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Venture Companies

Angel Investing on the Rise: Legal Considerations for the Formation of an Angel Fund

By Paige S. Connelly and Cassandra W. Borchers

Why the uptick in angel fund formation in the startup community?

Investors are becoming increasingly interested in the opportunities and benefits of launching angel funds. With a growing community of startup companies in the tech and software as a service (SaaS) markets with high growth potential, investors are making seed stage investments a part of their involvement in the emerging company ecosystem. Angel investors can offer strategic guidance and wisdom to the entrepreneurs, who also benefit from the symbiotic investment relationship. For accelerators, incubators and investor groups looking to start an angel fund for the purpose of investing in startup companies, there are several key legal considerations that impact the process.

What does the legal structure of an angel fund look like?

The sponsor needs to determine the organizational structure of the fund and its management. A limited partnership or a limited liability company is a common choice for the fund entity. Many institutionally backed venture capital funds are limited partnerships, and many seed stage investment funds follow this format as well. The limited partnership structure includes a general partner entity, which may serve as the management company for the fund unless a separate management company is engaged. The investors are limited partners and as such, have no role in the management of the fund. However, the fund may grant certain key investors advisory board roles. It's important to keep the management function separate and localized within the management company. The management company is often organized as a limited liability company or a C corporation and receives all of the fees in connection with the management of the fund. The management

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company will typically employ a portfolio manager to analyze investment opportunities, negotiate the terms of the transactions and direct the capital investments. Limited partnership interests should be targeted at investors with experience in the angel community who have done their due diligence on the type of investments that the fund will make.

The fund will be a for-profit entity, and in the event of any affiliation with an accelerator or incubator that is a non-profit entity with tax exempt status, it's important to consider the impact of applicable tax law in structuring the fund and related entities. The fund should be organized, governed and managed completely separately from any tax exempt entity due to restrictions on the investment activity of non-profit entities.

What are the legal considerations and questions to ask when launching an angel fund?

It's important to consider how many investors will invest in the fund, whether the investors will be accredited or non-accredited investors (as defined in Rule 501 of Regulation D under the Securities Act of 1933), how much capital the fund will raise and what types of investments the fund will make. These components impact the offering structure and applicable securities rules and regulations, which will dictate certain matters related to fund compliance.

Who should be limited partners of the fund?

The initial benchmark for purposes of determining whether certain securities exemptions for a private offering will apply is whether the fund will be offered to non-accredited investors. While exceptions may permit sale to 35 or fewer non-accredited investors, such sales may impact which private offering exemptions are available, and what information must be provided to non-accredited investors. In addition to the impact of securities rules, it is important to consider the business consequences of allowing non-accredited investors to join the fund. Many experienced angel investors prefer to invest alongside other accredited investors, and in order to attract a sophisticated membership base for the fund, it may be desirable to restrict the fund to only accredited investors.

In which type of companies will the fund invest?

Many accelerators in the emerging company space focus their efforts on scalable SaaS and tech companies with high growth potential, and angel investors seem to follow suit. On the other hand, some accelerators target companies whose business models are in line with the organization's mission, which may include minority- and women-owned businesses, social impact companies, lifestyle businesses and regionally-based businesses. It's important for the general partner and manager of the fund to identify the type of company investments that will be permissible, and to formulate an investment strategy for the fund as well as the criteria to be used to evaluate and select startup candidates for these investments.

What type of investments will the fund make in startup companies?

The most common types of early stage investments in startup companies are convertible debt transactions and preferred equity investments. Convertible notes are loans that can convert into preferred equity issued in the company's next qualified equity financing round. The note can also provide for contingencies and specify what happens to the note if it matures before conversion into equity, or if the company enters into an exit transaction prior to conversion. Convertible notes and, more recently, simple agreement for future equity (SAFE) and keep it simple security (KISS) instruments are commonly used in angel investing. Some investors prefer to invest directly in an equity security and will wait for a startup company to have a Series Seed or Series A preferred stock offering before the investor will invest. Convertible note financing transactions can be simpler, quicker and less expensive to close because they typically involve less negotiation and integration of investors' rights and preferences into the corporation's governing and organizational documents. Investors who want to invest directly in a preferred equity security often desire the certainty of establishing the price per share of the preferred stock at the time of the transaction, as well as the rights, preferences and privileges they will have as a holder of preferred stock. For each of these types of transactions, it is important to connect with counsel to discuss the applicable documentation, offering materials and relevant securities requirements and filings that are components of the transaction.

