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## **Burned Angels: The Coming Wave of Minority Shareholder Oppression Claims in Venture Capital Start-up Companies**

*Jeffrey M. Leavitt*<sup>1</sup>

### **I. Introduction**

The venture capital industry has undergone dramatic and unprecedented change over the last decade. Relative to other areas of the economy, this may not seem especially material given the youth of the venture industry as a whole. The practice of venture capital investing as we know it today began only about sixty years ago,<sup>2</sup> and not without serious reservations.<sup>3</sup> Nevertheless, the recent growth figures are more than noteworthy. During the six-year period from 1997 to 2003 alone, the number of venture funds actively investing jumped from 885 funds managing \$64.6 billion to 1,984 funds managing \$251.4 billion.<sup>4</sup> Nearly \$200 billion of venture capital was raised in the year 2000 alone.<sup>5</sup> In short, the venture capital industry has grown up.

The driver of this growth is plain. The technology bubble of the mid-1990s catapulted many venture capitalists, and the entrepreneurs they supported, into positions of great wealth. From

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<sup>1</sup> Of Counsel, Arnall Golden Gregory, LLP; Duke University, B.A., cum laude, 1994; University of Pennsylvania, J.D., cum laude, 1997. The author is the only practicing attorney in the country to have completed the Kauffman Fellowship Program, a competitive Fellowship designed to train professionals in and around the venture capital industry.

<sup>2</sup> See Paul A. Gompers, *A Note on the Venture Capital Industry*, Harvard Business School Case Study No. 9-295-065 (Rev. Nov. 9, 1994), at 4 (summarizing the history of the venture capital industry).

<sup>3</sup> See GEORGE W. FENN ET AL., *THE ECONOMICS OF THE PRIVATE EQUITY MARKET*, 168 STAFF STUDIES SERIES, 9–11 (1995) (“[P]ension fund managers had long regarded venture capital investments as a potential violation of their fiduciary responsibilities.”).

<sup>4</sup> Peter Morris, Presentation to venture capital conference in San Francisco (June 10, 2004).

<sup>5</sup> Jesse Reyes, Presentation to the Kauffman Fellowship Program at Babson College (Nov. 5, 2004).

1997 to 2000, the mainstream media was saturated with tales of “new economy” risk-takers reaping millions overnight, to the disturbing envy of the “old economy” establishment. While the lucky few inflated their bank accounts, the jealous many inflated their dreams into unrealistic ambitions. Thus was the context for the venture capital industry expansion and the birth of the modern day angel investor.

While the concept of “angel” investing has existed for literally centuries,<sup>6</sup> its emergence as a colloquial term and popular pastime for wealthy individuals is a recent phenomenon. With some variation, an angel investor is an individual investor considered “accredited” by the federal securities laws, who has disposable investment capital available for alternative asset class investment, and chooses to invest in early-stage technology companies. The divine nomenclature stems from the context in which a typical angel investment is made—namely, at the nascent stages of a company’s life when only the most beneficent investor would consider providing investment capital. This first financing round is sometimes called the “friends and family round,” since many angel investors have pre-existing relationships with the entrepreneurs in whose companies they invest.<sup>7</sup>

Angels generally invest with the expectation that, should the company progress as planned, one or more venture capital (“VC”) firms will subsequently invest in the company’s first “institutional round” of financing. Ideally, this second financing round will involve the sale of company stock at a higher valuation than at the angel round, resulting in some but not dramatic dilution of the angel’s equity holdings. This process of selling stock to venture investors continues through the company’s life until the investors realize an “exit opportunity,” which is a financing event after which investors may liquidate their holdings. The potential reward gained from such an exit event, anticipated to be at a

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<sup>6</sup> Cyrus Field had several angel investors in his transatlantic cable venture. See JOHN STEELE GORDON, *A THREAD ACROSS THE OCEAN* 40 (2002). In 19th century America, angel investors were referred to as “adventurers.”

<sup>7</sup> See Joseph W. Bartlett & Kevin R. Garlitz, *Fiduciary Duties in Burnout/Cramdown Financings*, 20 J. CORP. L. 593, 600 (1995) (“The angels invest on the strength of some form of personal relationship with the founder.”).

valuation much higher than the angel's initial investment, must be sufficiently high to justify the substantial risk taken during the angel round.

The angel investor community has grown alongside and beneath its venture capital counterpart, serving the significant role of supporting new companies from the point of conception through to institutional legitimacy.<sup>8</sup> Angels have become more prominent and accessible over time, and are now common shareholders in the typical venture capital portfolio company. Many have banded together to create branded regional organizations focusing on sharing deal flow,<sup>9</sup> utilizing communal resources such as lawyers and accountants, and providing capital for new venture capital-backed start-up companies ("start-up companies") in their home region.<sup>10</sup> Moreover, the very definition of an angel investor has changed in relation to its larger venture capital cousin. While typical venture capital funds have grown in size to \$200 million or higher, smaller venture capital firms, generally with funds of \$50 million or less, are now sometimes referred to as "angel funds," since their small size and investment style is more akin to "nascent

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<sup>8</sup> The Kauffman Foundation of Kansas City sponsored and endorsed the creation of the Angel Capital Association in late 2003. See Press Release, First Network for Angel Investing Groups Formed (Nov. 11, 2003), available at <http://www.kauffman.org/news.cfm/382> (citing a statistic from the Center of Venture Research that angel investors had deployed \$15.7 billion in United States entrepreneurial businesses during 2002) (on file with the North Carolina Journal of Law & Technology).

<sup>9</sup> "Deal flow" refers to the rate and quality of investment opportunities to which a private investor becomes exposed. The concept of deal flow is particularly important in the inefficient financial markets of private equity. Public markets, in contrast, are very efficient because information regarding investment opportunities is so readily available. While such immediate and comprehensive disclosure is generally good for investors in the aggregate, its accessibility hinders any given investor's ability to achieve extraordinary returns. Private equity's inefficiency stems from its relative secrecy, giving those investors with unique access to the good investment opportunities, or "deal flow", the chance to reap extraordinary returns.

<sup>10</sup> The Angel Capital Association website boasts membership by 200 regional angel investment organizations throughout the United States and Canada. See Angel Capital Association, at <http://www.angelcapitalassociation.org/> (last visited Apr. 13, 2005) (on file with the North Carolina Journal of Law & Technology).

stage” angel investing than “early stage” venture investing. This article refers to both wealthy individuals and these smaller venture funds as “angel investors,” since both are subject to the risk of minority shareholder oppression.

In theory, the role of the angel investor is magnanimous, exciting, and, in some cases, even heroic.<sup>11</sup> Many active angel investors consider themselves to be the driving force of America’s innovation engine, flush with patriotic pride as they wire funds to fledgling start-ups. The justification for angel investing also rests upon an attractive risk/reward model. As the argument goes, since angel investors take the most risk of any investors during the life of a new company, they stand to reap the greatest reward. While this may have been true in the past, the realities of venture capital investment practice have in many ways turned this theory on its head.

Venture capitalists are sophisticated financial investors charged with the sober responsibility of investing their funds’ capital (usually supplied by pension funds or other non-trivial sources) in very risky early stage companies. Since many of the investments in a given VC’s portfolio fail, the VC must be in a position to squeeze the most return out of those few companies that are successful. Consequently, VCs will often seek to structure the terms of investments so as to maximize their control of, and thus reward from, their portfolio companies. The specifics of these terms are well documented in other commentaries and beyond the scope of this article. What is important here is the resulting control

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<sup>11</sup> See Gompers, *supra* note 2, at 4 (commenting on how one of the first modern early stage venture capital firms invested in a company developing X-ray technology to treat cancer because of “the ethics of the thing and the human qualities of treating cancer”). Peter Cooper, an angel investor in the first transatlantic telegraph cable venture, noted that his investment decision was driven by a desire for

the consummation of that great prophecy, that ‘knowledge shall cover the earth, as the waters cover the deep,’ and with that feeling I joined [the venture] in what then appeared to most men a wild and visionary scheme . . . . But believing, as I did, that it offered the possibility of a mighty power for the good of the world, I embarked on it.

See GORDON, *supra* note 6, at 40.

of the company by the VC (or group of VCs acting in tandem by explicit cooperation or implicit alignment of interest), achieved either by owning a majority of the company's voting stock (or holding veto rights over certain actions and decisions of the company), controlling a majority of the company's board of directors, or both. Control of the company in this manner often appears fair and reasonable at the time of the VC's initial investment when each of the company's founders, angel investors, and VC investors are aligned in interest to grow their exciting new venture. The problems arise when things do not go as planned, and the interests of these three shareholder constituencies diverge. In such event, burdened by duties to maximize returns to a demanding limited partner investor base, the VC will invoke its control of the company to further its distinct interests at the expense of the angel investor.<sup>12</sup>

The potential for abuse is high, as many "burned angels" have learned, while the means for legal redress have not yet been properly tested in court. Recent market trends, however, are increasing the likelihood that we will see such a test sooner rather than later. The unusual investment dynamics from 2001 through 2004, which brought about many highly dilutive "down rounds,"<sup>13</sup> have set the stage for legal claims that aggrieved angels may assert in coming years. In the heydays of 1999 and 2000, angel investments in start-up companies were quickly followed by venture capital investment. When the bubble popped, however, many of these companies watched their cash reserves diminish in

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<sup>12</sup> See Joan L. Lesser & Carrie E. Johnson, *Financing Troubled Companies: Highly Dilutive (Down Round) Financings*, 20 No. 1 COMPUTER & INTERNET LAW 1, 2 (2003) ("[D]own-round financings frequently include terms designed to protect the value of the venture capitalists' investment . . . . Such terms not only restrict a company's flexibility and create a precedent for future financings but also tend to impair severely the value of, or even render worthless, securities held by existing investors."). Angels are much more at risk of suffering damage than the company's founders for several reasons. See *infra* Part IV.

<sup>13</sup> A "down round" occurs when a company's per share stock price declines from one financing event to the next, reducing the enterprise value and diluting all prior shareholders. Holders of preferred stock usually have some level of anti-dilution protection in the event of a down round, the presence of which results in exacerbated dilution to common stock holders who do not enjoy such protection.

the face of a tight-fisted investment climate. Raising new capital became extremely difficult, often forcing companies to raise additional funds from their current investor base.<sup>14</sup> The VCs, with larger holdings and deeper pockets than their fellow angel investors, often ended up effectively dictating the terms of these “insider” rounds, in many cases without legitimate arms-length negotiation since they also controlled or at least substantially influenced the companies in which they were investing. Consequential negative effects on angel investor holdings were typical.

As we move through the improving capital markets of 2005, some of those same companies that struggled through insider or down rounds are improving their performance, growing well, and now have a reasonable chance of achieving a profitable return. If and when this happens, angel investors will be able to quantify their losses and, in appropriate cases, justify initiating litigation.<sup>15</sup> While some cases of this ilk have been launched, none have survived pre-trial settlement,<sup>16</sup> and theories of liability postulated by commentators are, accordingly, still only theories.

This article analyzes the claims angel investors might bring against VCs who took companies through insider rounds with “abusive” terms. Part II introduces the concept of close corporation law, well-established in American jurisprudence, and concludes that venture-backed start-up companies would likely be treated as close corporations in the eyes of the courts. Part III then

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<sup>14</sup> See Willie Dennis & David Englander, *Down Rounds and Washouts*, 1344 PLI/CORP. 279, 281 (“Today, in contrast [to the late 1990s], valuations for companies seeking follow-on financings are frequently well below the valuations at which the previous financings were completed . . . . Accordingly, the only way to attract additional financing, even from the inside investors, is to price the next round below the prior round.”).

<sup>15</sup> In most cases, full litigation is a practical reality. Most angel investors are wealthy and possess the wherewithal to hire competent counsel and take a claim through to its resolution in court. There are strong incentives for a defendant venture capital firm to settle a claim, but the size of some losses may preclude any reasonable settlement amounts.

<sup>16</sup> See Constance Loizos, *Entrepreneur Settles Suit With Lightspeed, ComVentures*, PRIVATE EQUITY WK., Feb. 11, 2005; Scott Herhold, *Venture Capitalists Settle Suit, San Jose Mercury News*, Feb. 20, 1997, at 1C (covering a dispute of the settlement of a start-up company called Alantec Inc.).

presents what has become known as the close corporation “minority oppression doctrine,” outlining a set of principles courts have established to protect minority shareholders in close corporations from the potential abuses of a controlling shareholder group, such as that comprised of VC investors. Particular attention is given to jurisdictions likely to address venture capital shareholder issues first, namely Massachusetts, California, New York, and, of course, Delaware. Part IV describes in more detail the role angels play as investors in nascent and early-stage companies, their motivations and expectations when making their investments, and the specific areas where risk of abuse against them is high. A listing of distinctions between an angel’s interests and those of the company’s founders and venture investors is also provided to highlight how and when the angel’s unique interests can be subordinated to those of the company’s other, more influential shareholder constituents. Part V applies the minority oppression doctrine to the plight of angels in venture-backed start-up companies, concluding that courts will likely recognize a claim of oppression by an angel plaintiff, but the substantive result may vary depending on the jurisdiction in which the suit is brought and the particular facts of a case. Policy arguments are presented, highlighting the need to balance a shareholding majority’s right to corporate control with an angel investor’s right to participate in the company’s liquidity event, recognizing the critical need to preserve the expectations of both to ensure their future participation. Finally, Part VI prescribes specific actions venture capitalists may take to reduce their liability in the face of such claims. The article concludes by suggesting that angel investors may be able to bring successful claims against venture capital investors based on some variant of the minority oppression doctrine in each of the jurisdictions reviewed. However, there are certain steps venture capital firms can take before and during a dilutive transaction to help sanitize their actions and defend themselves.

## **II. Venture Capital Start-up Companies as “Close Corporations”**

The bulk of corporate law jurisprudence is directed toward



the typical public company where capital market forces usually can help provide shareholders with some “invisible hand” protection.<sup>17</sup> In publicly traded companies, where risk-bearing and management are separate, some level of market accountability can keep agency costs contained, and the presence of an accessible liquid market provides an immediate exit for a disgruntled shareholder.<sup>18</sup> How to manage the corporation’s profits is a question for the board of directors, which may decide to reinvest or declare a dividend. Unhappy shareholders may protest the board’s decisions by waging a proxy fight or, more simply, selling their stock in the open market. Privately held close corporations, on the other hand, do not generally exhibit these characteristics, and their shareholders accordingly do not enjoy the inherent structural protections relied upon by their public company counterparts.<sup>19</sup> Commentators have noted extensively how conventional corporate law’s application to the close corporation could lead to unfair results.<sup>20</sup> Both legislatures and courts have reacted to these observations, albeit in varying ways, and have consequentially laid the groundwork to treat the legal rights of shareholders in public and private companies differently when warranted.<sup>21</sup> Indeed, an

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<sup>17</sup> F. HODGE O’NEAL & ROBERT B. THOMPSON, *O’NEAL’S OPPRESSION OF MINORITY SHAREHOLDERS* 80 (2d ed. 1985).

<sup>18</sup> See FRANK H. EASTERBROOK AND DANIEL R. RISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 228–37 (1991).

<sup>19</sup> See Robert A. Ragazzo, *Toward a Delaware Common Law of Closely Held Corporations*, 77 WASH. U. L.Q. 1099, 1100 (1999) (noting how influential courts have “recognized that shareholders in closely held corporations have a different set of expectations and vulnerabilities than do shareholders in publicly held corporations”).

<sup>20</sup> See Douglas K. Moll, *Shareholder Oppression in Close Corporations: The Unanswered Question of Perspective*, 53 VAND. L. REV. 749, 757 (2000) (“Conventional corporate law norms of majority rule and centralized control can lead to serious problems for the close corporation minority shareholder.”); Robert B. Thompson, *The Shareholder’s Cause of Action for Oppression*, 48 BUS. LAW. 699, 702–03 (1993) (“In a closed setting, the corporate norms of centralized control and majority rule easily can become instruments of oppression.”).

