Approved 2-7-90
Date

MINUTES OF THE SENATE COMMITTEE ON ECONOMIC DEVELOPMENT.

The meeting was called to order by Senator Dave Kerr at
Chairperson

8:00 a.m./~~p.m.~~ on February 1, 1990 in room 123-S of the Capitol.

All members were present except:
Senator Lana Oleen
Senator Wint Winter

Committee staff present:
Bill Edds, Revisor of Statutes' Office
Lynne Holt, Kansas Legislatie Research Dept.
Sue Pettet, Secretary to the Committee

Conferees appearing before the committee:
Rich Bailey, Dept. of Commerce
Larry High, Kansas Venture Capital, Inc.
Charles Becker, Campbell-Becker, Inc.
Boone Porter, Attorney for KTEC
Stan Gegen, Pres., Carmen Venture, Inc.

Chairman Kerr called the meeting to order. He stated that the Joint Interim Committee had recommended some refinements of S.B. 438, which was passed in 1986.

He introduced Rich Bailey, Venture Capital Specialist with the Kansas Dept. of Commerce. (Att. 1) He stated that the Department cannot support the passage of S.B. 438 in its present form. If a definition of "arms length" investment can be constructed that will not be detrimental to the venture capital process in Kansas, the Department could be supportive of S.B. 438 or similar legislation.

Larry High, Kansas Venture Capital, Inc. testified. He stated that he cannot support section 1(g) in its present form, concerning "arms length" investments by certified venture capital companies.

Charles Becker, of Campbell-Becker, Inc. testified. (Att. 2) He stated that they are unable to support the language in Section 1(g) as presently written. He stated that it would preclude any certified venture capital company from making any subsequent investments in a portfolio company. Al Hack, associate of Mr. Bailey, asked for an amendment regarding the privilege tax for insurance companies. He wanted the 25% tax credit for investing in a venture or seed capital fund to be usable against an insurance company's privilege tax. The proposed language change is Att. 2(a).

Boone Porter, attorney for KTEC testified. (Att. 3) He stated that he was opposed to portions of S.B. 438. He stated that he felt section (g) would inadvertently frustrate the ultimate purpose of the statute, which is to promote capital formation in Kansas. He said he felt the language would prohibit a certified Kansas Venture Capital Co. from making second or third round financings in a portfolio company investment. It would effectively cut off certified Kansas Venture Capital Companies from a large source of potential investors; namely private pension funds. He urged adoption of amendment proposed by Campbell-Becker, Inc.

Stan Gegen, Pres., Carmen Venture Inc. testified. (Att. 4) He stated that he also opposed language in S.B. 438. He felt that serious problems would be created for emerging companies seeking financing. He said the language, in present form restricts the normal flow of venture funding. He offered suggested language changes. (Att. 4(a). Meeting adjourned.

Unless specifically noted, the individual remarks recorded herein have not been transcribed verbatim. Individual remarks as reported herein have not been submitted to the individuals appearing before the committee for editing or corrections.

Date 2-1-90

VISITOR SHEET

(Please sign)

Name/Company	Name/Company
Stacie Cooper / KU	
Larry J. High KLVCI	
Bud Mears KDOC	
Ann Patterson KDOC	
D. WAYNE ZIMMERMAN KDOC	
Chuck Stones KBA	
MARK A. BURGHART / REVENUE	
H. Boone Porter / Lewis, Rice + Fingersh	
ALAN HACK / Campbell-Becker	
Charles A. Becker [Campbell-Becker]	
Rich Bailey KDOC	
Stan Gegen Carmen Ventures Inc	
Charles Warren	Kansas Inc.

TESTIMONY ON SB 438

Senate Committee on Economic Development

February 1, 1990

Thank you, Mr. Chairman, for the opportunity to testify before this committee concerning SB 438, which involves some "fine tuning" suggestions for the venture capital legislation. I am Rich Bailey, Venture Capital Specialist with the Kansas Department of Commerce, which is charged with administration of the venture capital programs. Before commenting on SB 438, I would like to briefly update this committee on the status of the state's venture capital system.