For more information, please contact Paige Connelly or Cassandra Borchers.

Let the Buyer (of Preferred Stock) Beware

By Michael Ragan* and David J. Willbrand

Preferred stock is often the vehicle of choice for investors looking to buy into early stage growth companies.

Investment in preferred stock almost always includes a number of advantages over common stock: preference in assets should the corporation be liquidated, preference in the payment of dividends, and often, a contractual right to redeem the shares for a predetermined value at a given time. It is this last privilege that is at issue in *Frederick Hsu Living Trust v. ODN Holding Corp*., a Delaware case in which the Court of Chancery is exploring the potential for board member and investor liability resulting from a breach of fiduciary duty to the common stockholders of ODN. The case highlights a number of corporate governance issues important to investors, corporate officers and board members.

The fact of the matter is that the key players in *ODN* acted as many investors would; they did what they viewed as necessary to salvage a tanking investment. Unfortunately, they went too far (at least in the eyes of the court).

In 2008, venture capital firm Oak Hill Capital Partners sponsored a $150 million investment in the then-ascendant tech company, Oversee.net. To facilitate this investment, the parties formed the Delaware-based ODN Holding Corporation. Oak Hill was granted shares of preferred stock in ODN in exchange for its investment, and was given the option to require ODN to redeem them at any time beginning in February 2013. Eventually, Oak Hill became ODN's controlling stockholder, and purchased enough capital stock to take control of the board as well.

Business continued as usual for two years following the Oak Hill investment, and ODN stood by its prior commitment to growth, making some $23.7 million in acquisitions. However, everything changed in 2011. Oak Hill decided that year that "exercising its contractual redemption right in February 2013 was the most effective way to achieve the return of its capital." In 2011, ODN halted all acquisitions, sold off two of its four business lines, and doubled its cash reserves at the behest of Oak Hill. The corporation was clearly preparing for a large redemption event, going so far as to institute bonuses for certain officers should that redemption total at least $75 million for the holders of preferred stock. After a few offers and counter-offers concerning the terms of redemption, ODN and Oak Hill agreed to a payout of $45 million, not enough to trigger the redemption bonuses, but sufficient to reduce ODN's cash reserves to a mere $5 million.

With this change of direction came the lawsuit. It alleges that no longer was the ODN board (controlled by Oak Hill) acting in line with its fiduciary duty to its stockholders in the aggregate. Rather, it was acting in furtherance of its *contractual* rights to its preferred stockholders.

Oak Hill exercised its full redemption right in March 2013, and in accordance with the agreement, ODN paid out the $45 million. Unsurprisingly, Oak Hill was not satisfied with this first payout. Consequently, the Oak Hill-controlled board and senior officers set out to gut ODN in search of additional funds for further preferred stock redemption. When all was said and done, ODN was left a shell of its former self. It sold the bulk of its assets, slashed its employee base and experienced a 92 percent decline in annual revenue from 2011 to 2015. Through these steps, Oak Hill received an additional $40 million in redemption payments, bringing the total to $85 million. This resulted in a loss on its initial $150 million investment, but it was ostensibly a smaller loss than it would have suffered had ODN continued to focus on long-term growth.

Unfortunately for Oak Hill, one of the original founders of Oversee.net, and a holder of a significant portion of ODN common stock, was outraged. Frederick Hsu brought suit in Delaware court in March 2016, alleging multiple breaches of fiduciary duty, waste, unlawful redemptions and unjust enrichment. The defendants (which include ODN's board members, officers and Oak Hill) moved for summary judgment on all six of the claims levied against them, and in April 2017, the Court of Chancery denied their motion on four of those six.

A long established tenet of corporate governance is that the ultimate obligation of any corporation is to maximize value to its stockholders; any actions undertaken by the corporation and its directors that do not serve this end are breaches of the duty of loyalty.