<sup>21</sup> See, e.g., *Jones v. H.F. Ahmanson & Co.*, 460 P.2d 464, 473 (Cal. 1969) (noting that traditional corporate law “failed to afford adequate protection to minority shareholders and particularly to those in closely held corporations whose disadvantageous and often precarious position renders them particularly

entire body of law has sprung up and flourished to address the legal relationship of a close corporation's shareholders.<sup>22</sup>

### A. The Close Corporation Defined

A number of definitions have been proposed over the years to identify a "close corporation."<sup>23</sup> Among the most cited, particularly in jurisdictions relevant to this article's topic, is that set forth a mere thirty years ago by the Massachusetts Supreme Judicial Court in *Donahue v. Rodd Electrotype Co.*<sup>24</sup> In *Donahue*, Massachusetts defined a close corporation as having "(1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in the management, direction and operations of the corporation."<sup>25</sup>

It is easy to see how minority shareholders can be particularly vulnerable in such a context. Voting control gives the majority shareholder or shareholder group the keys to the corporate machinery, while the lack of a liquid market makes it very difficult for dissenting minority shareholders to sell their shares.<sup>26</sup> Majority

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vulnerable to the vagaries of the majority"); *Quinn v. Cardiovascular Physicians, P.C.*, 326 S.E.2d 460, 463 (Ga. 1985) (holding that all shareholders need protection because "in close corporations, minority stockholders may easily be reduced to relative insignificance and their investment rendered captive"); *Walensky v. Jonathan Royce Intern., Inc.*, 624 A.2d 613, 615 (NJ App. Div.1993) (noting the particular vulnerability of minority shareholders in close corporations); see also Thompson, *supra* note 20, at 699 ("Corporate statutes and judicial decisions reflect norms designed for publicly held corporations and do not always meet the needs of closely held enterprises.").

<sup>22</sup> The authoritative treatise on close corporation law, cited regularly by courts and commentators, is F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS (3d ed. 1998).

<sup>23</sup> See WILLIAM L. CARY & MELVIN ARON EISENBERG, CASES AND MATERIALS ON CORPORATIONS 389 (7th ed. 1995) ("Exactly what constitutes a close corporation is often a matter of theoretical dispute. Some authorities emphasize the number of shareholders, some the lack of a market for the corporation's stock, and some the existence of formal restrictions on the transferability of the corporation's shares.").

<sup>24</sup> 328 N.E.2d 505 (Mass. 1975). For further discussion on *Donahue* and its progeny, see *infra* Part III.A.

<sup>25</sup> *Id.* at 511.

<sup>26</sup> See Manuel A. Utset, *A Theory of Self-Control Problems and Incomplete*

control, which usually goes hand in hand with board control,<sup>27</sup> enables such abuses as the imposition of policies to pay special dividends or salary bonuses to some shareholders but not others,<sup>28</sup> an offer by the company to purchase one shareholder's shares at a high price but not make the same offer to other shareholders,<sup>29</sup> or a self-serving diversion of the company's assets or opportunities to an entity controlled by the majority shareholders.<sup>30</sup> Other popular forms of minority shareholder oppression include forcing a minority to sell its shares to the company at an unreasonably low price (a "squeezeout"),<sup>31</sup> merging the company with a shell

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*Contracting: The Case of Shareholder Contracts*, 2003 UTAH L. REV. 1329, 1339 (2003). Utset notes that

[t]here are two principal characteristics of close corporations responsible for the significant power majority shareholders wield over the welfare of minority shareholders. First, majority shareholders control the corporation, giving them wide latitude in making corporate decisions. Second, unlike non-controlling shareholders in public corporations, minority shareholders who disagree with the actions of majority shareholders cannot easily exit by selling their shares in a public market.

*Id.*

<sup>27</sup> See Moll, *supra* note 20, at 757 ("In a close corporation, the board is ordinarily controlled 'by the shareholder or shareholders holding a majority of the voting power.'") (citing Daniel S. Kleinberger, *Why Not Good Faith? The Foibles of Fairness in the Law of Close Corporations*, 16 WM. MITCHELL L. REV. 1143, 1148 (1990)).

<sup>28</sup> See *Sugarman v. Sugarman*, 797 F.2d 3 (1st Cir. 1986) (involving a case where a majority shareholder caused the company to pay him excessive salary and bonuses while denying any salary or dividends to other shareholders).

<sup>29</sup> See *Donahue*, 328 N.E.2d at 511.

<sup>30</sup> See *Thorpe v. Cerbco, Inc.* 676 A.2d 436 (Del. 1996).

<sup>31</sup> The term "squeezeout" in this context has been defined as "the use by some of the owners or participants in a business enterprise of strategic position, inside information, or powers of control, or the utilization of some legal device or technique, to eliminate from the enterprise one or more of its owners or participants." O'NEAL, *supra* note 17, at § 1.01, 1. Professor O'Neal has also identified a "partial squeezeout" as "action which reduces the participation or powers of a group of participants in the enterprise, diminishes their claim on earnings or assets, or otherwise deprives them of business income or advantages to which they are entitled." *Id.* at § 1.01, 1-2. See generally *id.*, §§ 3:01-3:20, 4:01-4:08, 5:01-5:39 (describing various squeezeout and partial squeezeout techniques).

corporation controlled by the majority shareholders under terms that force the minority to redeem their shares for cash at a low value (a “freezeout”),<sup>32</sup> or consummating a financial restructuring that significantly dilutes a minority shareholder’s holdings to the point of being worthless (a “washout”).<sup>33</sup>

## B. Application to Venture Capital Start-up Companies

The majority of close corporation case law deals with businesses founded by family members or friends in non-technology industries where things have gone awry. Although there have been a few cases filed against venture capital investors in start-ups in connection with their duties as directors,<sup>34</sup> and at least one against venture capital investors in their role as majority shareholders,<sup>35</sup> start-up companies and venture capital investment firms generally have not been quick to go to court.<sup>36</sup> However,

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<sup>32</sup> See *Leader v. Hycor, Inc.*, 479 N.E.2d 173 (Mass. 1985); *Sullivan v. First Massachusetts Financial Corp.*, 569 N.E.2d 814 (Mass. 1991); see also Douglas K. Moll, *Shareholder Oppression in Texas Close Corporations: Majority Rule isn't What it Used to Be*, 1 HOUS. BUS. & TAX. L.J. 12, 15 (2001) (noting that actions by a majority shareholder that are harmful to minority shareholder interests “are often referred to as ‘freeze-out’ or ‘squeeze-out’ techniques that ‘oppress’ the close corporation minority shareholder”). See generally O’NEAL, *supra* 17, at § 3.06 (2d ed. 1985).

<sup>33</sup> See Jose M. Padilla, *What’s Wrong with a Washout?: Fiduciary Duties of the Venture Capitalist Investor in a Washout Financing*, 1 HOUS. BUS. & TAX. L.J. 269, 271 (2001) (noting how the financial distress of a company can force the minority shareholders to accept draconian washout terms in order to continue the company’s operations). Mr. Padilla cites a number of other names for the “washout,” the favored technique of the venture capitalist, including “restart,” “restructuring,” “burnout,” “cramdown,” “down round,” “downside” and “dilutive.” *Id.* at 270 n.6.

<sup>34</sup> See *Orban v. Field*, 1997 Del. Ch. Lexis 48 (Del. Ch. Apr. 1, 1997); *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040 (Del. Ch. Apr. 25, 1997).

<sup>35</sup> See *Kalashian v. Advent VI L.P.*, Case No. CV739278 (Sup. Ct. Santa Clara Co., Cal. filed Mar. 23, 1994).

<sup>36</sup> Aside from the general youth of the industry, an oft-cited reason for VCs’ conspicuous absence from court is the overwhelming value placed on reputation and connections. The world of venture finance is small while the pool of entrepreneurs seeking venture capital seems to be bottomless. VCs regularly

should angel investors in VC-backed start-up companies become more litigious, as predicted in Part IV *infra*, courts would likely treat start-up companies in the same fashion as close corporations for the purpose of protecting minority shareholders from abuse.

The *Donahue* definition is easy to apply to the standard VC portfolio company. First, start-up companies, like close corporations, typically have few shareholders. The usual start-up company capitalization structure includes a minority position held by the founders, a minority position held by the angel investors, a small portion of common stock reserved for employees as part of an option incentive plan, and the balance held by the venture capital investors. With some variation, it is highly unusual for a start-up company to have more than one hundred shareholders. Most VCs, seeking to avoid an unwieldy shareholder base size, typically negotiate stock transfer restrictions among investors to intentionally keep the number of shareholders small.

Second, start-up companies do not enjoy a ready liquid market for their shares. These companies issue securities in reliance on the small issuance<sup>37</sup> or private issuance<sup>38</sup> exceptions to § 5 of the Securities Act of 1933.<sup>39</sup> This may be the most significant distinction between a private company shareholder and his public company shareholder counterpart. “In a large public corporation, the oppressed or dissident minority stockholder could sell his stock in order to extricate some of his invested capital. By definition, this market is not available for shares in the close corporation.”<sup>40</sup> Moreover, a VC will usually include a right of first

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boast that they invest in only one company for every one hundred they reject. This supply-demand imbalance is blamed for tilting the bargaining power toward the VC. Combine this power with the well-documented incestuous nature of the small VC industry and it is not unreasonable for a potential plaintiff to feel that any litigious steps toward a VC would bar him from the ability to ever seek venture capital again. Moreover, should an entrepreneur or angel be so bold as to threaten such litigation, the VC would have an incentive to settle to avoid stinging publicity from so rare an event.

<sup>37</sup> See Securities Act of 1933 § 3(a) (11), 15 U.S.C § 77a *et seq.* (2005).

<sup>38</sup> See Securities Act of 1933 § 4(2).

<sup>39</sup> See Securities Act of 1933 § 5.

<sup>40</sup> *Donahue*, 328 N.E.2d at 514; see also *Brenner v. Berkowitz*, 634 A.2d 1019, 1027 (N.J. 1993) (“[U]nlike shareholders in larger corporations, minority shareholders in a close corporation cannot readily sell their shares when they

refusal<sup>41</sup> and a co-sale right<sup>42</sup> as conditions to its investment, further shackling shareholders who may want to try to sell their shares.

Third, a start-up company's small shareholder base is made up of different constituencies who are all very interested in the company's development and frequently highly involved in its management, direction, and operation. Employees who own stock, which is common for start-up companies, are obviously involved in the management. VCs manifest their involvement through two primary means: (1) as board members, and (2) as preferred shareholders with enhanced voting rights. VCs will assume significant influence on the board as a condition to investment, and sometimes will enhance their influence by requiring the specific approval of the "VC directors" before the company may consummate certain transactions.<sup>43</sup> Furthermore, VCs typically sit on the board's hiring or compensation committee, giving them obvious and substantial influence over senior management.

Start-up company charters usually enumerate a host of transactions, some as banal as hiring managers or borrowing money to purchase necessary equipment, which cannot be consummated without the approval of the preferred stock voting as a separate class or with supermajority influence. Again, the effective result is to give the VCs enhanced influence and control over the company's operations.

Angels are usually the only shareholder group that is not

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become dissatisfied with the management of the corporation.").

<sup>41</sup> A right of first refusal forces a shareholder who has found an interested buyer to give the company or the other shareholders (or both) the right to buy (essentially a call option) the selling shareholder's shares first before any sales to a third party are permitted.

<sup>42</sup> In the event neither the company nor the other shareholders purchase all of the shares for sale pursuant to their right of first refusal thus enabling a sale to the third party, the co-sale right (also known as a "tag along" right) forces the selling shareholder to include the shares of his other shareholders in the sale to the third party, cutting back on the number of his own shares he can sell to the extent necessary.

<sup>43</sup> An example would be the issuance of a new series of stock with liquidation preferences senior to that held by the VCs. This essentially gives VCs a veto right over the company's ability to accept new capital, providing substantial bargaining power and control.

involved in the company's management on a regular basis, though this external position is not necessarily freely chosen. Upon the consummation of the first institutional financing round, they are replaced on the board by representatives of the new VC investors, have their information rights reduced, and sometimes see their founding team under the supervision of a new VC-selected CEO whom they usually have little say in selecting.<sup>44</sup>

Perhaps more important than whether VC start-up companies fit within the letter of the close corporation definition is whether they fit within its spirit. Close corporation law in general, and its minority oppression doctrine in particular, were developed and have evolved to protect shareholders from abuse at the hands of the controlling shareholder group. While some of the abuses common in traditional close corporations may not apply to VC start-up companies, the majority of them remain real dangers in both contexts. Squeezeouts, freezeouts, and especially washouts are techniques occasionally found in the VC-backed start-up company context.<sup>45</sup> Indeed, many commentators have assumed the application of close corporation law to venture capital start-up companies.<sup>46</sup>

In sum, since minority shareholders in start-up companies (namely angel investors) are at the same risk of majority oppression as their counterpart minority shareholders in traditional close corporations, they are just as deserving of the same protections. In fact, given the sophistication and aggressive profit motive of venture capital investors coupled with the large sums of money to be gained or lost, angel investors in start-up companies may actually be at greater risk and require enhanced protection.

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<sup>44</sup> See *infra* Part IV on the decreasing influence of angels as a start-up company grows through successive financing rounds.

<sup>45</sup> See *Kalashian v. Advent VI L.P.*, Case No. CV739278 (Sup. Ct. Santa Clara Co., Cal. filed Mar. 23, 1994) (addressing washout claims against a venture capital investor in Alantec Corporation that eventually ended in a large settlement payout from the VC to Alantec's founders). See generally Matthew P. Quilter et al., *Duties of Directors: Venture Capitalist Board Representatives and Conflicts of Interest*, 1312 *PLI/CORP.* 1101 (June 2002).

<sup>46</sup> See, e.g., Padilla, *supra* note 33, at 280–84 (citing Massachusetts' *Donahue* case and its progeny as authority for the protection of minority shareholders in venture capital start-up companies); Bartlett & Garlitz, *supra* note 7, at 610–16.

The rest of this article will discuss the kinds of protections courts have provided to minority shareholders in traditional close corporations, and suggest how those same protections could help angel investors in the venture start-up company context.

### III. The Minority Oppression Doctrine in Close Corporation Law

While Massachusetts' 1975 *Donahue* case is often cited as the foundation of the minority oppression doctrine's judicial recognition, in truth, courts in many jurisdictions have been granting similar (albeit arguably undisciplined) protections to minority shareholders for decades.<sup>47</sup> The doctrine is grounded in a concept of fiduciary duty, based on principles of equity, which "often acts as an important restraint on [oppressive] action by controlling shareholders that seems clearly permitted by the language of the applicable statute."<sup>48</sup>

There are two general theories of liability minority shareholders in close corporations look to when considering a claim: (1) a breach of fiduciary duty held by majority shareholders; and (2) a breach of fiduciary duty held by the board of directors. This Part will review the law in jurisdictions likely to

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<sup>47</sup> See, e.g., *Kavanaugh v. Kavanaugh Knitting Co.*, 123 N.E. 148, 151–52 (N.Y. 1919); *Bennett v. Breuil Petroleum Corp.*, 99 A.2d 236 (Del. Ch. 1953) (recognizing the duty held by majority shareholders to the minority). In *Kavanaugh*, the court stated that,

[when a number of shareholders] constitute themselves, or are by the law constituted, the managers of corporate affairs or interests, they stand in much the same attitude towards the other or minority stockholders that the directors sustain generally towards all the stockholders, and the law requires of them the utmost good faith. . . . [and a court of equity] will protect a minority stockholder against the acts or threatened acts of the board of directors or of the managing stockholders of the corporation, which violate the fiduciary relation and are directly injurious to the stockholders.

123 N.E. at 151–52.

<sup>48</sup> O'NEAL & THOMPSON, *supra* note 17, at § 7:3; see also *Schnell v. Chris-Craft Industries, Inc.*, 285 A.2d 437, 439 (Del. 1971) ("[I]nequitable action does not become permissible simply because it is legally possible.").



be battlegrounds for application of the doctrine in the venture capital start-up company context—namely, Massachusetts, New York, California, and Delaware.<sup>49</sup> Each of these jurisdictions treats claim (1) differently, while claim (2) is more or less governed nationally by reference to Delaware common law.