The program, to date, appears to be a very effective means of raising and keeping Kansas investment capital in Kansas. Currently, we have 13 venture capital companies and two local seed capital pools certified and making investments in businesses throughout the entire state. As of today, more than $25 million in private risk capital has been raised in the state, and this does not include current fund-raising efforts by Kansas Venture Capital, Inc. and the KTEC Ad Astra Seed Capital Fund. The actual amount of tax credits claimed by investors in certified funds is approximately $3 million according to the Department of Revenue.

Since our first fund was certified just over three years ago, venture and seed capital funds have made over 50 separate investments in Kansas companies totalling about $10.5 million. Approximately 60% of these investments have been early stage in nature --- about twice the national average. The estimate of jobs created or retained as reported by the certified companies totals 1,016, and investments have been made in businesses in the following Kansas communities:

> Wichita, Lawrence, Perry, Topeka, Glen Elder, Baxter Springs, Overland Park, Olathe, Hutchinson, Lenexa, Hoisington, Lyons, Fairway, McPherson, Chapman, Chanute, Silver Lake, Arlington, Kansas City, Cawker City, and Great Bend.

Turning to SB 438 now, the Department of Commerce proposed and supports the revised time guidelines for venture capital company investment. We feel the present guidelines are very lenient, and this recommendation would simply insure that certified funds keep their investment money moving. Consultation with several of our certified funds has assured us that these new investment guidelines would not appear to be overly restrictive.

The Department of Commerce, however, cannot support Section 1(g) <u>in its present form</u> which concerns "arms length" investments by certified venture capital companies. We agree with the amendment's intent to prohibit venture capital company "self dealing", where a fund invests in a company which the principals of the fund already own.

However, in its present form, this amendment would be extremely detrimental to the Kansas venture capital system, as it would disallow second and third round investments in companies in which a fund has already invested. This could easily cause many businesses to fail if that additional capital injection is not available to further nurture a company after the initial investment. It is very common for venture funds to make subsequent investments in a company in which they initially invested, especially in the case of start-up and early stage businesses.

In another case, this proposed amendment would be especially harmful to Kansas Venture Capital, Inc. in that most of KVCI's stockholders are Kansas banks. Consequently, KVCI would not be able to invest in any company where one of its bank stockholders already had a debt instrument in place. This would bar KVCI from any "expansion" or "turnaround" financing in a company where further conventional financing might not be possible.

In yet another case, this amendment would prohibit a certified fund from making an investment in a company where one of the fund's investors had made even a small, personal investment. This would effectively discourage investors in certified funds from making personal investments in deserving companies for fear of jeopardizing a potential future investment by the certified fund.

It is for these reasons and probably many more financing scenarios that we cannot recommend passage of SB 438 in its present form. If an administrable definition of "arms length" investment can be constructed that will not be detrimental to the venture capital process in Kansas, then the Department of Commerce would be supportive of this or similar legislation.

TESTIMONY TO MEMBERS OF THE SENATE ECONOMIC DEVELOPMENT COMMITTEE

THE HONORABLE DAVID KERR, CHAIRMAN

FEBRUARY 1, 1990

Good morning. My name is Charles A. Becker, Executive Vice President of Campbell-Becker, Inc. of Lawrence, Kansas. Thank you for giving us the opportunity to address the committee concerning Senate Bill #438. With me is Alan G. Hack, Director of Development for Campbell-Becker, Inc.

In regard to the proposed changes to the timing of investments for a Kansas venture capital company to maintain its certification, Section 1.(1), we have no discussion comments and feel that this timetable is reasonable.

Regarding Section 1.(e), we would like to reemphasize our support for service industry being included as a use of invested funds. The service industry is the fastest growing segment of the Kansas economy, as well as the economy of the country as a whole. In our opinion, the service industry is creating jobs which have significant, positive economic impact on the Kansas economy. However, we also recognize that it is difficult for the Department of Commerce to administer this particular addition to the use of invested funds because of the possible complexity of the definition of service industry. We would like it known that we would be happy to assist the Department of Commerce in developing an administratable definition should this addition occur. We recognize quite clearly that the inclusion of service industry should not create an unworkable leviathan for the Department of Commerce.