A breach of the duty of loyalty is the primary charge brought by Hsu against ODN. He alleges in his complaint that the defendants violated this duty to the common stockholders when they broke up ODN in order to raise funds to satisfy the redemption rights of the preferred stockholders. Of course, the primary beneficiary of this plan was Oak Hill, whose representatives and appointees proposed and oversaw the selloff process. The court agreed that there is a triable issue of fact in regards to this potential fiduciary breach, and thereby exposed the defendants to liability.

It is here that corporate board members, officers and investors should take note. The court opined that the fiduciary principle *does not* protect the special rights or preferences of preferred stockholders; rather, decision makers have a duty to maximize the value of the "undifferentiated equity in the aggregate."

This means that the duty of the board is to *prefer* the interests of common stock over the special rights and preferences of preferred stock when discretionary judgment is being exercised. While preferred stock is technically a form of equity, the court views the obligations to the preferred holders as primarily contractual. Fiduciary duties are owed only to residual claimants, and in the vast majority of instances, this means the common stockholders. Therefore, a board is permitted to focus on the interests of preferred stockholders only insofar as those interests are consistent with the interests of the common stockholders. To otherwise focus on the privileges of the preferred stockholders (as the defendants in the ODN case appear to have done) is to invite potential liability for a breach of the aforementioned fiduciary duty of loyalty.

According to the Delaware Court of Chancery, boards need to consider the potential for an "efficient breach" when dealing with odious contracts.

If the penalties to be paid as a result of the breach of contract are less than the costs of fulfilling said contract, it is the duty of the board to consider breaching: "directors who choose to comply with a contract when it would be value-maximizing (broadly conceived) to breach could be subject, in theory, to a claim for breach of duty." In the case at hand, the ODN board should have considered breaching its contractual duty to redeem Oak Hill's preferred stock. The corporation would have incurred penalties in doing so, but it's possible that the resultant losses would have been less than the destruction of value incurred in honoring the Oak Hill redemption. It is important to note that the generally lenient business judgment rule did not apply here because it was a self-interested transaction; the entire fairness doctrine was instead applied.

Investors considering the purchase of any type of stock with special rights should contemplate taking steps to safeguard their privileges from contractual breach by their investment target.

The ODN case has further important implications for investors who purchase preferred stock. When investments fail to pan out, sponsors often attempt to mitigate losses by using the special preferences associated with their preferred stock. *ODN* indicates that Delaware courts are willing to critically evaluate board decisions regarding the contractual obligations to preferred stock when those decisions also affect common stockholders. If the board goes too far, sacrificing the welfare of the common stockholders to satisfy contractual obligations to the preferred, it is possible that the board will be in violation of its fiduciary duties. To safeguard their preferred status, as well as to limit potential liability, purchasers of preferred stock should consider taking steps to incentivize boards to honor their enumerated privileges. These steps would likely take the form of provisions that would provide relief should a mandatory redemption (or any other guaranteed preference) go unsatisfied. We recommend possibilities that include cumulative dividends, favorably priced conversion options of the preferred stock to common stock, automatic issuance of common stock or even a mandatory sale of the company. Essentially, the investor's goal should be to put a thumb on the scale in favor of honoring the privileges associated with its preferred status. Making it more painful for a board to breach contractual obligations increases the likelihood that the preferred stockholder's preferences will be upheld, thereby providing greater protection from loss.

With the court's refusal to dismiss the case, the ultimate finding regarding Oak Hill's liability remains to be seen. However, in some respects this holding could turn out to have unintended consequences – in promulgating a decision that would seem to benefit common stockholders (and that was certainly the court's intention), the court may have inadvertently pushed investors to structure even more aggressive preferred stock terms.

With any questions, please contact David Willbrand.

**Michael Ragan (Washington University School of Law, '18) contributed significantly to this article. Michael is a Thompson Hine summer associate; he is not admitted to the practice of law. Please contact Julia Zerman to learn more about our summer program.*

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Commercial Contracts

Dispute Resolution Clauses: They Only Matter When They Matter

By John L. Watkins

In the throes of finishing a commercial transaction, one contractual clause often put off until the very last minute, if considered at all, is the dispute resolution provision. Perhaps this is human nature. At the time of making a deal, most of us are thinking about opportunity and profit, not claims and disputes.