### **A. The Duty Owed by Majority Shareholders to Minority Shareholders**

Claim (2) relating to director duties is a favorite commentator topic. Corporate board rooms, law school classrooms, and legal journals spend great time and effort addressing the fiduciary duties held by corporate directors to corporate shareholders. In contrast, much less attention is given to the notion of fiduciary duties held between and among shareholders directly, likely because such duties are only relevant where relatively few shareholders may constitute and wield majority influence over a corporation's actions. This kind of strong influence from a few shareholders is rare in public companies, but it is typical in close corporations and venture capital start-ups. Indeed, many venture capital professionals, well-schooled in their duties as directors, are often wholly unaware of their additional fiduciary duties as majority shareholders, notwithstanding the fact that such shareholder duties have been recognized for nearly a century. The highest court in New York noted as early as 1919 that whenever a number of shareholders

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<sup>49</sup> See THOMSON VENTURE ECONOMICS, NATIONAL VENTURE CAPITAL ASSOCIATION 2004 YEARBOOK, Figure 1.05, 19 (2004) (listing California, New York, and Massachusetts as the top three states ranked by venture capital under management in 2003, with \$97.3 billion, \$44.1 billion and \$42.6 billion, respectively). Silicon Valley surrounding California's San Francisco area and Waltham surrounding Massachusetts' Boston area are the two most concentrated centers of venture capital firms and start-up companies in the United States. See *id.* at Figure 9.0, 12 (listing California, Massachusetts, and New York as the first, second, and fifth ranked states by venture capital dollars received by companies based in those states, receiving \$7.6 billion, \$2.5 billion, and \$0.7 billion, respectively). While start-up companies may be located anywhere, many choose Delaware as their state of incorporation, sometimes at the insistence of their VC investors. Accordingly, these four jurisdictions are likely to be among the first to develop case law in this area in coming years.

constitute themselves, or are by the law constituted, the managers of corporate affairs or interests, they stand in much the same attitude toward all the stockholders, and the law requires of them the utmost good faith [such that a court] will protect a minority stockholder against the acts or threatened acts of the board of directors or of the managing stockholders of the corporation, which violate the fiduciary relation and are directly injurious to the stockholders.<sup>50</sup>

Professor F. Hodge O'Neal has more recently been quick to note that "[t]here is also a growing recognition that controlling shareholders stand in a fiduciary relationship to the corporation and to minority shareholders."<sup>51</sup> A few states have even codified

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<sup>50</sup> *Kavanaugh*, 123 N.E. at 151–52 (1919). The courts of Delaware have formally recognized a similar duty for nearly as long, as noted in its holding in *Allied Chemical & Dye Corporation v. Steel & Tube Co. of America*, 120 A. 486, 491 (1923):

The same considerations of fundamental justice which impose a fiduciary character upon the relationship of the directors to the stockholders will also impose, in a proper case, a like character upon the relationship which the majority of stockholders bear to the minority. When, in the conduct of the corporate business, a majority of the voting power in the corporation join hands in imposing its policy upon all, it is beyond all reason and contrary, it seems to me, to the plainest dictates of what is just and right, to take any view other than that they are to be regarded as having placed upon themselves the same sort of fiduciary character which the law impresses upon the directors in their relation to all the stockholders.

*Id.*

<sup>51</sup> O'NEAL & THOMPSON, *supra* note 17, at § 7:13. For additional case law recognizing the fiduciary duty held by majority shareholders to the minority, see *Burton v. Exxon Corp.*, 583 F. Supp. 405, 414 (S.D.N.Y. 1984) ("[T]he status of a majority stockholder or parent corporation carries with it a fiduciary duty . . . to be fair in their dealings insofar as those dealings affected the interests of the minority stockholders."); *Crosby v. Beam*, 548 N.E.2d 217 (1989) (holding that "freeze out" and "squeeze out" attempts by majority to shareholders to deprive minority shareholders of the benefits of their investments constitute breaches of fiduciary duty to the minority); *Ferber v. American Lamp Corp.*, 469 A.2d 1046 (Pa. 1983) (noting that the majority shareholders may not use their power to exclude minority shareholders from their proper share of the benefits accruing

these inter-shareholder fiduciary duties by statute.<sup>52</sup>

### B. The Oppression Doctrine in Massachusetts—the Majority Shareholder Perspective

The Massachusetts Superior Judicial Court's decision in *Donahue v. Rodd Electrottype* is often cited as establishing a cause of action by oppressed minority shareholders against their majority oppressors in a close corporation. *Donahue* held that whenever certain shareholders receive a benefit from the corporation, all shareholders must have equal access to that benefit.<sup>53</sup> More broadly, the court held that all shareholders in a close corporation owe each other a fiduciary duty of "the utmost good faith and loyalty," and "may not act out of avarice, expediency or self-interest in derogation to their duty of loyalty to the other stockholders and to the corporation."<sup>54</sup> Indeed, *Donahue* suggests that this duty between shareholders may be even more stringent than that held by directors toward the corporation's shareholders.<sup>55</sup>

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from the company and that the majority may only act in its best interest when it is also in the best interest of all the shareholders).

The concept of a fiduciary relationship is borrowed from the law of trusts and, some commentators have noted, is actually misapplied when used in the shareholder relationship context. See Ragazzo, *supra* note 19, at 1104–05 (1999). Ragazzo notes that

[a]lthough *Donahue* denominated this newly created shareholder duty as 'fiduciary' in nature, this designation is a misnomer. A true fiduciary is required to act in a non-selfish manner for the benefit of some other party . . . . However, controlling shareholders in closely held corporations, like all other shareholders, have legitimate selfish interests. Thus, the 'fiduciary' duty recognized in *Donahue* is really a duty to act fairly toward other shareholders.

*Id.*

<sup>52</sup> See, e.g., MINN. STAT. § 302A.751(1)(a)(2)(2001) (authorizing a court to grant relief when "those in control of the corporation have acted . . . in a manner unfairly prejudicial toward one or more shareholders in their capacities as shareholders, directors, or officers, or as employees of a closely held corporation"); N.D. CENT. CODE § 10-19.1-115b(3) (2001).

<sup>53</sup> See *Donahue*, 328 N.E.2d at 518–19.

<sup>54</sup> *Id.* at 515.

<sup>55</sup> *Id.* at 515; see also *Coggins v. New England Patriots Football Club, Inc.*, 492

Massachusetts also took advantage of the *Donahue* case to establish a direct right of action for minority shareholders against their fellow majority holders.<sup>56</sup> The court recognized that other remedies traditionally available to shareholders were absent or obviously futile in the close corporation context, such as a derivative action,<sup>57</sup> the statutory remedy of dissolution,<sup>58</sup> and the ability to sell one's shares into a fair and liquid market.<sup>59</sup> The creation of a direct claim was an attempt to fill a frustrating vacuum of practical redress by a minority shareholder who is subject to oppressive conduct and, for all intents and purposes, is "trapped in a disadvantageous situation."<sup>60</sup> The creation of the direct claim highlights the privity of the duty between fellow shareholders, since "[t]he claim is asserted in the shareholder's personal capacity, not derivatively on behalf of the corporation, and it lies directly against the shareholder who breached his or her fiduciary duty, not against the corporation."<sup>61</sup>

What became known as the "equal opportunity principle" as set forth in *Donahue* quickly sparked controversy and criticism amid fears that such a rule would unduly limit a majority's ability to properly manage the corporation.<sup>62</sup> In a quick response just one year later, Massachusetts acknowledged that it may have gone too

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N.E.2d 1112, 1117 n.13 (1986).

<sup>56</sup> See *Donahue*, 328 N.E.2d at 519.

<sup>57</sup> *Id.* at 508, n.4

<sup>58</sup> *Id.* at 514.

<sup>59</sup> *Id.*

<sup>60</sup> *Id.* at 515.

<sup>61</sup> Thomas P. Billings, *Remedies for the Aggrieved Shareholder in a Close Corporation*, 81 MASS. L. REV. 3, 5 (1996).

<sup>62</sup> See, e.g., EASTERBROOK & FISCHER, *supra* note 18, at 247 (noting that "courts have found the equal opportunity rule . . . impossible to administer"); see also *Toner v. Baltimore Envelope Co.*, 498 A.2d 642 (Md. 1985); *Sundberg v. Lampert Lumber Co.*, 390 N.W.2d 352 (Minn. Ct. App. 1986). *But see Jones v. H.F. Ahmanson & Co.*, 460 P.2d 464 (Cal. 1969) (holding in California prior to *Donahue* that majority shareholders breach their fiduciary duty by creating a market for their stock that was not made accessible to the minority shareholders); James D. Cox, *Mergers and Acquisitions: Equal Treatment for Shareholders: An Essay*, 19 CARDOZO L. REV. 615 (1997) (defending the application of the equal opportunity doctrine).

far and scaled back its *Donahue* holding.<sup>63</sup> In *Wilkes v. Springside Nursing Home, Inc.*,<sup>64</sup> the court held that the majority shareholder may still not treat the minority unfairly, but it will be considered to have fulfilled its fiduciary duty to the minority when (1) it shows that it acted in pursuit of a legitimate business purpose and (2) the minority shareholder cannot demonstrate that this purpose could be accomplished in an alternative manner less detrimental to the minority's interests.<sup>65</sup> The burden of demonstrating a legitimate purpose falls on the defendant majority shareholders and, if they are successful, the burden of demonstrating a less harmful alternative falls on the minority.<sup>66</sup> The *Wilkes* court noted retrospectively that "[t]he majority, concededly, have certain rights to what has been termed 'selfish ownership' in the corporation which should be balanced against the concept of their fiduciary obligation to the minority."<sup>67</sup> Massachusetts courts have reinforced the holding and application of the *Wilkes* standard in several subsequent cases,<sup>68</sup> clarifying that the duty is not just from the majority to the minority but the converse as well.<sup>69</sup> Much of

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<sup>63</sup> *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657 (Mass. 1976). While many consider the *Wilkes* decision to be a scaling back, others see it as more of a clarification rather than a retreat. See, e.g., O'NEAL, *supra* note 17, at 7-36 (commenting that in *Wilkes* "the Massachusetts court added depth and bounds to its *Donahue* pronouncements").

<sup>64</sup> 353 N.E.2d 657, 663 (Mass. 1976).

<sup>65</sup> *Id.* at 663.

<sup>66</sup> See O'NEAL & THOMPSON, *supra* note 17, at 7-37. O'Neal and Thompson note that,

[w]hen a minority shareholder challenges majority action as a breach of fiduciary duty, the court should ask if the controlling group can demonstrate a legitimate business purpose for its actions and if the answer is affirmative, give the minority an opportunity to demonstrate that the same legitimate objective could have been achieved through an alternative course of action less harmful to the minority's interest.

*Id.*

<sup>67</sup> *Id.*

<sup>68</sup> See, e.g., *Zimmerman v. Bogoff*, 524 N.E.2d 849 (1988); *Smith v. Atlantic Properties, Inc.*, 422 N.E.2d 798 (1981). But see *Hunt v. Data Management Resources, Inc.*, 985 P.2d 730, 732 (Kan. 1999) (holding that a shareholder may act in a self-interested manner without the burden of strict fiduciary duties).

<sup>69</sup> See, e.g., *A.W. Chesterton Co. v. Chesterton*, 128 F.3d 1, 3 (1st Cir. 1997)

the growing nationwide judicial recognition of fiduciary duties held by one shareholder to another in a close corporation can be traced back to some initial grounding in the standard set forth by *Donahue* and amended by *Wilkes*.<sup>70</sup>

Commentators sometimes refer to Massachusetts' rule as the "majority perspective rule," since it assesses the fairness of a majority shareholder's actions by looking at the facts from the majority's perspective.<sup>71</sup> In other words, Massachusetts, and the states which follow its lead, first ask "whether the majority has pursued legitimate goals rather than whether the majority's conduct has had an unfair impact upon the minority's investments."<sup>72</sup> Interestingly, both New York and California courts have adopted a countervailing "minority perspective rule" which assesses fairness from the minority's perspective. The minority perspective rule could be construed as favorable to the minority's claims and more understanding of its "trapped" disadvantageous position. Delaware, arguably the most influential of the jurisdictions covered here, has expressly declined to recognize any direct fiduciary duty held by majority shareholders toward minority shareholders. However, some commentators have suggested that other aspects of Delaware's mature corporate common law provide functionally equivalent protection to minority shareholders.<sup>73</sup> Each variant is addressed in turn below.

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(affirming a judgment against a minority shareholder who attempted to create a liquid market for his stock that was not accessible to all shareholders of the corporation); *Zimmerman v. Bogoff*, 524 N.E.2d 849, 853-54 (Mass. 1998); *Smith v. Atl Props., Inc.*, 422 N.E.2d 798, 801-02 (Mass. App. Ct. 1981).

<sup>70</sup> See O'NEAL & THOMPSON, *supra* note 17, at § 9.21 ("Differences as to the scope and meaning of the fiduciary duties under a *Donahue* standard do not detract from its widespread acceptance.").

<sup>71</sup> See Ragazzo, *supra* note 19, at 1105; Douglas K. Moll, *Shareholder Oppression in Close Corporations: The Unanswered Question of Perspective*, 53 VAND. L. REV. 749, 763 (2000) (noting that "the [Massachusetts] court's language echoed the majority perspective's emphasis on preserving the controlling shareholder's decision-making discretion").

<sup>72</sup> Ragazzo, *supra* note 19, at 1105.

<sup>73</sup> See, e.g., *id.* at 1135 ("[E]ven if the Delaware Supreme Court stands firm in its refusal to create special rules for closely held corporations, there is no reason the Delaware courts cannot employ Delaware's general law on the fiduciary duties of majority shareholders to prevent [overly dilutive events] in closely held

### C. The Oppression Doctrine in New York and California—the Minority Shareholder Perspective

While the majority perspective pioneered by Massachusetts is credited as the first to formally recognize the need to protect the special vulnerabilities of minority shareholders in close corporations, it is quickly losing its position as the leading state rule. The minority perspective variant, led by the courts of New York,<sup>74</sup> has been rapidly adopted by most states seeking to provide redress for aggrieved minority shareholders in close corporations.<sup>75</sup>

The minority perspective rule focuses the analysis not on the nature or intention of majority shareholder conduct, but on the consequential impact that such conduct has on minority shareholders. This rule emphasizes protection of the minority interest rather than punishment of the majority's behavior, and typically employs a "reasonable expectations" approach to determine whether the expectations of the minority have been materially frustrated by the majority's actions.<sup>76</sup> "Indeed, in describing the reasonable expectations standard, the New York Court of Appeals focused primarily on the harm to minority shareholders that potentially results from majority action."<sup>77</sup>

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corporations.").

<sup>74</sup> The first and most commonly cited case articulating the minority perspective variant of the oppression doctrine in New York was *In re Kemp & Beatley, Inc.*, 473 N.E.2d 1173 (N.Y. 1984).

<sup>75</sup> See *McCallum v. Rosen's Diversified, Inc.*, 153 F.3d 701 (8th Cir. 1998) (applying Minnesota law); *Stefano v. Coppock*, 705 P.2d 443 (Alaska 1985); *Machmeier v. Southside Press, Ltd.*, 435 N.W.2d 377 (Iowa Ct. App. 1988); *Brenner v. Berkowitz*, 634 A.2d 1019 (N.J. 1993); *McCauley v. Tom McCauley & Son, Inc.*, 724 P.2d 232 (N.M. Ct. App. 1986); *Meiselman v. Meiselman*, 307 S.E.2d 551 (N.C. 1983); *Balvik v. Sylvester*, 411 N.W. 2d 383 (N.D. 1987); *Davis v. Sheerin*, 754 S.W.2d 375 (Tex. Ct. App. 1988); *Masinter v. Webco Co.*, 262 S.E.2d 433 (W. Va. 1980).

<sup>76</sup> See Robert B. Thompson, *Corporate Dissolution and Shareholders' Reasonable Expectations*, 66 WASH. U. L.Q. 193, 219–20 (1988) ("The increasing use of the reasonable expectations standard reflects a move away from an exclusive search for egregious conduct by those in control of the enterprise and toward greater consideration of the effect of conduct on the complaining shareholder, even if no egregious conduct by controllers can be shown.").

<sup>77</sup> See Moll, *supra* note 20, at 764.

Focusing scrutiny on the expectations of the minority rather than the actions of the majority marks a significant change in the assessment process, essentially removing the legitimacy of the majority's actions from the inquiry.<sup>78</sup> New Jersey's highest court has noted that "[f]ocusing on the harm to the minority shareholder reflects a departure from the traditional focus, which was solely on the wrongdoing by those in control, and reflects the current trend of recognizing the special nature of close corporations."<sup>79</sup> Accordingly, this test places critical analysis on the "reasonable expectations" of the minority shareholders, arguably a less than perfect analysis. In setting forth the original rule, the New York court in *Kemp* tried to provide the following guidance:

[m]ajority conduct should not be deemed oppressive simply because the petitioner's subjective hopes and desires in joining the venture are not fulfilled . . . . Rather, oppression should be deemed to arise only when the majority conduct substantially defeats expectations that, objectively viewed, were both reasonable under the circumstances and were central to the minority's decision to join the venture.<sup>80</sup>

The objective standard set forth in *Kemp* does not require an explicit document setting forth an articulation of the minority's expectations, but rather requires only that the majority shareholders were aware, or should have been aware, of the relevant expectations given the particular circumstances of the situation.<sup>81</sup> Moreover, while most jurisdictions measure a minority shareholder's expectations as of the time of such shareholder's

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<sup>78</sup> See Ragazzo, *supra* note 19, at 1106 ("According to [the minority perspective] view, the legitimacy of the majority's purposes is irrelevant if the minority is denied something for which it bargained, explicitly or implicitly, at the time of investment.").

<sup>79</sup> See *Brenner v. Berkowitz*, 634 A.2d 1019, 1029 (N.J. 1993).