We have carefully considered the proposed language in Section 1.(g). We fully recognize and agree with the intent of the language to prevent "self-serving" on the part of certified venture capital companies and investors. However, we have serious difficulty with the language as it is presently written. In our opinion, it would preclude any certified venture capital companies from making follow-on or any subsequent investments in a portfolio company. As you are well aware, as an early stage company begins its growth and development into a thriving, successful enterprise, it takes additional monies and financing. Section 1.(g) as written would limit these additional rounds of funding to outside investors which may not exist or be available. The small business concern needs to rely on investors who are well acquainted with the company, its history, products and needs and who have a vested interest in its success.

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It should also be understood that additional rounds of funding may include new investors, but the language as proposed precludes the venture capital company and very importantly its investors from making follow-on investments with deserving, qualified companies. We would like to point out that one of the major reasons for an investor to put monies into a certified venture capital company is to gain exposure to existing or new companies that they may be willing to support through additional personal or corporate investments.

As mentioned above, this circumstance not only allows for additional funding opportunities but these monies come from sources which are committed to the success of the small business concern and the venture capital company.

As an alternative to the the proposed language, we have developed what we think is a workable, reasonable alternative; however, we would like to emphasize that it is only a suggestion, a point of departure for a satisfactory solution of the issue.

Thank you very much for your attention and your consideration of these important issues.

SENATE BILL NO. 438

SECTION 1.(g)

Suggested Language Change

"A certified Kansas venture capital company shall not own an equity interest in or a debt instrument of a business in which an investor in the certified venture capital company already owns a controlling interest."

STATEMENT OF H. BOONE PORTER, III

TO THE

JOINT COMMITTEE ON ECONOMIC DEVELOPMENT

REGARDING SENATE BILL NO. 438

February 1, 1990

Good morning, Mr. Chairman and members of the Committee. My name is Boone Porter and I am appearing today in opposition to portions of Senate Bill No. 438.

For those of you who do not know me, I am a resident of Prairie Village, Kansas and a partner of the law firm of Lewis, Rice & Fingersh in Overland Park, Kansas. Approximately 50% of my time is devoted to representing clients (including Kansas Technology Enterprise Corporation) involved in various facets of the risk capital business. I have attached to this statement a resume which gives a detailed description of my firm's venture capital practice, as well as pertinent biographical information.

I am fully supportive of this committee's desire to prevent any abuses of the tax credits created by the Kansas Venture Capital Company Act. However, I am troubled by that portion of S.B. 438 which would add a new subsection (g) to K.S.A. 1989 Supp. 74-8304. I believe the text of S.B. 438 will inadvertently frustrate the ultimate purpose of the statute, namely, promoting capital formation in Kansas.

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2-1-90 Att. 3

I have reached that conclusion because the proposed text of S.B. 438 will create unintended legal barriers which will prevent otherwise willing investors from investing in certified Kansas venture capital companies. For example:

1. The proposed text of S.B. 438 would expressly prohibit a certified Kansas Venture Capital Company from making second or third round financings in a portfolio company investment, even if such later stage financings were desirable to support the portfolio company's continued growth and expansion. No venture fund manager will seek to certify his fund as a Kansas Venture Capital Company if, as a result of certification, the fund is statutorily prohibited from making further investments in its portfolio companies.

2. The proposed text would effectively cut off certified Kansas Venture Capital Companies from one of their largest sources of potential investors, private pension funds subject to Title I of the Employees Retirement Income Security Act of 1974. Pension funds are collectively one of the largest groups of investors in venture capital funds. However, a private pension fund will not invest in a venture capital fund unless the investment satisfies the requirements of the Department of Labor's so-called "plan asset safe harbor regulation." 29 C.F.R. §2510.3-101, 51 F.R. 41262 (Nov. 13, 1986).

The Department of Labor has recently ruled in Opinion 89-15 A (August 3, 1989) that an investment in a venture fund does not satisfy the DOL Regulation unless the fund already has a portfolio investment in a company in which the fund has so-called

"management rights" prior to the time of the pension plan's investment in the venture fund. To meet this requirement, it is necessary for a sponsor of a new venture fund to cause the fund to acquire such an investment prior to soliciting investors. However, any venture fund engaged in such a practice, which is in no way abusive or improper, would be precluded from obtaining certification under the Kansas Venture Capital Company Act.