As both a commercial litigator and business lawyer, I have a more cynical view: Dispute resolution provisions matter, and they *really matter when they matter,* which is, of course, when a claim has been made or a lawsuit filed. Dispute resolution provisions can be the difference between winning or losing a claim or dispute. Thus, dispute resolution clauses deserve meaningful attention on the front end when the contract is being drafted. Here are a few thoughts.

Forum Selection Clauses

Clauses that specify that litigation relating to a contract must be conducted in a particular location are known as forum selection clauses and are generally enforceable. It is almost always advantageous to specify the courts of your home jurisdiction if possible. It can also be important *not* to agree to the other party's home jurisdiction. Sometimes no forum selection clause is better than agreeing to the other party's chosen forum.

Arbitration or Litigation?

Binding arbitration is a dispute resolution option in almost any commercial contract. Arbitration allows arbitrators—who should have some familiarity with the general subject matter of the dispute—to decide cases instead of judges and juries. Arbitration awards are binding and can be overturned only on limited grounds.

Arbitration is often an attractive alternative in international transactions, as international companies are leery of the U.S. judicial system, and particularly the jury system. Arbitration is also often used in the construction industry. However, arbitration can be required in almost any commercial contract through including an arbitration clause requiring claims and disputes to be decided by arbitration.

Zealous arbitration proponents say it is better, cheaper and faster than the court system. I take this view with a grain of salt, especially the "cheaper and faster" part. However, arbitration allows persons with expertise to decide the matter, is generally confidential, and is a particularly good alternative in the areas noted above.

The Arbitration Clause: Is Simpler Better?

I sometimes see arbitration clauses that read like the tax code. These clauses try to specify the procedure in considerable detail. Many I have reviewed appear to have been drafted by persons with no litigation or arbitration experience.

Here are two contrasting examples. Some arbitration clauses used in complex commercial contracts specify that the arbitration must be conducted under the American Arbitration Association's Expedited Procedures, which provide a *very* summary proceeding that would seldom seem appropriate for a case of any complexity or magnitude. On the other hand, one also sees arbitration clauses providing for discovery to the full extent provided in the Federal Rules of Civil Procedure. Discovery in arbitration is traditionally more streamlined, and discovery in court is one of the primary reasons litigation is so expensive.

My evolving view is that simpler arbitration clauses are generally better: Specify the governing rules, the administering organization (if there is one), where the arbitration is to be held and the number of arbitrators. Simpler clauses are also probably less likely to be challenged regarding their enforceability. Note that others may disagree, and each situation should be considered on its own merits.

Is a Multi-Tiered Process Better?

Multi-tiered dispute resolution processes specify an escalating procedure for resolving disputes, often specifying negotiation by principals, followed by mediation, and then arbitration if necessary. Provided they do not end up looking like the tax code, multi-tiered approaches can have value. This is especially true if the parties have a long-term business relationship they want to maintain. The problem with multi-tiered provisions is that they may delay resolution, particularly of simple matters such as a claim for payment.

Conclusion

The most important point is that dispute resolution provisions deserve respect, and respect requires meaningful attention when the contract is being drafted. It is critical to consider what types of disputes are likely to arise and how they would be best handled. It is important to understand how mediation, arbitration and the court system work and the strengths and weaknesses of each. If arbitration is being considered, it is also helpful to have at least a basic understanding of the differing arbitration organizations and their rules. It may be useful to get a consultation from a litigator. The bottom line regarding the dispute resolution clause is simple: Understand what it means and how it works *before* signing.

With any questions, please contact John Watkins.