<sup>80</sup> *In re Judicial Dissolution of Kemp & Beatley, Inc.*, 473 N.E.2d 1173, 1179 (N.Y. 1984); see also *Meiselman v. Meiselman*, 307 S.E.2d 551, 563 (N.C. 1983) (holding that "[i]n order for plaintiff's expectations to be reasonable, they must be known to or assumed by the other shareholders and concurred in by them").

<sup>81</sup> See *Kemp*, 473 N.E.2d 1173.



initial investment, some courts and commentators have suggested that this expectation may properly evolve over time following the investment.<sup>82</sup>

California's minority oppression doctrine was outlined by its Supreme Court in *Jones v. H.F. Ahmanson & Co.*<sup>83</sup> The court made plain the explicit recognition of a duty owed by majority shareholders. "The rule of corporation law . . . is well settled . . . . The majority has the right to control; but when it does so, it occupies a fiduciary relation toward the minority, as much so as the corporation itself or its officers and directors."<sup>84</sup> California seems to follow a hybrid rule, lying somewhere between Massachusetts' majority perspective and New York's minority perspective. California appears to approach the issue of a fiduciary breach by looking at the minority's treatment and whether it has been fair, suggesting a minority-centered view.<sup>85</sup> However, in addition to considering the minority's treatment, California will also look at whether the actions taken by the majority shareholders were in genuine pursuit of a proper corporate purpose.<sup>86</sup>

The California case and eventual settlement involving a company called Alantec Inc. involved facts where two minority shareholders received treatment that was decidedly and objectively

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<sup>82</sup> See, e.g., *A.W. Chesterton Co. v. Chesterton*, 128 F.3d 1 (1st Cir. 1997); *Meiselman v. Meiselman*, 307 S.E.2d 551 (N.S. 1983); O'NEAL & THOMPSON, *supra* note 22, § 9.30, at 143 (noting that "[t]he relevant expectations are those that exist at the inception of the enterprise, and as they develop thereafter through a course of dealing concurred in by all shareholders"). Professor O'Neal has conceded, however, that the court's focus should be on the "participants' original business bargain [because] the most significant bargaining occurs at the initial stage of the enterprise." See *id.* at 91.

<sup>83</sup> 460 P.2d 464 (Cal. 1969); see also *Stephenson v. Drever*, 947 P.2d 1301 (Cal. 1997).

<sup>84</sup> *Jones v. H.F. Ahmanson & Co.*, 460 P.2d 464, 473 (Cal. 1969).

<sup>85</sup> See *id.* at 472 (noting that the rule in California is one of "inherent fairness from the viewpoint of the corporation and those interested therein").

<sup>86</sup> See *id.* at 471 (recognizing that majority shareholders have "the right to dissolve the corporation to protect their investment if no alternative means were available" and requiring that "no advantage was secured over other shareholders"); see also 2 H. Marsh, CALIFORNIA CORPORATION LAW & PRACTICE § 11.46, at 958-60 (3d ed. 1995).

unfair.<sup>87</sup> Founded in 1987, Alantec completed several venture capital rounds over a four year period that diluted the initial investors' holdings down to eight percent of the company while the venture capitalists owned the remaining 92%.<sup>88</sup> With control of the company, the VCs engineered a financing round with terms that diluted the minority shareholders from eight percent down to 0.007%. Not long after this dilutive event, the company went public and was subsequently sold for \$770 million. Had the minority shareholders retained their eight percent position, they would have garnered over \$40 million, but were left with only approximately \$500,000 after the dilutive financing event. During the trial's preliminary motions, plaintiff's counsel argued that the majority shareholders acted solely in pursuit of their personal gain at the minority's expense, at times doing so in bad faith.<sup>89</sup> The presence of both unfair treatment and a lack of proper business purpose put the venture capital defendants in a difficult position, forcing them to settle for \$15 million soon after their motion for summary judgment was denied.<sup>90</sup> Similar settlements have been reached more recently. The founder of a company called Nishan Systems filed suit against several prominent investors, including Lightspeed Ventures and ComVentures, claiming that the investors engaged in transactions that significantly diluted the founder's return upon the company's sale for \$85 million in 2003. The founder received \$800,000 as a result of the sale, and sued for an undisclosed greater sum. The dispute settled in February 2005, and while specifics were not disclosed, press coverage of the settlement suggested the receipt of a substantial payment to the plaintiff.<sup>91</sup> A similar suit brought by the founders of Epinions.com is pending against Benchmark Capital, August Capital, and BV Capital, all significant pillars of the venture capital community.<sup>92</sup>

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<sup>87</sup> See *Kalashian v. Advent VI Limited Partnership*, Case No. CV739278 (Sup. Ct. Santa Clara Co. filed Mar. 23, 1994); see also Scott Herhold, *Venture Capitalists Settle Suit*, SAN JOSE MERCURY NEWS, Feb. 20, 1997, at 1C (covering the Alantec settlement).

<sup>88</sup> See Herhold, *supra* note 87.

<sup>89</sup> See *id.*

<sup>90</sup> See *id.*

<sup>91</sup> See Loizos, *supra* note 16.

<sup>92</sup> *Id.*

Venture capitalists conducting business in a minority perspective jurisdiction must be particularly careful, since liability may be assessed even while acting with good intentions. So long as a minority holder shows that his investment expectations were reasonable and frustrated by the majority's actions, the majority will be held to have breached its duty. Of notable importance is the courts' use of a constructive knowledge standard in assessing whether the majority was aware of the minority's expectation, thus helping it satisfy the definition of "reasonable." The objective nature of the test may spur majority shareholders into conducting some minimum investigation into the minority's expectations prior to embarking upon a potentially oppressive action.<sup>93</sup>

## **D. The Oppression Doctrine in Delaware—Still Undetermined**

### **1. Delaware's View on the Majority Oppression Doctrine**

The Delaware Court of Chancery first faced a case involving a freezeout of a minority shareholder's position in *Little v. Waters*.<sup>94</sup> The plaintiff in *Little*, who owned one-third of the stock versus the defendant's two-thirds, alleged that the majority shareholder's suppression of dividend payments rendered his stock worthless as part of a freezeout scheme.<sup>95</sup> In finding for the plaintiff, the court held that a close corporation majority shareholder has a fiduciary duty of fairness to a minority shareholder that precludes the use of freezeout tactics. Moreover, the Chancery Court applied New York's minority perspective version of the oppression doctrine to find that a majority shareholder breaches its fiduciary duty if it frustrates the reasonable investment expectations of the minority, irrespective of

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<sup>93</sup> See *infra* Part VI.A for a discussion of managing minority shareholder expectations preemptively as both a sanitizing action for the company and a layer of liability protection for venture capital firms upon entering a deal.

<sup>94</sup> No. 12155, 1992 Del. Ch. LEXIS 25 (Del. Ch. Feb. 10, 1992).

<sup>95</sup> See *id.* at \*5.

the majority's intentions or ambitions.<sup>96</sup>

A year after *Little*, the Delaware Supreme Court decided the case of *Nixon v. Blackwell*, where it first considered the question of "[w]hether there should be any special, judicially-created rules to 'protect' minority stockholders of closely held Delaware corporations."<sup>97</sup> The case involved a corporate practice of buying key man life insurance policies for executive employees and using the proceeds paid upon the death of an employee to buy back the employee's stock from the estate. The non-employee minority shareholders had no such means of liquidity for their stock upon death or otherwise, and claimed that the policy unfairly provided a liquidity benefit for the employee shareholders that was unavailable to non-employee shareholders.<sup>98</sup> The Chancery Court, in deference to the equal opportunity principle set forth in *Donahue v. Rodd. Electrotape Co.*,<sup>99</sup> held that this practice constituted discrimination and that the majority shareholders breached their fiduciary duty through its implementation.<sup>100</sup>

On appeal, the Delaware Supreme Court overturned the Chancery Court's ruling, and added emphatic language to reject the notion of an oppression doctrine to protect minority shareholders in Delaware close corporations.<sup>101</sup> The court cited Delaware's legislation that enables close corporation shareholders to govern their relationships by contract,<sup>102</sup> and postulated that any shareholder protection should be sought through private contract negotiation and not by judicial intervention.<sup>103</sup>

Delaware's hard stand on this issue has sparked some caustic debate.<sup>104</sup> In many cases involving traditional close

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<sup>96</sup> See *id.* at \*22 (citing *Gimpel v. Bolstein*, 477 N.Y.S.2d 1014, 1017 (1984)).

<sup>97</sup> 626 A.2d 1366, 1379 (Del. 1993).

<sup>98</sup> See *id.* at 1376-77.

<sup>99</sup> 328 N.E.2d 505 (Mass. 1975).

<sup>100</sup> See *Nixon*, 626 A.2d at 1373.

<sup>101</sup> See *id.* at 1379.

<sup>102</sup> See DEL. CODE ANN. tit. 8, §§ 341-356 (1998). The Delaware statute explicitly permits close corporation shareholder agreements that limit a board's discretion and function, effectively providing for the company's management directly by the shareholders. See *id.* §§ 350-351.

<sup>103</sup> See *Nixon*, 626 A.2d at 1380.

<sup>104</sup> See *Ragazzo*, *supra* note 19, at 1311; Robert B. Thompson, *The Taming of*

corporations, the suggestion that minority shareholders can and should protect themselves by contract is a plausible position. However, in the venture start-up context, angel investors encounter significant limitations on their ability to do so.<sup>105</sup> Some commentators claim that it is unrealistic to expect minority shareholders to adequately protect themselves in a close corporation context.<sup>106</sup> Others, grounded generally in equitable and public policy concerns, note that “[i]t would seem to be the courts’ job to . . . enforce the spirit of the deal between the parties, even in cases where no formal contract exists.”<sup>107</sup> Still others, recognizing that close corporation minority shareholders may consider the costs of retaining preventative legal counsel to be prohibitively expensive, argue that courts should focus their inquiry on “what the parties would have contracted for had transaction costs been nil.”<sup>108</sup> It has also been noted that the *Nixon* appeal did not directly involve a freezeout scheme or other issue of minority shareholder oppression, couching all language against

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*Limited Liability Companies*, 66 U. COLO. L. REV. 921, 935 (1995).

<sup>105</sup> See Manuel A. Utset, *A Theory of Self-Control Problems and Incomplete Contracting: The Case of Shareholder Contracts*, 2003 UTAH L. REV. 1329, 1335 (2003) (“[A] minority shareholder who is fully informed of applicable legal rules, is not overly trusting, and has a strict preference to enter into shareholder contracts, may still fail to do so due to self-control problems [based on] fairly straightforward human motivations.”); F. Hodge O’Neal, *Close Corporations: Existing Legislation and Recommended Reform*, 33 BUS. LAW 873 (1978); F. Hodge O’Neal, *Oppression of Minority Shareholders: Protecting Minority Rights*, 35 CLEV. ST. L. REV. 121 (1987).

<sup>106</sup> See O’NEAL & THOMPSON, *supra* note 17, § 2.20, at 54 (recognizing “[t]he widespread reluctance of the participants in small businesses to obtain competent legal advice”).

<sup>107</sup> Ragazzo, *supra* note 19, at 1311.

<sup>108</sup> See EASTERBROOK AND RISCHER, *supra* note 18, at 250. Judge Easterbrook and Professor Rischel also note that

[r]ules bite most frequently . . . when parties are ignorant of them until a dispute arises; then they are bound by whatever the standard term happens to be. Many commentators believe that such ignorance is widespread and that the law of closely held corporations is defective because it fails to protect investors who neglect to protect themselves.

*Id.* at 237.

minority shareholder protections in non-binding dicta.<sup>109</sup> In short, the *Nixon* court's assertion that contract terms should be the only means of minority shareholder protection in close corporations has not been formally resolved, and remains subject to serious debate.<sup>110</sup>

The only other Delaware case involving a claim of breach of duty by a close corporation's majority shareholders was in *Riblet Products v. Nagy*, decided in 1996.<sup>111</sup> That case involved the enforcement of an executive shareholder's employment agreement where the executive claimed that the company's controlling shareholders breached their fiduciary duty by failing to uphold their obligations in his agreement.<sup>112</sup> The case was brought in federal court in Indiana, which held that the majority shareholders had breached their duty and imposed upon them \$375,000 in punitive damages. On appeal, the question certified by the Seventh Circuit was "whether corporate law requires controlling shareholders to act as fiduciaries toward minority shareholder-employees."<sup>113</sup> The circuit court deemed that Indiana, following Massachusetts' majority perspective version of the oppression doctrine set forth in *Wilkes*, would recognize such a fiduciary duty and would likely find that it had been violated in the *Nagy* case.<sup>114</sup> The case was governed by Delaware law, however, and the Seventh Circuit certified the question for review by the Delaware Supreme Court, noting that "[t]he Supreme Court of Delaware has never addressed the question."<sup>115</sup>

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<sup>109</sup> The *Nixon* case as appealed did not include the claim that the majority had utilized a freezeout scheme to force the minority's sale of its shares at a low price, even though those facts were involved in the lower court case.

<sup>110</sup> See *Hollis v. Hill*, 232 F.3d 460, 469 n.28 (5th Cir. 2000) ("[T]he Delaware Supreme Court has yet to consider the precise issue in this case, namely whether a controlling shareholder is liable for actions taken with the purpose and effect of freezing out another shareholder.").

<sup>111</sup> 683 A.2d 37 (Del. 1996). *But see* *Clemmer v. Cullinane et al.*, 2002 WL 1923868, at 3 (Mass. Super.) ("[T]he Delaware Supreme Court in *Nixon* has specifically addressed the minority shareholder freezeout claim indicating that it is not a new theory of liability and will not ultimately prevail.").

<sup>112</sup> *Nagy v. Riblet Prods. Corp.*, 79 F.3d 572, 573-74 (7th Cir. 1996).

<sup>113</sup> See *id.* at 576.

<sup>114</sup> See *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657 (Mass. 1976).

<sup>115</sup> *Nagy*, 79 F.3d at 577. The fact that the Seventh Circuit didn't reference

When the Delaware court accepted the certification for *Nagy*, it reformulated the certified question narrowly, limiting its analysis to “[w]hether majority stockholders of a Delaware corporation may be held liable for violation of a fiduciary duty to a minority stockholder who is an employee of the corporation under an employment contract with respect to issues involving that employment.”<sup>116</sup> The Delaware court took advantage of this reformulated limited context addressing employment contract issues, noting the relatively lengthy extent to which the contested terms were negotiated in the agreement, and finding that in such a case where a detailed contract exists addressing the issues directly, the contract terms would apply and there is no cause for the courts to impose any fiduciary duty on the majority shareholders.<sup>117</sup> The court took some pains to avoid the direct question of whether a duty is owed among and between close corporation shareholders in the *Nagy* case, consequently leaving the issue of majority shareholder fiduciary duty unresolved to this day.

## 2. Application of Delaware’s Entire Fairness Test

Even in the event that Delaware would refuse to impose any fiduciary duty upon a close corporation’s majority shareholder via any version of the minority oppression doctrine, an angel investor plaintiff may still be able to impose the same standard of responsibility through different means. Directors of Delaware corporations are, of course, bound to maintain the minimum standards of the jurisdiction’s oft-cited duties of care and loyalty. The duty of care considers such factors as whether directors acted

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*Nixon* strongly suggests its endorsement of the view that Delaware’s law has not yet weighed in on the question of shareholder oppression in close corporations. The court cited *Ueltzhoffer v. Fox Fire Development Co.*, No. 9871, 1991 Del. Ch. LEXIS 204 (Del. Ch. Dec. 19, 1991), as the only relevant Delaware authority. *Ueltzhoffer*, as noted by the court, does not resolve the issue of whether Delaware recognizes a fiduciary duty owed by shareholders in close corporations.

<sup>116</sup> *Riblet Prods. Corp. v. Nagy*, 683 A.2d 37, 39 (Del. 1996).

<sup>117</sup> *See Nagy*, 79 F.3d at 577 (declaring that “the label ‘fiduciary’ does not trump a real contract; it is a gap-filling approach”).

in a manner that was informed, in good faith, and in the belief that the action taken was in the best interests of the company.<sup>118</sup> The duty of loyalty “is intended to prevent a director from taking action that would accrue to the advantage of himself or herself personally (or a separate third party) at the expense of, or to the detriment of, the corporation and its shareholders.”<sup>119</sup> A court looks for any conflicts of interest that may arise between a director’s self-interest and duties to the company,<sup>120</sup> and is particularly wary of any transactions between the company and a separate firm in which the director has a direct financial interest, such as a venture capital firm.<sup>121</sup> So long as these duties are met, directors will enjoy the liability protection granted by the business judgment rule to shield a board’s business decisions from the second-guessing scrutiny of a court with the benefit of hindsight.<sup>122</sup> Should either duty not be met, and some have suggested that the duty of loyalty can never be properly fulfilled in the context of a venture capital start-up company,<sup>123</sup> a Delaware court will apply its “entire fairness” test to the actions of a board, resting the burden on the board to prove that a given company action was fair to all shareholders.<sup>124</sup> Meeting

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<sup>118</sup> See *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (noting that the business judgment rule stems from the principle and presumption that a company’s directors are the ultimate managers of the company’s business affairs).