It is unrealistic to think investors will purchase interests in venture funds which are geographically focused on Kansas and limited to industries specified by the Kansas Venture Capital Company Act without the receiving tax credits as an incentive for restricting the fund's investment horizons. Venture funds may be organized with the expectation that they will not be certified under the Kansas Venture Capital Company Act, but it is a sure bet such funds will not invest predominately in Kansas companies. Kansas does not have in place at the present time the conditions prevailing in other parts of the country where most venture capital transactions traditionally occur.

In order that the Committee meet its stated objective of preventing possible abuses, but without destroying, as a practical matter, the ability of venture funds to obtain certification under the Kansas Venture Capital Company Act, I urge you to adopt the alternative amendment suggested by Charles Becker earlier this morning. I believe his proposal will satify all parties.

Thank you.

STAN GEGEN

PRESIDENT

CARMEN VENTURE INC.

Testimony to the Committee on Economic Development

February 1, 1990

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I am Stan Gegen, President of Carmen Venture Inc. I along with two other principals, Tom Devlin and Bob Taylor, manage 3 certified Venture funds totaling $5.3 million.

We oppose the proposed changes to Senate Bill 74-8307 in its current form.

The proposed language states, " Investors in a Kansas Venture Capital Company shall not own an equity interest in, or a debt instrument of a business in which the Venture Capital Company has invested funds."

With this language, serious problems would be created for emerging companies seeking financing. I understand that the purpose of this language is to prevent investors in a venture fund from totally financing their own deals. However, this language, in present form, restricts the normal flow of venture funding.

The problems are as follows:

I. This would prevent investors of a venture fund from investing simultaneously in a business when additional funds are needed. In closely held funds, investors jointly make decisions in investments. This group may decide for example, to invest $150,000 when $200,000 is needed for the project. One or more of the individual investors may like the deal better

than the others and decide to fund the additional $50,000 themselves. The investment is made without the tax credit and with full knowledge by the other investors in the fund. This should be encouraged rather than discouraged.

We have recently invested in Flex Industries, a start-up company engaged in the manufacture and distribution of a unique barbecue grill. Devlin Venture Partners invested $120,000, when $200,000 was needed. Due to this pending legislation, no individual investors put up any additional funds, even though 2 of the partners were willing to do so.

II. Most of the funds have between $1.5 million and $2.0 of capital. This means that the maximum a fund can invest in any company is $300-$400,000, with the 20% cap. Many of the attractive projects require much more capital than any fund can invest, if they are successful. Why should we discourage the individual investors from investing additional capital in eligible activities, when no tax credit is given up. That doesn't make sense.

In no situation have the funds of which I am affiliated made an investment where any of our owners had a prior investment. However, we have made simultaneous investments and it is our

intention to invest additional funds individually over what the funds can or are willing to invest.

I have struggled to draft language which addresses perceived self-dealing and have had great difficulty trying to cover every situation. However, I recommend the attached changes, shown as (Exhibit 1), which generally reflect the Internal Revenue Service Guideline for related persons.

Other structural problems exist when very specific rules are developed. For example, venture funds cannot be shareholders of a Sub-S corporation. In many start-up situations, the Sub-S corporation is the best business structure. In these cases, it is appropriate for the fund to make a subordinated debt investment, and individuals own part of the business being funded. In this way the venture investors can exercise voting control, if desirable.

I applaud this committee's efforts to keep the venture capital program on target. We believe this program has created real jobs and will continue to benefit Kansas if the rules can remain constant and reasonable.

I appreciate the opportunity to meet with you this morning.

Re-designate current 74-8307 (f) to 74-8307 (h)

74-8307 (f) Investments by Kansas venture capital companies in related persons shall not be counted as equity investments for the purpose of continuing certification under this sub-section.

74-8303 (g) "Related persons" are:

(1) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly, by or for such individual;

(2) Two corporations which are members of the same controlled group (as defined in IRC 267(f);

(3) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;

(4) A corporation and a partnership if the same persons own —

(A) more than 50 percent in value of the outstanding stock of the corporation, and

(B) more than 50 percent of the capital interest, or the profits interest, in the partnership;

(5) An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or

(6) An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation.

Ownership for purposes of this definition shall not include equity investments made by a Kansas venture capital company if such investment was a qualified equity investment at the time it was originally made.