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Customer Considerations for Negotiating Force Majeure Provisions

By Kelsey Mehaffie and John D. Cottingham

Copper is everywhere. Everything from plumbing and electrical systems to MRIs and cell phones contains copper. In February 2017, it was reported that the world's largest publicly traded copper producer, Freeport-McMoRan Inc., declared force majeure on nearby deliveries of copper concentrate from its mine in Indonesia's Grasberg mineral district (one of the world's largest copper deposits). It was reported that Freeport-McMoRan provided notice to smelters in Asia with deliveries scheduled for first quarter that Freeport-McMoRan could not guarantee when shipments would be made. Freeport-McMoRan issued a press release indicating that the root cause of the force majeure declaration was an impasse in negotiations with the Indonesian government in relation to new Indonesian regulations. Considering that consumer electronics, municipal infrastructure and industrial facilities are heavily dependent on copper, the impact of this force majeure declaration affected a broad array of supply chains.

The concept of force majeure is often expressly included in a contract for the sale of goods, primarily to protect the supplier by excusing the supplier from performing its obligations under the contract under certain conditions outside the supplier's control. As a result, the supplier's non-performance does not constitute a breach of contract, and the customer is not entitled to any damages for breach. This is all well and good for suppliers, but what about the customers? What about the smelters who have contracts with Freeport-McMoRan? Below are a few issues to consider when negotiating force majeure provisions on behalf of a customer in a contract for the sale of goods:

- **Require a robust business continuity plan and limited force majeure rights.** Critical suppliers should have in place a strong business continuity plan and limited force majeure rights, particularly if that supplier has exclusivity rights. Review the business continuity plan closely to make sure that single localized catastrophic events will not render the supplier unable to perform.

- **Require that the supplier notify the customer as soon as possible of the force majeure event and its anticipated duration.** In the example above, Freeport-McMoRan's customers who are expecting shipments received notice, but the notice did not explain how long the force majeure event would last. Requiring that the supplier provide detailed information to the customer in a force majeure event will limit this uncertainty.

- **Include an allocation provision.** In the event of a shortage of supply, the customer will want to include an allocation provision that requires the supplier to deliver a certain percentage of the available supply to the customer (as compared to the supplier's other customers).

- **Expressly limit the supplier's rights under the Uniform Commercial Code.** UCC § 2-615 provides that when a supplier's performance has been made impracticable, the supplier's delay in delivery or non-delivery in whole or in part does not constitute a breach, so long as the supplier allocates the goods among its customers in any fair and reasonable manner and notifies the customers seasonably of delay or non-delivery and the customer's allocated share. If the contract includes robust notice and allocation provisions (as described above), but does not expressly limit the supplier's rights under the UCC, the customer might still find itself in a dispute over sufficiency of the force majeure notice or the customer's allocated supply. The safest bet is to expressly state in the contract that UCC § 2-615 does not apply.

- **Require that the supplier reimburse the customer for any additional cost of mitigation in excess of the contract price.** A customer might turn to other suppliers for goods in a force majeure event in order to mitigate its damages or enable itself to perform under its own contracts. The customer will want to ensure that it has reimbursement rights from the original supplier.

- **Provide for termination without liability to the customer if the force majeure event is uncured.** If the force majeure event lasts for longer than a certain period of time, the customer might want to simply call it quits with the supplier. If the contract does not otherwise include a termination for convenience without penalty provision, a termination provision in the force majeure clause will achieve the same result.

For more information, please contact Kelsey Mehaffie or John Cottingham.

Investment Management

The Growing Commercial Applications of Blockchain Technology

By Jim Brown and James P. Jalil

A blockchain is a decentralized and immutable ledger. It provides an unalterable record of all transactions that have ever taken place on that ledger. No one party to the blockchain controls the ledger and no one party can record a transaction on the ledger. Blockchains can be either public or private, but in either case all members of the ledger (the public in the case of public blockchains and multiple parties in the case of private blockchains) maintain the entire transaction ledger together; the ledger cannot be edited single-handedly by any party or group. The genius of the blockchain lies in its openness – all entries exist in complete transparency and any change must be agreed to by all users.