<sup>119</sup> Matthew P. Quilter, et al., *supra* note 45, at 1107–08.

<sup>120</sup> See *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939).

<sup>121</sup> See *id.* at 1108.

<sup>122</sup> See *id.* at 872 (citing *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971) in asserting that, if the business judgment rule applies, a Delaware court “will not substitute its own notions of what is or is not sound business judgment”).

<sup>123</sup> See *Bartlett & Garlitz*, *supra* note 7, at 617–20 (enumerating several claims of independence by venture capital start-up company directors and explaining why each is unconvincing).

<sup>124</sup> See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983). The Delaware legislature has created a safe harbor provision enumerating certain steps an interested director may take to mitigate the appearance of impropriety. See DEL. CODE ANN. tit. 8 § 144(a)(1)-(3) (2001). However, even if a director were to follow the statute and undertake to satisfy the safe harbor, Delaware courts have not absolved liability but rather view satisfaction of the safe harbor as a mitigation of concern that “merely removes an ‘interested director’ cloud . . . [but] nothing in the statute . . . removes the transaction from judicial scrutiny.” *Fliener v. Lawrence*, 361 A.2d 218, 222 (Del. 1976). In most cases, if a party



this burden is notoriously difficult in Delaware courts, leading many to consider the invocation of the entire fairness test as an all but dispositive outcome in favor of the plaintiff.<sup>125</sup>

In most corporations, shareholders are numerous and widely dispersed, with even relatively large shareholders owning only a small fraction of the company's outstanding stock. Though such large shareholders may wield some influence of the company's affairs, absent separate contractual or voting arrangements, that influence does not approach any material level of control. This is the case in most public corporations, resulting in a concentration of corporate control in the hands of the elected directors acting as representatives of a wide shareholder base. It is proper, in this large public company model, for the fiduciary responsibilities described above to rest with the company's direct managers—its board of directors.

However, courts have noted that where there is one large controlling shareholder or a block of shareholders constituting a majority, the majority shareholders are "generally subject to many of the same fiduciary obligations as a director, because the shareholder may control the directors."<sup>126</sup> This fiduciary duty inures to majority shareholders in both public and private companies, though it is more likely to be implicated in smaller private companies where the shareholder base is smaller and a controlling shareholder's control is more evident. The U.S. Supreme Court has specifically noted that "[t]he majority has the right to control; but when it does so, it occupies a fiduciary relation

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meets the safe harbor qualifications, the most a Delaware court will do is shift the burden to the party challenging a board's alleged self-dealing action, leaving it to the plaintiff to prove that the action was unfair. *See Kahn v. Lynch Communications Sys., Inc.*, 638 A.2d 1110, 1117 (1994).

<sup>125</sup> *See, e.g., Ragazzo, supra* note 19, at 1137 (suggesting that the application of the entire fairness test borders on "outcome-determinative"); *Mills Acquisition Co. v. MacMillan, Inc.* 559 A.2d 1261, 1279 (Del. 1988); *AC Acquisitions v. Anderson*, 519 A. 2d 103 (Del. Ch. 1986).

<sup>126</sup> WILLIAM E. KNEPPER & DAN A. BAILEY, *LIABILITY OF CORPORATE OFFICERS AND DIRECTORS*, § 1.13 (7th ed.); *see, e.g., Pepper v. Litton*, 308 U.S. 295, 306 (1939) (declaring that [a] director is a fiduciary, . . . [as] is a dominant or controlling stockholder or group of stockholders"); *Perlman v. Feldmann*, 219 F. 2d 173 (2d Cir. 1955); *Mason v. Pewabic Mining Co.*, 133 U.S. 50 (1890); *Camp v. Dema*, 948 F.2d 455 (8th Cir. 1991).

toward the minority, as much so as the corporation itself or its officers and directors.”<sup>127</sup> With their substantial control, majority shareholders step into the shoes of the directors and bear the same set of responsibilities as would directors. As one commentator put it,

[a]lthough the traditional corporate model posits that directors, rather than shareholders, direct corporate activity, this model breaks down where a single shareholder or group of shareholders owns a controlling interest. In such situations, the board is usually just a proxy for the controlling shareholder or group. The power incident to control gives rise to equivalent responsibility.<sup>128</sup>

Accordingly, even if the Delaware Supreme Court does eventually spell out its stance against an oppression doctrine set forth in *Nixon*, majority shareholders with de facto control of a board could nonetheless serve as an extension of a board of directors of a Delaware corporation and accordingly bear the same fiduciary responsibilities.

In sum, although Delaware’s *Nixon* court suggested its aversion to imposing an explicit fiduciary protection for minority shareholders in close corporations, that position has yet to be couched as a binding precedent in a case directly addressing the issue. The view has also received significant comment and criticism, causing Delaware to soften its view and defer a firm decision through its opinion in *Nagy*, which goes so far as to suggest that Delaware law may protect minority shareholders in freezeout cases. Irrespective of how Delaware’s minority oppression doctrine may be settled, there exist today the duties of care and loyalty owed by both directors and controlling shareholders of public and private Delaware corporations. To the extent the duty of loyalty cannot be satisfied, a likely result for VC

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<sup>127</sup> *Southern Pacific Co. v. Bogert*, 250 U.S. 483, 487–88 (1919).

<sup>128</sup> See *KNEPPER & BAILEY*, *supra* note 126, at § 1.13 (“When minority shareholders have no voice in management, the majority shareholders have a duty to protect the interests of the minority.”); *River Management Corp. v. Lodge Properties, Inc.* 829 P.2d 398 (Colo. Ct. App. 1991); *Ragazzo*, *supra* note 19, at 1135.

investors in start-up companies,<sup>129</sup> a Delaware court will apply its entire fairness test to a challenged transaction, possibly resulting in the provision of the same protection to the aggrieved minority shareholders as would a formal recognition of special majority shareholder fiduciary duties, albeit via a different analytical route.

#### IV. The Angel's Unique Role in VC Start-ups

Angel investors are a rare and courageous breed. In many cases, they are the beneficent providers of a new company's initial capital that is the launch pad of the new venture. Angels enter a deal at the inception stage usually for at least one of the following four reasons: (1) they have a pre-existing relationship with the company's founders toward whom they likely feel a positive bias;<sup>130</sup> (2) they get excited about the promise of a company's technology and want to be a part of its commercialization; (3) they like the perceived economics of investing at the "ground floor" of an enterprise with the hopes of buying low and selling at a high multiple; or (4) once VCs get involved with a company at a slightly later stage of its life, it is unlikely that the VCs will tolerate the expansion of a company's shareholder base to include an angel, thus limiting an angel's investment opportunities to those that a VC would decline as being "too early." Each of these reasons are problematic in their own right, implicating the angel's expectations or vulnerability to abuse in a manner that is relevant to a court's analysis of their deserved protection.

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<sup>129</sup> See Quilter et al., *supra* note 45, at 1120. Quilter notes that [t]he potential for the venture fund to obtain rights and benefits above and beyond those that would have been achieved in an arm's length negotiation presents a stark conflict of interest dilemma for the venture capitalist board representative: he or she is bound by a fiduciary duty of loyalty to the company, yet is faced with the prospect of helping to structure and approve a financing in which the venture fund he or she represents may ultimately accrue excess profits at the expense of the company and its shareholders.

*Id.*

<sup>130</sup> Sometimes an angel financing round is referred to as a "friends and family round."

Sophisticated angels try to invest in the same security as venture investors, creating and purchasing a preferred series of stock with certain rights and return benefits senior to the common stock. Some very seasoned angels, or at least angels represented by seasoned counsel, will invest in a convertible note with principal and interest convertible into the company's subsequent preferred equity round. This method benefits the angel for a number of reasons: it grants a security interest in the company's assets, defers the valuation negotiation, and piggybacks off of the negotiating leverage of the VC by essentially pre-buying into the venture round's series of stock. At the other extreme are angels who purchase common stock, or "founders stock," which carries no benefits other than a residual value that is likely to be significantly diluted during the course of a company's life.<sup>131</sup> Whichever method of investment used, angel investors are susceptible to actions and potential abuse by venture capital investors, even when such "abuse" is not intentionally directed toward the angels and is in perfect compliance with the VC's mandate to serve its limited partner ("LP") investor base.<sup>132</sup> This Part describes some of the reasons for an angel's unique susceptibility, setting the stage for a claim of minority shareholder oppression against the larger VC shareholder.

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<sup>131</sup> Typically, all venture capital investors in a start-up will negotiate to purchase preferred stock. The only common stock will be held by the company's founders, any consultants or professionals paid with stock along the way, and a pool of common shares reserved for issuance upon the exercise of options held by the company's employees (often called the "option pool"). An option pool is needed to properly incent management and key employees to increase the value of the stock so they can derive a profit upon the exercise of their vested options. Option pools usually constitute between 15% and 30% of a company's fully diluted capitalization and, importantly, are often "re-upped" after each financing event to fend off any dilutive effects the financing may have. This keeps the option pool at a consistent relative size, but often significantly dilutes the value of the common stock held by others, including that held by unwary angels.

<sup>132</sup> Investors in venture capital firms are often referred to as "LPs," an abbreviation for limited partner which is the legal definition of an LP's relationship to the venture capital fund. This article may refer to "LPs" hereinafter.

## A. Angels Often Invest On Trust

Though angels generally satisfy the requirements of the accredited investor definition promulgated by federal securities laws,<sup>133</sup> rarely are they fluent in the distinct practice of venture capital investing.<sup>134</sup> Angels are usually introduced to a start-up investment opportunity through a personal relationship, sometimes by family relation, and are accordingly driven to their investment decision by factors beyond a pure return analysis.<sup>135</sup> These range from a sympathetic interest in helping a struggling entrepreneur get off the ground to an enthusiastic inclination to readily accept unduly optimistic financial projections. This notion is especially true in cases where new companies issue securities pursuant to the registration exemption in the SEC's Rule 504, which does not demand much in the way of company information disclosure.<sup>136</sup>

Moreover, angels generally place far too much comfort in the presumed support of and alignment of interests with venture capital investors. “[M]inority shareholders as a rule only seem to have wittingly left themselves open to majority exploitation and the consequent disaffection and disappointment of their expectations.”<sup>137</sup> They commonly do not have a firm enough grasp

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<sup>133</sup> See Rule 501(a) of Regulation D, 17 C.F.R. § 230.501, promulgated by the Securities and Exchange Commission pursuant to Section 2(15) of the Securities Act of 1933, 15 U.S.C. § 77e.

<sup>134</sup> See O'NEAL & THOMPSON, *supra* note 17, at § 9:01 (arguing that minority shareholders invest in close corporations without a full understanding that “in the absence of special protective arrangements, almost absolute control” is in the hands of the majority shareholders).

<sup>135</sup> See Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1799–1807 (2001).

<sup>136</sup> See Rule 504 of Regulation D, 17 C.F.R. § 230.504, promulgated by the Securities and Exchange Commission pursuant to Section 3(b) of the Securities Act of 1933; Utset, *supra* note 26, at 1333 (2003) (“[M]inority shareholders generally fail to enter into shareholder contracts due to ignorance or overly trusting behavior.”); see also Edwin J. Bradley, *An Analysis of The Model Close Corporation Act and a Proposed Legislative Strategy*, 10 J. CORP. L. 817 (1985).

<sup>137</sup> See Manuel A. Utset, *supra* note 26, at 1345 n.68 (noting that “the correct explanation [for this exhibited behavior] is a naïve complacency, an overly trusting nature, bad legal advice or a blunder”).

on a company's financing requirements to reach an exit event, particularly in the current financial climate, and underestimate both the challenge and nature of raising subsequent financing. While a substantial private equity brokerage or placement agent industry exists, venture capital investors in start-up companies typically try to avoid using them to keep transaction costs down. The VC and its professional network then become the main source of new investor candidates, putting the angel investors even further at their mercy.<sup>138</sup>

### **B. Angels Often Do Not Have Adequate Legal Representation**

In *Nixon*, the Delaware Supreme Court based much of its resistance to upholding a fiduciary duty for the benefit of minority shareholders on its faith that the minority shareholder should be able to defend and protect its own rights through contract.<sup>139</sup> No additional judicial protection should be forthcoming, according to this argument, where minority investors can protect themselves. In theory, this argument properly restrains judicial activism, suppresses an overly paternalistic position of the court over private party business dealings, and better allows for freedom of contract and negotiation. In general, such a hands-off approach makes for sensible jurisprudence. In the VC start-up company context, however, it has some troubling limitations.<sup>140</sup>

For many reasons, minority investors in close corporations,

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<sup>138</sup> See Jeffrey A. Blomberg, *The Lurking Danger in Insider-Led Financings*, 12 BUS. L. TODAY 55, at 55 (May/June 2003), ("These companies typically do not retain an investment banker to locate financing. Instead, they rely on the company's venture capitalist directors who often have the means to obtain outside financing.").

<sup>139</sup> See *Nixon v. Blackwell*, 626 A.2d 1366, 1379 (Del. 1993).

<sup>140</sup> Ragazzo, *supra* note 19, at 1129 ("There are, nevertheless, significant limitations on the minority's ability to protect itself by contract [in close corporations]."); F. Hodge O'Neal, *Close Corporations: Existing Legislation and Recommended Reform*, 33 BUS. LAW 873 (1978) (noting how minority shareholders still need protection in addition to their ability to enter into protective contracts since state statutes which permit such governance by contract are not "self-executing").

and angel investors in particular, are not able to get adequate legal representation at the initial or later stages of their investments. This is more the result of financial or negotiation realities than a conscious choice. The smaller the enterprise, the larger the relative cost of securing and properly utilizing sophisticated legal representation. For example, a group of angel investors investing a total of \$500,000 into a nascent technology company, or defending its investment position at the next VC investment stage, is often unable to bear the same level of legal representation as a large public company.

Even where an angel engages legal counsel at the point of initial investment, that point is usually the last at which the angel will consider itself an independent constituency. During the subsequent rounds of venture capital financing, angels will often look to borrow and “piggyback” upon the legal representation provided by the round’s “lead” investor. A lead investor is typically the largest VC participant in a new financing round, and is responsible for negotiating the terms and nature of the round with the company. It is customary for other “follow on” VCs who invest alongside the lead to rely on the lead’s legal representation as a proxy for all investors.<sup>141</sup> This is appropriate where VCs of a like nature invest together in the same security. However, few angels appreciate the misalignment of their investment interests and those of the lead VC, both because of the nature of their securities held and their ability to participate in later rounds, and they leave themselves without proper legal representation.

For example, angel investors by their nature do not have access to the amount of reserved capital that a large VC fund may, and as such may be unable to defend its equity position through subsequent financing stages. Notwithstanding this distinction, VCs often arrange a company’s financing so as to require substantial additional investment at specified future development milestones. Staging investment is a common method used by VCs to minimize the amount of risk capital deployed until a company grows through its more vulnerable phases. The angel investor suffers dilution at each of these stages and his investment could be

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<sup>141</sup> Indeed, sometimes the lead investor’s law firm is incorrectly referred to as “investors’ counsel.”

eventually washed away if the staging continues beyond the angel's staying power. To force insider support of a company, sometimes VCs will impose a "pay to play" provision in a given investment round. Here, the VCs will force the company to offer a certain amount of stock to current investors at a certain price. If any investors do not participate to their full pro rata share of the issuance, they suffer a penalty, usually resulting in some additional dilution.<sup>142</sup> With less investment capital and weaker bargaining power, angels are often the most susceptible to penalty by a pay to play and usually suffer the greatest injury.

Angels also often hold common stock instead of, or in addition to, preferred stock. Since angels invest in a company at its inception, the first security they purchase is "founders stock," or the same common stock held by founders at the time of the company's launch. A VC will purchase some variant of preferred stock when it first invests, followed by subsequent rounds of preferred stock issuances at each financing stage. Thus, an angel will hold both common and preferred stock while VCs will only hold preferred stock. The different mix of securities held creates an inherent conflict between VCs and angels, since most of the terms VCs negotiate for in their preferred stock are, by definition, at the expense of the return of the common stock. VCs will generally protect some portion of the common stock as a reserved pool for the exercise of employee options to keep employees motivated, but there is no such protection granted to common stock held by non-employees like angels. Consequently, an angel relying on a lead VC investor to negotiate on behalf of his holdings is negotiating against himself.<sup>143</sup>

At other times, angel investors believe their interests are aligned with those of the founders, as in the case where an angel investor has purchased common stock, the same kind of security

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<sup>142</sup> See *Watchmark Corp. v. ARGO Global Capital, LLC et. al.*, Del. Ch., C.A. No. 711-N, Chandler, C. (Nov. 4, 2004) (validating the use of pay to play dilutive provisions by holding that directors of a Delaware company did not violate their fiduciary duties by approving a financing that employed such a framework to force inside investor participation).

