money to invest money anymore because I find that I can't effect when a business is getting into trouble. I had a business a couple weeks ago that was in trouble. They just weren't getting customers that they needed to get in the door. I just gave about two weeks of my time doing gorilla marketing. It is cash flowing as of last week. I mean, I just did it and gave my skill set. One of my skill sets happens to be customer attention and attraction, and I just went in and did it. If I didn't have that skill set in a business that I invested, we would get it. We would fix it.

I don't let things that I have invested in or groups I have invested in that I am responsible for get there. But you have to make investments where your investees will let you do that. They understand and respect you enough that they want you to come in and help.

I said, look, I have been in London. I came back. You are in trouble. You don't have enough feet through the door. You are in trouble. And I am just going to gorilla the market. What are you going to do? We sent out 4,000 flyers for this business and, you know, today it is cash flowing.

It was just simple street market. They were doing all this high-level stuff, radio, TV – expensive stuff. I said, "Look, what happened to shoe leather?" We corrected it.

I am into making investments where I can make a difference. I think different venture people are different. They want to give it time or they don't. Some of them are just hands off – they put in the money and think that they can walk away and not put a lot in it. I mean, the venture money is really, really important. Certainly, if you want the money of people I represent and people I work with, it would be to say, you know, it is an alternative, and we don't get to that point. We would intervene.

DR. KING: Dan, we are getting near the noon hour.

MR. SANDLER: Yeah. Is there a question right behind you?

MS. HORTON-PANZICA: It is also kind of nice because it is almost lunch.

MR. SANDLER: Do you have one more question?

MR. GROETZINGER: If you have an entrepreneur come to you with a great new idea, identified a niche market, looks like it will go but not terribly protective, being, in other words, it will be hard to patent it or trademark, whatever way you want to protect it – do you make up the fact that it is not so protectable by aggressive marketing, or does every investment you make

have to have some element that will prevent competitors from coming in and having significant barrier entry?

MS. HORTON-PANZICA: Are you asking me?

MR. GROETZINGER: Either.

MR. CHERNIAK: Yeah, I can answer that, or if you want to take it Cathy, please do.

MS. HORTON-PANZICA: I love intellectual property. I tend to look for stuff that I can see is going to make it because I can see the real estate. If it looks fun and exciting, I probably would get a bunch of people to put in some money and have a little fun with it, but it wouldn't be something that would turn me on.

I really love the world of intellectual property. I know we have that on the stage later, but I think intellectual property is incredibly exciting for venture capitalists. Why? If you understand the intellectual property, you can commercialize it.

If everything goes to hell-in-a-hand-basket, you still own the property, still own the corner with the beach view. You just didn't build a very nice house. So you tear down the house, and it is still the property, right? That's what I love, and that's what gets my boat floating, but you may have a different spin on that.

MR. CHERNIAK: I took a little bit of a different tack in the sense that you certainly want the intellectual property. I took the view that most businesses are really service business, and I go in it with the presumption that you are not going to be able to protect it, and that there may be, in a real practical sense, nothing to protect anyway. Companies had to constantly be innovating to stay ahead of the curve and spent too much time looking back protecting past initiatives rather than forward to the next initiative.

In that case, how well have you identified your customers, and what are you providing to them? And if you try like hell and you market like crazy and you do everything, you work as hard as you possibly can, can you defend that for any period of time? And if I see enough runway, I would probably do it because if you are successful in that regard, chances are you are going to be able to sell out to somebody that has more IP.

You become a tuck under to somebody else's technology in a sense. At the end of the day, as long as the business makes sense to me, that's the first order of defense and not the IP specifically, whether it is patented and what the prior art position is. That's a second level, but it is still critical and especially – I mean, I don't know what specific sector we are talking about. Also, it varies in terms of what type of business, but overall –

MS. HORTON-PANZICA: When I refer to intellectual property, I refer to intellectual property as a basket of intellectual capital. It is more than just a registered patent for me. I mean, is there something here that is protectable, that I can put up a fence on my property and keep you out?

MR. SANDLER: That's a good question that we can take up at 2:15 with the IP subject, but unfortunately, I think we have to draw this one to a close.

MR. UJCZO: Lunch will be held upstairs where we had dinner last evening for those of you that were here, but it is directly upstairs where we ate lunch yesterday.