In a world of ever increasing and complex data entries and record keeping, blockchain technology addresses, among other things, two related concerns: "double spending" and the need for trusted intermediaries. Sellers want to be assured that a buyer has the required funds and that it has not promised the same funds for their transaction to another transaction. This problem is typically addressed by using various intermediaries such as banks and letter of credit and credit card companies. The need for these trusted intermediaries adds cost and time to the completion of a transaction, particularly in the case of cross-border transactions. The blockchain ameliorates these concerns by virtue of its incontrovertible and decentralized structure. Once a transaction is added to the blockchain, it can be viewed by all parties and cannot be revised or reversed. If Party A pays Party B $5, the ledger is updated for all to see and Party A cannot then try and use that same $5 for a subsequent transaction. Without the need for trusted intermediaries, commercial transactions can happen immediately and without the cost of a middleman.

One of the most popular uses of blockchain technology is Bitcoin. Bitcoin was created by Satoshi Nakamoto, a still-anonymous person or group of persons, largely in response to the 2008 financial crisis. The idea behind Bitcoin was to create a unit of value that could be traded transparently and anonymously by anyone, anywhere. While Bitcoin remains popular and has inspired numerous cryptocurrencies in its wake, individuals and firms inspired by the underlying technology have started to think outside of cryptocurrencies, utilizing the blockchain for the movement of any asset, the recording of personal and public data, and even for state and corporate governance.

While there is no shortage of grand aspirations for the blockchain, there are several commercial uses already being implemented and utilized by firms worldwide. One popular application, and a term that has also garnered considerable buzz, is the "smart contract." A smart contract is an agreement between parties, detailed in computer code, that utilizes blockchain technology. Once the smart contract is uploaded into the blockchain, it executes according to the rules imbedded in the code and cannot be changed by any one party. This removes the need for intermediaries that would traditionally hold assets in escrow, ensure the credibility of the parties or enforce the obligations of an agreement, which could considerably lower transaction costs and streamline global commercial activity.

The blockchain is also being utilized in supply chain management. Currently many global supply chains are subject to incredible amounts of paperwork across varying jurisdictions, which creates the potential for errors, waste and fraud. The blockchain's very nature as an immutable, decentralized ledger makes its use in logistics a perfect fit.

Walmart, working with Tsinghua University and IBM, has completed two pilot programs, tracking pork products in China and tracing produce in Latin America. This supply chain tracking technology has even greater potential when combined with smart contracts, creating a logistics system that defines and executes delivery, shipment and payment protocols, in each case automatically and based on predetermined rules, removing the need for a trusted intermediary and facilitating the transparent transfer of goods along the supply chain.

Blockchain technology is also enticing to the financial services industry as a potential replacement for current payment systems. Financial services firms may also look to the blockchain for use in "know your customer" and anti-money laundering procedures and to otherwise reduce fraud.

In addition to these more commercial uses, the blockchain as a repository for data is gaining considerable attention. For example, a bill passed by the Delaware General Assembly and signed by the governor on July 21, 2017 clarifies that companies can use blockchain ledger technology to maintain their records. The fact that one of the most sophisticated corporate governing bodies in the world is addressing the use of the blockchain shows the potential it may hold.

Lastly, another recent use of blockchain technology that is gaining popularity is the initial coin offering (ICO). In an ICO, a startup creates a private blockchain. It then offers "coins" (sometimes called "tokens"), which represent assets, or blocks, on the blockchain (and are created on the blockchain itself). Coins, once issued, can be used as currency (sometimes called cryptocurrency, of which Bitcoin is an example) to buy a good or service that the startup is promoting or to purchase any third party good or service, or may be sold on the open market for another cryptocurrency or traditional currency, such as dollars or euros (known as a "fiat" currency). The benefit for a startup to engage in an ICO and use coins is the ability to raise capital without compliance with federal or state securities laws. At the moment, coins created in a blockchain are not viewed as securities. In an ICO there is no private placement memorandum, registration with the Securities and Exchange Commission or disclosure other than a "white paper" that describes the project, the coin, the use of the coin and the exchange value of the coin for either another cryptocurrency or fiat currency. ICOs are generally sold in crowdfunding structures.

The blockchain has great potential to transform firms, industries and even entire ways of engaging in commerce. While many are still skeptical of the effect that the blockchain will ultimately have in business, the action being taken by some of the world's largest companies, and the increasing number of ICOs, shows that there is a very real interest in the blockchain and what it can be used to accomplish.

Please contact Jim Brown or Jim Jalil with any question