<sup>143</sup> See Edward B. Rock & Michael L. Wachter, *Waiting For the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 IOWA J. CORP. L. 913 (1999).



owned by the founders. An angel might reasonably believe that since the founders share the same equity interests, that they will adequately represent those interests when negotiating against the VCs on behalf of the company. For many of the reasons cited below, however, those interests are frequently not as aligned as many angels would hope. In recognition of this, one commentator has gone so far as to suggest that when an angel investor's interests are not precisely aligned with those of a represented constituency in a close corporation transaction, the company should provide independent counsel for the angel at its own expense.<sup>144</sup>

### **C. Angel Interests are Distinct From and Often Adverse to Those of Founders**

#### **1. Founders Have Non-Pecuniary Interests**

Founders of legitimate and credible start-up companies are few and far between. These are often scientists or entrepreneurs who have spent a substantial portion of their lives working toward the development of a technology to serve as the platform of a start-up company. Many founders are astonished and understandably overwhelmed by all the attention they suddenly attract from service providers and business executives the moment a VC begins to take an interest in their lab project. Their flattery and excitement is counterbalanced by a healthy dose of trepidation once others begin to recognize, and fight for a piece of, the value in their invention.

The emotion and hard work contributed by a founder to a start-up's technology is a particularly special type of investment that demands rewards beyond the mere pecuniary. Founders are watching their life's work commercialized from vision to reality,

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<sup>144</sup> See *Ragazzo*, *supra* note 19, at 1139 ("Where the corporation's lawyer is also in effect acting as the majority's counsel, however, the minority deserves to be represented by an independent lawyer at the corporation's expense."); *Ryan v. Tad's Enterprises, Inc.*, 709 A.2d 682, 693 (Del. Ch. 1996) ("A desire to control costs cannot relieve corporate fiduciaries from their duty to assure that the interests of minority shareholders in a self-dealing transaction are adequately protected."); *Davis v. Sheerin*, 754 S.W.2d 375 (Tex. App. 1988).

and will often readily sacrifice their own interests (and those of others) to keep their dream alive.<sup>145</sup> Consequently, if the company is facing a down round or possibly a washout situation, founders may acquiesce to draconian VC terms much sooner than their angel investors, even if both shareholders own the same type of securities. The founder simply has a greater emotional investment in seeing the enterprise to fruition than the angel, and is willing to sacrifice his return to get it. The unassuming angel follows suit often relying in false comfort that his and the founders' interests are aligned.

## 2. Founders Stock Earned by Less Return-Sensitive "Sweat Equity"

Another significant distinction between angel and founder interests lies in the consideration each paid for their stake in the venture. Angels have, of course, purchased their equity with cash. In return they receive an illiquid security with the potential for significant value dilution. Should the company grow successfully and exit at a sufficiently high value, an angel investor will measure the success of his investment as a multiple of the initial cash invested and, in turn, his internal rate of return. Founders, on the other hand, usually do not pay anything in cash but rather earn their ownership in the company through "sweat equity," or the work they have put in to develop the company to the point of its financing. A company's initial investors sometimes refer to the value a founder has generated before any money is invested as a company's "pre-money value."<sup>146</sup>

Founders who own stock earned by their sweat equity do not calculate the same investment return as angels since their cash investment in the company is zero. Accordingly, if a founder receives anything from the company, it is a positive return. Furthermore, since most founders begin and remain employed by the companies they create, the salaries they earn and the

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<sup>145</sup> See Padilla, *supra* note 33, at 279 ("As founders, the company may be seen as their 'baby' and would not want to see the company go bankrupt.").

<sup>146</sup> See generally ALEX WILMERDING, TERM SHEETS & VALUATIONS: AN INSIDE LOOK AT THE INTRICACIES OF TERM SHEETS & VALUATIONS (2001).

employment prospects they have at the company serve as an immediate return. Any actual return on their stock is certainly welcome, but comes on top of the return they receive every day by their mere employment. This fact causes a divergence of founder interests from angel interests in at least two ways. First, once VCs get involved in the company and generally impose significant influence over a company's operations, a founder may worry about his continued employment at the company. In the face of investors who want to consummate a washout transaction, founders "are largely at the mercy of the board of directors, [which is] composed of a majority of directors designated by the investors."<sup>147</sup>

Accordingly, founders employed by the company are unlikely to stand up for their and their angel investors' rights in a position adversarial to their employer. Second, since founders are generating a positive return on their investment from the first day they draw a salary check, they are not as hungry for a return as is an investor who has put in cash.<sup>148</sup> In VC slang, founders are "playing with the house's money" from the first day, and are not considered to have put any "skin in the game" by virtue of having received stock they did not purchase with cash. They are less sensitive to maximizing their return than an angel who is working toward a targeted return multiple on actual invested cash, and may therefore not be as staunch a negotiator on the angel's behalf.

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<sup>147</sup> *Id.* at 279.

<sup>148</sup> Arguably, founders could be considered to have invested their opportunity cost which they may be foregoing by working at the start-up company rather than a possibly more lucrative alternative. This argument rests on the assumption that founders accept a lower cash salary at the start-up in exchange for their equity stake and its potential to rise dramatically in value. In reality, however, this is not the case. Start-up cash salaries are usually competitive to those at larger company counterparts, even with the additional equity potential on top of the cash payments. Another argument suggests that founders are suffering a higher degree of job instability at a start-up than at a larger company. This has traditionally been true and may continue to be so to a lesser extent today, but job instability and overseas job outsourcing is an increasingly important issue at even the largest companies today. In short, few jobs can legitimately be considered safe in today's economic climate.

### **3. Angels Don't Have a Founder's Access to or Influence Within the Company's Operations**

At a company's earliest stages, founders and their angel investors are generally working closely together side by side. Employees are few, the investor group is small, dollars are precious, and both groups feel bound by a common and worthy sense of mission. As the enterprise grows, however, complications arise. The angel investors may serve as the founders' confidant up to and during the first institutional round, but once venture capitalists are involved, the VCs will thereafter dictate the board membership and information flow. Most start-up boards consist of five or seven directors, nearly half of which are designated by the VCs, one or two for management, and one or two for an outside director, usually designated or approved by the VCs. Founders generally retain a position as an officer of the company, usually as chief technology officer or vice president of business development, and accordingly have daily access to the company's information, progress, and even board meeting activities.

Angel investors, on the other hand, are often considered unnecessary to the company's future once the VCs get involved. The angels have made their contribution by helping the company get off the ground, but now that it is up and running, the VC's substantially deeper pockets should be all that is needed to help the company achieve its growth path. With the angel's decreasing relevance as the company grows, and the founders' (and company's) increasing reliance on the future assistance of the VC investors, the angel begins to be less connected to and informed by the company. A savvy angel may be able to negotiate a board observer position to stay on top of the company's progress, but most VCs like to keep their board meetings small and will resist. The angel's influence on the company becomes diluted along with its equity holdings, and the resulting forced divergence keeps the angel investor less informed and less protected. Indeed, it is not uncommon for a company to consider, negotiate, and consummate significant transactions (such as a new stock issuance or divestiture of assets) without the angel investors even being aware of the

transaction until its completion.<sup>149</sup>

#### **D. Angel Abuse is Likely to Increase in Current Economic Climate**

While angel investing has been risky in the past, current economic conditions have imposed certain incentives and realities upon VC activity that could make things even harder for angels.

##### **1. Longer Time to Exit**

All investors in start-up companies do so with one goal in mind—reaching an exit event that can provide some liquidity for their initial investment. Exits are the only way VCs and angel investors make money and generate a return on capital. Generally speaking, there are only two main avenues for a positive exit event: The company goes public or is acquired by another company. Neither of these events is common in today's financial markets, particularly for high risk technology companies of the sort in which angels and VCs invest. The number of VC-backed company IPOs has fallen dramatically from over 300 in 2000 to only 24 in 2002, 29 in 2003, and improving to 93 in 2004.<sup>150</sup> Mergers and acquisitions activity has experienced a similar decline, falling from \$68 billion paid for acquisitions of venture-backed start-up companies in 2000 to only \$7.8 billion paid for acquisitions in 2002, \$7.7 billion paid in 2003, improving to \$15.1 billion in 2004.<sup>151</sup>

Hand in hand with the scarcity of exits comes the longer time and limited window of opportunity for reaching an exit event for a given company. In 1998, a start-up company needed to raise about \$20 million and wait just over two years, on average, to

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<sup>149</sup> For example, small shareholders in the start-up company AuctionWorks, which included several angel investors, were not even aware that the company had consummated a new preferred stock issuance that was dilutive to their holdings until after the deal was completed in May of 2004.

<sup>150</sup> See Press Release, NVCA, 2004 Venture-Backed IPO Activity Exceeded Prior Three Years Combined (Jan. 3, 2005), *available at* [www.nvca.org](http://www.nvca.org).

<sup>151</sup> See Press Release, NVCA, Total Venture-Backed M&A Valuations Nearly Doubled in 2004 (Feb. 8, 2005), *available at* [www.nvca.org](http://www.nvca.org).

reach a successful exit for its investors. In 2001, that average had grown to \$45 million and nearly five years, and by 2003, it took nearly \$60 million and six years to achieve a successful exit event.<sup>152</sup> The additional funding and longer time to exit puts angel investors in an increasingly weak position. Each successive round of investment calls upon all investors, including the angels, to invest more to defend their equity position all the way through to exit. As individuals, angels do not have the staying power held by the larger VC funds, particularly in the face of provisions such as the “pay to play” mechanism described above.

## 2. Increasing Pressure on VC Performance

Venture capital is one of the most aggressive of asset classes, and in the volatile markets since 2000, has been a particularly difficult place to make money. In fact, VC fund returns have been negative every year since 2000, posting an abysmal average -13.7% internal rate of return (“IRR”) for funds raised in 1999 and 2000, -11.9% for funds raised in 2002, and an even worse -35.2% for funds raised in 2003.<sup>153</sup> In fact, a venture capital fund raised in 2000 can demonstrate a -3.9% return and claim to be one of the top quartile performing funds of that year.<sup>154</sup> These return figures are, of course, averages, and a further inspection reveals a more disturbing trend. Top venture capital firms, generally referred to as “top quartile funds,” have performed well during the last several years, in fact increasingly so during the

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<sup>152</sup> MPM Capital, Presentation to the Kaufman Fellowship Program at Babson College (Nov. 5, 2004).

<sup>153</sup> See Silicon Valley Bank, Venture Capital Update Q2 2004; Reyes, *supra* note 5. IRR figures posted for venture capital funds raised during the most recent two years are generally not considered valid due to the industry’s “J-Curve” return dynamic. Venture funds typically perform badly in the first two years of existence simply because bad investments tend to fail quicker than good investments succeed, weighing the back end of a fund’s investment life with the successes, and thus ideally creating a “J” shape in the fund’s investment return graph. Moreover, return figures for venture capital funds are derived from relatively small sample sizes. Only a few venture capital firms, which are not required to divulge performance data except to a few public investment vehicles in select states, provide their performance data to accessible sources.

<sup>154</sup> See Silicon Valley Bank, Venture Capital Update Q2 2004.

volatile years of 2000 through 2004. Top quartile venture capital funds have historically returned an average cumulative return of 16.2% versus a capital weighted average of only 3.9% for all venture capital funds.<sup>155</sup> The remaining bottom 75% of funds, on the other hand, have demonstrated significantly worse performance.<sup>156</sup> Indeed, on average, the bottom 75% of venture funds have actually never generated a positive return since 1980 when VC returns started to be tracked.<sup>157</sup>

The growing performance dichotomy between top quartile funds and everyone else has not gone unnoticed by those who care most about VC returns, namely the LP investors who invest in VC funds. These LPs, typically pension or endowment funds that allocate a portion of their investment assets to venture capital, are under great pressure to generate returns quickly as the baby boomer generation nears retirement. Limited partners believe that only top quartile venture funds are worthy of their money, and seek them out almost exclusively.<sup>158</sup> Venture capital firms know this, and accordingly know that their continued existence is dependent upon membership in the coveted top quartile designation. This desperation for returns by VC funds, dramatically enhanced in recent years, manifests itself in an increasingly aggressive negotiating posture at the portfolio company level, usually to the detriment of the angel investor. The only way a VC investor can increase his return is by accordingly reducing the return of other investors, the angel investor included. And with successful exits becoming more and more rare, the frenzied desire for a VC to make the most of a successful deal can become rabid, sometimes leading to unethical behavior.<sup>159</sup> In this state, a venture capitalist

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<sup>155</sup> *See id.*

<sup>156</sup> *See Reyes, supra* note 5.

<sup>157</sup> *See id.*

<sup>158</sup> *But see* Grove Street Advisors, LLC, *The Case for Investing with New and Emerging Private Equity Fund Managers*, June 2002, available at [http://www.grovestreetadvisors.com/news/gsa\\_white\\_paper\\_01.pdf](http://www.grovestreetadvisors.com/news/gsa_white_paper_01.pdf) (arguing that LP investors should allocate a portion of a portfolio to new private equity funds without any track record, but noting that, over time, track record and manager team longevity are among the most critical factors in making an investment decision).

<sup>159</sup> *See* the discussion of the Alantec lawsuit in Part III.C.

may understandably be driven to an overly-aggressive posture during a market period when desperation is high and angel investors are vulnerable. At the end of the day, “[t]he ‘primary purpose’ of the venture capital investor is to obtain more equity at a lower price, a benefit to which they think they are entitled in view of the issuer’s circumstances at the time.”<sup>160</sup>

### 3. Perverse Influences on Company Financing Policy

In addition to the rational macroeconomic reasons discussed above which lead to anti-angel VC behavior, there are additional behavioral drivers that are often harder to explain and certainly harder to anticipate. Sometimes there exist circumstances unique to a particular VC investor that give that investor certain motivations not necessarily in the best interests of the company as a whole. For example, the average size of a venture capital fund grew dramatically to nearly \$250 million in 2001, up from its historical average of approximately \$70 million (to which the average size reverted in 2004).<sup>161</sup> In fact, forty-six funds were raised in 2001 in amounts larger than \$1 billion.<sup>162</sup>

Notwithstanding the bigger fund size, VCs must still adhere to their LP investors’ return demands, albeit with a much higher absolute return threshold to meet.<sup>163</sup> With this kind of pressure looming, VCs with large sums of money available will tend to heap as much money as possible onto promising companies in an attempt to maximize their bet. This could result in a start-up company being forced to raise significantly more capital than it needs, and thereby issue significantly more stock than it should, in order to satisfy the particular needs of one or two large fund investors. This turn of events is caused by the capital deployment

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<sup>160</sup> Bartlett & Garlitz, *supra* note 7, at 615.

<sup>161</sup> Reyes, *supra* note 5.

<sup>162</sup> *See id.*

<sup>163</sup> For a simple but powerful example, a venture fund with a \$1 billion size must generate and return an additional \$1 billion to its investors within five years just to demonstrate a 14.4% IRR, well below the average 20.0% demanded by most VC investors.



demands of an investor rather than the capital expenditure needs of the company, and could result in unnecessary but significant dilution to an angel investor.

## V. An Aggrieved Angel's Potential Claims

As the plight of angels becomes both more difficult and more common, two likely phenomena following from the discussion above, courts may be more likely to consider providing them with legitimate protection. At the same time, the standards for ascertaining the need for protection are changing, under both the majority perspective and minority perspective methods. For example, in Massachusetts, the ability for a minority shareholder plaintiff to demonstrate a less harmful alternative to a washout financing is becoming more difficult as fewer alternatives are available. Likewise, jurisdictions such as New York and California, which consider the minority shareholder's expectations when investing, must also recognize that those expectations are changing and, hopefully, becoming more conservative. In either event, the application of these various standards has not yet been sufficiently tested through litigation, most likely because the incentive for parties to settle such suits is so great.<sup>164</sup> This Part attempts to forecast how each jurisdiction's test would apply to claims of an aggrieved angel investor who suffers through the dilution of a washout financing only to watch the company subsequently achieve a profitable exit event in which the angel can no longer participate.

### A. Application of Massachusetts Law

An angel investor with the opportunity to bring a case in Massachusetts would do so only if the angel believes that (1) the VCs cannot show that the dilutive action was in the furtherance of

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<sup>164</sup> Investors and entrepreneurs in the technology community are a close-knit group, with each of the belief that continued participation in the industry depends upon maintaining credibility and good relations with the other. Overt disputes are rare, and a formal legal proceeding by a technology industry participant might quickly brand someone with a costly litigious reputation.

a legitimate business purpose or (2) if the VCs can show a legitimate purpose, that the same legitimate purpose could have been achieved through means less harmful to his and other minority shareholder interests. Such is the manner in which a Massachusetts court would likely apply the *Wilkes* balancing test in this situation. Cases brought will likely have varied and distinct circumstances upon which each fact-specific decision will rest. The *Wilkes* balancing test accommodates this required flexibility, and permits the court to seek and subsequently define exactly what constitutes a legitimate business purpose or less harmful alternative.

Certainly venture capitalists may be able to demonstrate several legitimate business purposes for company actions that may have the effect of diluting an angel investor's holdings. In cases where a company is running low on cash and quickly approaching a point of insolvency, issuing stock at an extremely reduced price may be the company's only realistic alternative. The resulting dilution to the angels, likely compounded by the triggering of the venture capitalist's anti-dilution protection, is still preferable to bankruptcy. Similarly, issuances of a company's stock to employees or founders as consideration for services performed has been deemed to be a legitimate purpose by courts and commentators.<sup>165</sup>

In *Horton v. Benjamin*,<sup>166</sup> the Massachusetts Superior Court found that the issuance of 22,225 shares of stock in Vital Technologies, Inc. to defendants as consideration for past performed services to the company was a legitimate business purpose. The court properly considered several specific factors, including the company's extremely low cash balance, the lack of any provision in the company's charter or bylaws prohibiting issuing cash in exchange for services, and the value of the stock as compared to the value of the services provided.<sup>167</sup> In response, the plaintiff angel investor could not convince the court of the existence of a less harmful alternative, and the court found for the

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<sup>165</sup> See, e.g., *Horton v. Benjamin*, 1997 WL 778662 (Mass. Super. Ct. Nov. 26 1997); Padilla, *supra* note 33, at 287.

<sup>166</sup> See *Horton*, 1997 WL 778662.

<sup>167</sup> See *id.* at 27-28.

defendant. Importantly, the difficulty in identifying a less harmful alternative was the result of the court's feeling that the issuance of a relatively small amount of stock, resulting in a relatively small level of dilution, was not particularly harmful to begin with. This case, while finding for the defendant,<sup>168</sup> does not necessarily illustrate how a Massachusetts court would respond to a set of facts in which the angel investors suffered real harm, such as in the *Alantec* case described above. There, the minority shareholders saw the value of their equity holdings reduced dramatically shortly before the company's exit. Facts involving legitimate harm to angels will likely sway a court's sympathy toward the plaintiff. The degree of loss suffered by the minority shareholders certainly played a role in the *Alantec* defendant's quick settlement.

With a relatively sparse history of case law to review, the only clear forecast for these cases is that they will be fact driven. It is plausible that Massachusetts courts may permit venture capitalists to consummate a dilutive down round only when absolutely necessary and no other alternative exists. The level of diligence required of venture capital investors and company executives to seek and identify any other possible source of capital has not yet been tested in court, but may end up at a threshold higher than most venture capitalists would like. For example, a court may not consider two months of presentations to twenty potential investors sufficient, and may require greater foresight and breadth of search in order to claim that all reasonable alternatives have been exhausted. This is particularly true in cases where a company's current investors forego all potential new investors and instead close an "insider round" at an internally set valuation. In such a case, venture capital investors should take special care to tie the inside round valuation to some objective benchmark such as a third party offering price or fairness opinion. A subjective and arbitrary inside round valuation, particularly with a down round

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<sup>168</sup> While holding generally that the defendants did not breach their duty by issuing the additional stock, the court did hold defendants in breach by approving a reorganization of the company from a joint venture into a limited partnership claiming that "the same legitimate objective could have been achieved through an alternative course of action less harmful to the minority's interest." *Id.* at \*28.

anti-dilution triggering effect for the benefit of the participating investors, will likely be viewed skeptically by a Massachusetts court when considering less harmful alternatives.<sup>169</sup> A court in such a case would likely ask the participating venture capitalists to defend their chosen valuation with an expectation of a methodology beyond a subjective estimate.<sup>170</sup> Accordingly, even if *Wilkes'* first prong of legitimate purpose is satisfied by claiming business exigency, the second prong of "least harmful alternative" is open to wide interpretation.

### B. Application of New York and California Law

The minority perspective view of minority shareholder oppression focuses, of course, on the reasonable expectations of the minority shareholder. A New York or California court, when faced with an angel investor claiming a breach of duty by a company's VC investors, would look to the reasonable expectations of the angel investor at the time of his decision to invest and then assess whether those expectations had been wrongly frustrated. This is likely to be no easy task, especially in light of the overly rosy media attention given to high-growth technology start-ups and widely varying expectations of angel investors as they enter a new venture.<sup>171</sup> Surely no court will grant

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<sup>169</sup> Indeed, commentators have suggested that a heightened level of scrutiny of VC actions has become an automatic component of a court's analysis. See, e.g., Douglas K. Moll, *Shareholder Oppression in Texas Close Corporations: Majority Rule Isn't What it Used to Be*, 1 HOUS. BUS. & TAX L.J. 12, at 20 ("[T]he fact that courts applying the oppression doctrine are subjecting the majority's actions to 'reasonable expectations' or 'burdensome, harsh, and wrongful conduct' standards suggests that courts are requiring majority shareholders to do more than merely articulate a rational business purpose for their decisions.") (citing *Smith v. Atlantic Properties, Inc.*, 422 N.E.2d 798, 801 (Mass. App. Ct. 1981)).

<sup>170</sup> See *Bartlett & Garlitz*, *supra* note 7, at 618 ("[I]f the investors do elect to invest, it is not clear why equity should not impose fair and reasonable conditions on the pricing equations because in the final analysis the investors are dealing with themselves (unless an independent board exists to negotiate an arm's length trade).").

<sup>171</sup> Indeed, while some angel investors invest solely for the prospect of financial gain, many do so for other, higher reasons. Peter Cooper, an angel investor in

any credence to an angel investor's expectation of a given company's success or failure, since such is the risk undertaken by all early stage investors. Rather, the notion of expectation here is the preservation of an angel investor's opportunity to participate in the success of a start-up company, should success be achieved.

While decisions will be rendered on a highly fact specific, case-by-case basis, there are certain expectations held by angel investors that courts will likely recognize in nearly all circumstances. For example, angel investors likely do have an objectively reasonable expectation at the outset of their investment in a company that, if the company should perform and grow at a reasonably consistent pace throughout its life up to and including a positive exit event, the angel investor should expect to participate in the success of that exit event. Any actions by a company's venture capital investors to frustrate or lessen the angel's share of that success will likely be considered a violation of that expectation and a breach of fiduciary duty by a jurisdiction that applies the minority perspective rule. Other reasonable expectations of an angel investor may include an expectation to receive comprehensive and accurate updates on a company's development progress, either on a regular basis or at least upon request. Less clear-cut but somewhat reasonable expectations of an angel are that a VC investor (1) will strive to avoid unnecessary dilution of a company's shareholder base whenever possible; (2) will not encourage or endorse any overly-aggressive dilutive events for their own benefit, or (3) will not force its own particular interests on a company to the detriment of a company's best

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the first transatlantic telegraph cable venture, noted that his investment decision was driven by a desire for

the consummation of that great prophecy, that 'knowledge shall cover the earth, as the waters cover the deep,' and with that feeling I joined [the venture] in what then appeared to most men a wild and visionary scheme . . . . But believing, as I did, that it offered the possibility of a mighty power for the good of the world, I embarked on it.

JOHN STEELE GORDON, *A THREAD ACROSS THE OCEAN*, WALTER & COMPANY, at 40 (2002) (citing ISABELLA FIELD JUDSON, *CYRUS W. FIELD: HIS LIFE AND WORK* 62 (1896)).

interests as a whole;<sup>172</sup> and (4) will not recapitalize or otherwise alter a company's basic corporate structure unless absolutely necessary.<sup>173</sup>

In addition to the equitable concept of honoring an angel investor's initial expectations, jurisdictions enforcing the minority perspective rule may support their position based on sound macroeconomic policy foundations. Angel investors fill an important niche in the financial food chain that supports technology commercialization in the U.S. economy. Many of the country's greatest technology company success stories, including Hewlett Packard, Cisco Systems, Microsoft, Apple Computer, and others, began first with the receipt of angel financing before gaining enough credibility and traction to attract an initial round of institutional venture capital funding. Angels fill a finance vacuum between a company's inception stage as little more than a university laboratory experiment to something worthy of VC funding once products and markets can be identified. It is not unreasonable to suggest that some promising technologies may never make it beyond the inception stage without the initial investment role taken on by angel investors. Any increase to the risks of such early stage investment activity, including risks created by the potential frustration of an angel investor's reasonable expectations, will inevitably make it harder for angels to justify their investment activity, reducing or even ceasing it altogether.

Some commentators argue that imposing a fiduciary duty on majority shareholders to protect minority shareholders such as angel investors stifles the free will of a corporation's electorate.<sup>174</sup>

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<sup>172</sup> This includes not forcing the company to raise more money than needed so a big fund may put excess cash to work or forcing a company to accept a premature acquisition offer at a low price just so a VC can claim credit for an exit.

<sup>173</sup> See Part VI *infra*, for a suggestion on how a VC may protect itself by forcing an angel investor to identify, determine, and agree upon the boundaries of "reasonable expectations."

<sup>174</sup> See Padilla, *supra* note 33, at 306. Padilla notes that in the fast moving world of technology start-ups,

directors and officers do not have time to worry about what is and is not a shareholder interest. It is the viability of the

This argument is short-sighted, and must be balanced against the fearful prospect of suffocating angel investors out of the practice of commercializing new technology, thus eliminating a critical component of our economy's technology industry. Angel investors should have some level of the comfort that their reasonable expectations will be protected and that their potential to realize an investment return is legitimate in order to justify their investment. The alternative is to risk the loss of this important investor class, which could inhibit the growth of promising start-up companies and place a drag on the economy's innovation engine.

### C. Application of Delaware Law

Much has been made over the Delaware Supreme Court's language in *Nixon* explicitly rejecting the state's recognition of a minority oppression doctrine in close corporations. In the years since *Nixon*, however, the need for additional equitable protection of minority shareholders has become more clear, and the laissez-faire notion of reliance on contract and market forces has weakened. At best, the application of a doctrine in Delaware to protect the interests of angel investors when confronted by oppressive venture capital behavior is unclear.

Even if explicitly rejected, however, aggrieved angels may still have a viable claim in Delaware based on an extension to controlling shareholders of a director's duty to the company's shareholders. Since VC shareholders frequently exercise explicit or de facto control over the board of portfolio companies, such VCs may be vulnerable to a claim based on improper board conduct. When challenged with such a claim, controlling VC shareholders must demonstrate fulfillment of their duty of care and loyalty just like any director on the board over which they hold substantial influence.<sup>175</sup> The duty of care is likely to be easily

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company that is at stake. For this reason, controllers of an enterprise should have the freedom to make decisions in the best interests of the corporation as a whole.

*Id.*

<sup>175</sup> See *United States v. Byrum*, 408 U.S. 125 (1972) (noting that a majority shareholder with influence and control of a company's board of directors may

satisfied in such cases, given the high interest level of such large shareholders, but the duty of loyalty is more difficult to satisfy, given the strong potential for conflicts of interest. “[T]he problem of self-dealing (broadly understood) in a closely held corporation is omnipresent.”<sup>176</sup> Conflicts are particularly likely in venture capital start-up companies, where the large VC shareholders often have close relationships with each other outside of the context of the company at issue,<sup>177</sup> and always hold fiduciary obligations to their own individual investor base, which is increasingly insistent that venture investors maximize their return.<sup>178</sup>

Even in cases where VCs do not have explicit control of a company through their ownership of 51% of the voting shares,<sup>179</sup> control of the board,<sup>180</sup> or other method, “VCs are, at least arguably, in de facto control either because of their stock position, their board seats, or, more importantly, because they control the spigot; they sit on the company’s lifeline, with the ability to turn it on or off.”<sup>181</sup> The VC’s need to serve its LPs while wielding significant interest over its portfolio companies conflicts with and

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not promote its personal interests at the expense of the minority shareholders).

<sup>176</sup> Ragazzo, *supra* note 19, at 1146.

<sup>177</sup> See Bartlett & Garlitz, *supra* note 7, at 601 (“[T]he venture capital community is small and incestuous, with most managers knowing each other.”).

<sup>178</sup> See Bartlett & Garlitz, *supra* note 7, at 624 (noting that a typical washout or similar type of financing transaction in a venture capital start-up that benefits certain shareholders at the expense of others is “by definition...an insider trade”).

<sup>179</sup> Preferred stock, most often the kind owned by venture capital investors, usually votes with the common on an as-converted basis, sometimes at a conversion rate that is better than 1:1.

<sup>180</sup> In cases where a venture investor does not own greater than 51% of the voting stock, the VC will often require that at least one board seat be filled at its designation, and demand additional influence (through a veto right or some other enhanced voting mechanism) at the board or shareholder level, over who sits in the other board seats and for how long.

<sup>181</sup> Bartlett & Garlitz, *supra* note 7, at 601. Even if a company is able to generate investment interest from additional new investors beyond its current VC shareholders, the company will likely need the approval of its current VC base to issue any additional preferred stock (sometimes it will need approval from each VC individually, each of which may have a veto right). This required consent lets the current VCs dictate the terms of any new investment transactions even if they don’t participate.



may undermine a VC's duty of loyalty to minority shareholders, thus precluding the protections of the business judgment rule.<sup>182</sup> Even aside from the breach of duty, the inherently illiquid nature of a start-up company's stock and its insulation from normal market movements provides a separate reason for denying business judgment protection. As Judge Easterbrook and Professor Fischel explain, "[o]ne rationale for the business judgment rule is that managers who make errors (and even those who engage in self-dealing) are penalized by market forces while judges who make errors are not . . . . If neither managers nor courts are disciplined by markets, this justification has less force."<sup>183</sup>

Without business judgment rule protection, a Delaware court might apply its entire fairness standard to analyze a VC's actions. This puts the burden on the venture capitalist to prove that a given transaction is fair to all of the company's shareholders. Though arguably there are several ways for a Delaware court to conduct such an analysis, it is not unreasonable to suggest that a balancing test similar to Massachusetts' *Wilkes* standard may be employed. The court would likely first look at the legitimacy of the business purpose of a VC's action and, to the extent that such a legitimate business purpose can be found, then consider the nature of the harm inflicted on the angel investor and whether that harm could have been avoided while serving the same business purpose. The Illinois Court of Appeals recently undertook such an analysis while applying Delaware law to a claim of minority shareholder oppression.<sup>184</sup> The court recognized that a majority shareholder group with substantial influence or control over the board of directors owes a fiduciary responsibility to the minority shareholders, and held that the necessity of the transaction did not outweigh the harm caused to the minority. Thus, a logical extension of director liability in Delaware draws majority

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<sup>182</sup> See Matthew P. Quilter et al., *supra* note 45, at 1121 (noting the inherent conflict between a venture capitalist's duty to maximize its own returns while at the same time protecting all stockholder interests, with a duty to "at all times work in good faith to promote the best interests of the company and its shareholders as a whole").

<sup>183</sup> EASTERBROOK & FISCHEL, *supra* note 18, at 243.

<sup>184</sup> See *Feldheim v. Sims*, 2003 Ill. App. LEXIS 908 (Ill. App. Ct. 2003).

shareholders into a similar position of fiduciary responsibility as if they were in Massachusetts.

## **VI. Steps Venture Capitalists Can Take to Protect Themselves**

This article has suggested that venture capital investors in start-up companies may be vulnerable to claims from angel investors pursuant to the minority oppression doctrine, recognized by an increasing number of relevant jurisdictions throughout the country. There are, however, some straightforward sanitizing steps VC investors can build into their daily practice to both deter and defend such potential claims. An overview of such practices is briefly outlined and recommended here.

### **A. Add Explicit Protections into Initial Investment Documents**

The issues raised by this article highlight the complex nature of the relationship between the angel investor and the venture capitalist. Both serve necessary but insufficient roles in the venture creation process, and both grow potentially adversarial toward each other as the company moves toward exit, with each vying for a large piece of the pie. Those who structure these relationships must balance fairness toward the minority with freedom of the majority. The foundations are set in the company's organizing documents. Accordingly,

[d]rafters of the organizing documents of a closely held corporation cannot avoid a trade-off. On the one hand, they must provide some protection to minority investors to ensure that they receive an adequate return on the minority shareholder's investment if the venture succeeds. On the other hand, they cannot give the minority too many rights, for the minority might exercise their rights in an opportunistic fashion to divert returns.<sup>185</sup>

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<sup>185</sup> EASTERBROOK & FISHEL, *supra* note 18, at 238.

This balance can only be achieved by adding as much clarity and explanation to a company's legal documentation as possible. Comprehensive anticipation of conflict at the relationship's outset is the best way to avoid subsequent disputes and, in turn, formal litigation. Indeed, some have argued that the process of filling in the gaps that a company omitted when originally structuring the relationship between and among its shareholders is all a court should do when a dispute arises.<sup>186</sup> Adding anticipation and clarity to the organizational and investment documents is a solution that should resonate with the judiciary, particularly those jurisdictions seeking to protect and preserve the reasonable expectations of angel investors. The best way to do so while leaving little to chance is simply to specify and enumerate those expectations with precision. Doing so would take the guesswork out of the process for a reviewing court, and deter dispute altogether by anticipating and resolving potential issues before the fact.

For example, a venture capitalist negotiating an investment in a new company may require that the deal's closing documentation include an agreement, signed by all of the company's angel investors, acknowledging the possibility of dilution-causing events in the future should the company not perform in accordance with the VC's financing strategy. Angels with high expectations of a company coupled with high confidence in the performance ability of the management team should be held accountable for their optimistic expectation, and agree at the outset that a slip or delay in the company's development will result in some kind of ownership transfer from them to the venture capital investor. Alternatively, the VC and angel investor could negotiate an arrangement during a down round scenario that guarantees an angel's anti-dilution protection, perhaps by converting an angel's previously purchased security into the security purchased by the VC.<sup>187</sup> This would be especially important for angels who only

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<sup>186</sup> See *id.* at 250 ("The right inquiry is always what the parties would have contracted for had transactions costs been nil . . . .").

<sup>187</sup> This has been referred to as the Next Round Pricing Strategy, and usually takes the form of a convertible note which accepts the angel's investment capital at the company's inception, but defers the terms and value of the note's

own common stock at the time of the first institutional round financing. It also could better align the angel's interest with those of the venture investor, and better mitigate a divergence of those interests down the road. To stave off the threat of converting an angel's holdings back to less desirable common stock, angels could negotiate an ability to satisfy the requirements of a pay to play round without having to invest their full pro rata amount.<sup>188</sup>

### **B. Take Appropriate Actions at the Time of a Conflicting Interest Transaction**

Venture capital investors who control a start-up company recognize two important aspects of a down round or insider round transaction: (1) they stand to benefit from the extra stock they will acquire possibly at the dilutive expense of the minority angel investor shareholders and (2) such benefit gained by majority shareholders to the detriment of the minority shareholders may not be considered fair by a court reviewing the deal at a later time. In such situations, VC investors usually ask their attorneys to set forth certain steps and procedures they could take which might make the deal more equitable. These steps generally include holding a rights offering, solicitation of a fairness opinion, formation and approval of a special independent board committee, and solicitation of minority shareholder approval of a given transaction. For various reasons, only the last of these prescribed measures offers legitimate perceived and actual protection for venture capital investors in start-up companies.

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conversion into equity until the time that the VC's institutional round is negotiated. See Joseph W. Bartlett, *The Next Round Pricing Strategy*, 1312 PLI/CORP. 263 (June 2002). Such convertible notes typically have a conversion price discount or warrant coverage bonus that compensates the angel investor for the extra risk of investing at the earlier time.

<sup>188</sup> These are, of course, only a few generic examples of actions to be considered. A company's or investor's counsel should structure any sanitizing measures to address the risks and concerns of each particular set of circumstances.

## 1. Rights Offerings

A rights offering is the opportunity, offered by the company, for all shareholders to participate and invest in a financing round that is arguably favorable to insider VC investors, even those who do not have preemptive participation or other contractual rights to do so. This exercise is grounded in two rationales: (1) it supposedly prevents VCs from being perceived as selfish by hoarding participation in an investor-friendly transaction; and (2) it provides all shareholders, including common holders, with the ability to invest in the round and mitigate any dilution they might otherwise suffer.<sup>189</sup> The problem, of course, lies in the weaker participation capabilities of angel versus VC investors. An insider or down round could be several million dollars in size,<sup>190</sup> with each VC investing several million by itself. Individual angel investors who have supported the company for a period of time longer than the VCs and who rely on their personal funds to participate may be nearing or even beyond their comfortable investment maximum.<sup>191</sup> Indeed, it is rare that angel investors have sufficient staying power to participate in financing rounds from the company's inception all the way through to exit, even if offered the opportunity to do so via rights offerings at each stage.<sup>192</sup> As a result, courts generally concede that the provision of

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<sup>189</sup> The concept of a rights offering originated in the New York judiciary with an early recognition of the need to stem dilution from minority shareholders. See *Katzowitz v. Sidler*, 249 N.E.2d 358, 363 (N.Y. 1969) (“[L]egislation fixed the right with respect to proportionate voting but left to the judiciary the role of protecting existing shareholders from dilution of their equity.”).

<sup>190</sup> As venture capital fund sizes grew in the late 1990s so did the need to deploy larger amounts of money in a single financing transaction. Practical limitations preclude a firm with ten general partners controlling a \$1 billion fund to make investments of \$2 million or \$3 million in each deal.

<sup>191</sup> See *Blomberg*, *supra* note 138, at 64 (“[I]t is often the case that common stockholders in a company like this will not have the money to invest in such a financing and most boards know this—so the opportunity is seen as a mere gesture.”).

<sup>192</sup> See *Bartlett & Garlitz*, *supra* note 7, at 601. Bartlett and Garlitz note that [d]epending on the attitude of the board (which may be VC-controlled), the founder and other common shareholders may or may not have been invited to participate in the dilutive

a rights offering to angel investors is little more than an illusory privilege.<sup>193</sup>

## 2. Fairness Opinions

Public companies frequently engage investment banks or other financial service firms to provide fairness opinions to assess an objective valuation of an asset or proposed transaction. Boards seek out and pay handsomely for these opinions which help to sanitize a transaction against claims of unreasonable pricing or unfair dealing. Engaging a bank and commissioning such a letter are both time consuming and costly, two things a start-up company cannot afford. Courts have regularly held that a hastily prepared or poorly researched fairness opinion will not hold weight in any subsequent dispute,<sup>194</sup> making them even more impractical for the time-pressured and cash-sensitive start-up. Consequently, it is rare and would likely be considered wasteful and impractical for a start-up to obtain a fairness opinion prior to consummating a questionable transaction.

## 3. Special Independent Board Committees

Special independent committees are similarly impractical at the start-up company stage for the simple reason that board members are almost never legitimately independent. This is another mechanism used at the public company level, and

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rounds of financing. If invited, however, the invitation may be more technical than real because the founder, [angels] and others may have lacked the resources necessary to preserve their percentage interest in the company.

*Id.*

<sup>193</sup> See Bartlet & Garlitz, *supra* note 7, at 619 (“[J]udges seem to see through this false appearance to the economic realities.”).

<sup>194</sup> See *Mills Acquisition Co. v. MacMillan, Inc.* 559 A.2d 1261 (Del. 1989); *In re Trans World Airlines, Inc. Shareholder Litig.*, No. CIV.A.9844, 1988 WL 111271, at \*4–5 (Del. Ch. Oct. 21, 1988); *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264 (2d Cir. 1986); *Weinberger v. UOP, Inc.* 457 A.2d 701 (Del. 1983); *MacLane Gas Co. Ltd. v. Enserch Corp.*, No. CIV.A.10760, 1992 WL 368614 (Del. Ch. Dec. 11, 1992).

supported by court decisions in leading jurisdictions as a means to ensure conflicting interest transactions are fair, with no relevant start-up company counterpart. Start-up company boards are often comprised entirely of investors and management.<sup>195</sup> Even if such a company could find and convince an independent individual to serve on the board (a particularly difficult task in the current climate of increased director scrutiny and liability),<sup>196</sup> that individual would likely be compensated with options or some other equity derivative beyond mere cash. But even where equity consideration is not granted, relationship dynamics may impede the independent director's objective judgment.<sup>197</sup> In fact, the ability to present a director as truly independent is becoming increasingly difficult in private and public companies alike. The Delaware Chancery Court recently increased the standard for independence in a case involving Oracle Corporation.<sup>198</sup> The court noted the traditional test for independence was too heavily dependent on the existence of economic ties or the "domination and control" of others. The new standard, articulated in a decision that found a seemingly independent board committee to be "fraught with conflicts," focuses not only on economic ties but also the social and personal interactions between the members of the independent committee and the majority shareholders in a manner that might influence their decisions against protecting the minority.<sup>199</sup> This newly raised standard will likely be applied with even greater scrutiny in the start-up company context where relationships are close and conflicts of interest are bound to

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<sup>195</sup> See Part III, *supra* for a discussion of start-up board membership.

<sup>196</sup> The difficult task of identifying and securing one independent individual for service on a start-up company board is required for a legitimate independent special committee on the board of a Delaware corporation. See DEL. CODE ANN. tit. 8, § 141(c)(2). It is even more difficult in California, which requires at least two independent directors to comprise a legitimate independent special committee. See CAL. CORP. CODE § 311.

<sup>197</sup> See Bartlet & Garlitz, *supra* note 7, at 620 ("Even though a director may be technically 'disinterested,' it is unlikely that real neutrality will be present. The VCs on occasion will induce a third party to join the board, but the reality is that appointees of that nature will be allies of the VC investors.").

<sup>198</sup> See *In re Oracle Corp. Derivative Litigation*, 824 A.2d 917 (Del. Ch. 2003).

<sup>199</sup> See *id.*

influence board level decisions.

#### 4. Solicitation of Minority Shareholder Approval

There remains one sanitizing action that may legitimate a board's actions in the face of an unfair dealing claim—securing the explicit and affirmative approval of the minority shareholders. Not surprisingly, it is probably the most difficult sanitizing action to realize, both because of the nature of the shareholder base or the nature of a transaction's terms. When assessing the validity of a transaction involving an interested director, both Delaware and California have statutory safe harbor provisions that specifically reference minority shareholder approval as a means of bolstering a transaction's independent legitimacy.<sup>200</sup> However, even in director liability cases where the interested directors satisfy the safe harbor provisions, doing so does not by itself validate an otherwise voidable transaction. Rather, minority shareholder approval would merely shift the burden of proof from the defendant to the plaintiff, with the aggrieved shareholder now forced to prove that a transaction was unfair.<sup>201</sup> In some decisions, however, this burden shift has been almost expressly dispositive of the outcome.<sup>202</sup>

#### C. Business Exigency is the Best Defense

Arguably the most effective defense for a VC is the

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<sup>200</sup> See DEL. CODE ANN. tit 8 § 144(a)(1)-(3) (2001); CAL. CORP. CODE § 310(a)(1)-(3); see also JOSEPH F. TROY AND WILLIAM D. GOULD, ADVISING AND DEFENDING CORPORATE DIRECTORS AND OFFICERS § 4.5 at 91 (Oct. 2000).

<sup>201</sup> See *In re Wheelabrator Technologies, Inc. Shareholders Litigation*, 663 A.2d 1194, 1203 (Del. Ch. 1995); *Flieger v. Lawrence*, 361 A.2d 218, 222 (Del. 1976) (noting that meeting a statutory safe harbor “merely removes an ‘interested director’ cloud” but that “[n]othing in the statute . . . removes the transaction from judicial scrutiny”).

<sup>202</sup> See *Lewis v. Vogelstein*, 699 A.2d 327, 327, 336 (Del. Ch. 1997) (“In all events, informed, uncoerced, disinterested shareholder ratification of a transaction in which corporate directors have a material conflict of interest has the effect of protecting the transaction from judicial review except on the basis of waste.”).



“business exigency defense,” which recognizes that the company simply has no other choice but to accept the terms of a dilutive transaction or else face bankruptcy or dissolution. This defense generally requires the existence of two key facts: (1) that the company is truly on the verge of collapse and a heavily dilutive round is the only possible means of keeping operations running,<sup>203</sup> and (2) that the company (and the VCs) have affirmatively sought and exhausted all other possible financing alternatives.<sup>204</sup> The nature and extent of a corporate emergency or the definition of an “exhaustive search” are still being shaped by the courts, but initial decisions set the bar fairly high.<sup>205</sup> Moreover, VC investors who participate in the transaction will bear the burden of proving the existence and legitimacy of both components to the defense.<sup>206</sup>

Attorneys who counsel companies through such difficult periods should take two procedural steps to help sanitize the terms of an emergency financing transaction. First, efforts should be made to keep all shareholders well-informed of the company’s cash situation and fundraising process. This might take the form of a memorandum from the company’s board of directors addressed to its shareholders, preferably with periodic updates. The memo should mention the reasons for the company’s difficult financial situation, the opportunities and strategies for the company to resolve its difficulties, and the steps the board is taking to do so. This helps maintain full disclosure in a documented format and deters shareholder claims of board conspiracy or lack of transparency. It also has the positive effect of soliciting assistance from shareholders who have a strong interest in identifying suggested solutions to the company’s troubles.

A second, more powerful means of bolstering a venture

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<sup>203</sup> See *Rosenberg v. Oolie*, No. 11,134, 1989 Del. Ch. LEXIS 152 (Del. Ch. Oct. 16, 1989); *Marciano v. Nakash*, 535 A.2d 400 (Del. Ch. 1987).

<sup>204</sup> See *Box v. Northrop Corp.*, 459 F.Supp. 540 (S.D.N.Y. 1978), *aff’d mem.*, 598 F.2d 609 (2d Cir. 1979); *Rosenberg v. Oolie*, at \*12.

<sup>205</sup> See *id.* at 550 (noting that the company aggressively solicited investment interest from over forty investment entities with no interest); *Rosenberg v. Oolie*, at \*12 (noting that the company engaged two placement agencies to raise funding with no success for “several years” prior to the consummation of the dilutive transaction).

<sup>206</sup> See *Browning v. C&C Plywood Corp.*, 434 P.2d 339 (Or. 1967).

capitalist's defense in the face of an oppression claim involves incorporating substantial detail and acknowledgment into the shareholder and board resolutions to be approved in conjunction with the transaction. The resolutions should set forth a history of the emergency and the fundraising process, with an explicit intent to satisfy the two components of the exigency defense: (1) emergency conditions and (2) no alternatives. Specific detail of the number and nature of funding solicitation meetings held, reasons for declines, travel and other efforts invested by management to pursue alternatives, and other evidence of exhaustive measures taken should be mentioned and formally acknowledged by as many shareholders as possible, with unanimous shareholder approval if at all possible.

## VII. Conclusion

Angel investors who have suffered significant dilutive financings during the nadir of the technology markets of late may soon be forced to stand by and watch as the companies in which they once held a substantial equity position reach exit events in which they are unable to participate. Venture capital investors, on the other hand, are likely to benefit from these exit events, in some cases as a result of a questionable prior washout transaction at the expense of an aggrieved "burned angel." Chances are that at least one of these burned angels will have the resources to quantify the loss and bring a suit against the VCs in one of the four jurisdictions covered here: Massachusetts, California, New York, or Delaware. The angel plaintiff could make a claim derived from that state's minority oppression doctrine, if not explicitly then implicitly, under Delaware's entire fairness standard as applied to controlling shareholders, and set what could be a frightening precedent for the VC industry. An aggrieved angel's claim might well be judicially recognized, possibly resulting in damages to a VC defendant and sounding a wake up call to an unsuspecting venture industry which may be currently unconcerned by the prospect of such claims. A single plaintiff victory may trigger a wave of similar suits, quickly forcing VCs into an unprecedented defensive position.

The outcome of any such triggering case would depend

heavily on the particular facts and circumstances, of course, which mitigates the risk of a particular VC's exposure. To avoid any liability, venture capital investors should educate themselves about the issues raised here, recognize the duties held by their positions as influential shareholders separate from their director duties, and operate with an awareness of potential legal action by angel investors. In general, the angel's equity interests should be protected and preserved to the same extent as all other shareholders, information about the company's status should be free and transparent, and any compromise of an angel's interests should only be done after all other alternatives have been exhausted. The VC's legal counsel should document these efforts diligently and build a record of actions that tracks the relevant jurisdiction's legal standard to survive a claim of minority oppression. In sum, if VCs act honestly, diligently, in the best interests of all company shareholders, and with a genuine effort to obtain the approval (or at least acknowledgement) of angel investors in all financing transactions, they will be ready to present a credible defense to any claims.