MINORITY SHAREHOLDER OPPRESSION IN THE VENTURE CAPITAL INDUSTRY: WHAT YOU CAN DO TO PROTECT YOURSELF

INTRODUCTION

The venture capital company is a product of modern innovation. While the first venture capital company was organized in 1946,[1] it was a far cry from what we think of today. In fact, it was not until the 1970s and 1980s that this type of alternative investment was really recognized as a viable method for entrepreneurial financing.[2] Nevertheless, it took several more years for venture capital to hit its stride, which it finally did in the 1990s. The venture capital industry quickly evolved into the newest source of producing incredible profits for willing investors. Spurred on by the tech-

1. *See* Paul A. Gompers, *A Note on the Venture Capital Industry*, Harvard Business School Note No. 9-295-065 (Nov. 9, 1994), at 4 (summarizing the history of the venture capital industry).

2. *See* José 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, 272 (2001) (explaining that changes in regulation and the evolution of the limited partnership were two primary factors in driving the origins of the venture capital industry). *See also* George W. Fenn, Nellie Liang & Stephen Prowse, *The Economics of the Private Equity Market*, 168 FED. RES. BD. STAFF STUD. 1, 9–11 (Dec. 1995), *available at* http://www.federalreserve.gov/pubs/staffstudies/168/ss168.pdf.

nology boom in Silicon Valley, venture capital became the growing choice of funding for high-risk businesses that would not, or, more often, could not, obtain financing through more traditional sources.[3] Furthermore, with these successes came a growing impression on the rest of the world that the venture capital industry provided a never-ending stream of resources that was ripe for everyone to take from. From authors and economists arguing that a "third industrial revolution"[4] was upon us to the Harvard Business School's change in curriculum, there seemed to be no downside for venture capital.[5]

The key word in the preceding sentence is "seemed." With every upside there is a downside, and the venture capital industry is no different. In particular, there is a growing problem in the venture capital industry of minority shareholder oppression. Often referred to by different names—squeeze-outs, freeze-outs, and washouts are just a few—these venture capital "tools" essentially take advantage of the ingenuity and passion of startup company founders and early-stage angel investors by reducing the value of their shares by enormous amounts. This Note will begin in Part I by discussing the origins of the relationship between a startup company and venture capital financers and how the relationship may lead to minority shareholder oppression. Part II will examine the minority oppression doctrine and the differing perspectives on it throughout the United States. Part III will address the *Alantec* case as an example of more recent pro-protection development against minority shareholder oppression. Part IV will lay out several different ways minority shareholders can better protect themselves prior to engaging in litigation. Finally, the Conclusion will analyze the future of minority oppression in the venture capital industry and provide some simple tips that entrepreneurs will hopefully heed.

I. THE STARTUP COMPANY/VENTURE CAPITAL RELATIONSHIP

Imagine you are a promising computer science engineer, but your day consists of typing code for a major software corporation who, in your opinion, does not appreciate your brilliance. Day after day you sit in your cubicle, daydreaming about the big idea that will make you millions. While there are many that live this same life, only a few fulfill that dream. It is those few that venture capitalists are in search of.

So, you finally take the leap—you quit your job, scrounge up money from family and friends, and get your business off the ground. However,

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3. *See* Padilla, *supra* note 2.

4. *Id.* at 270 (citing Jeremy Greenwood, *The Third Industrial Revolution*, AM. ENTER. INST. PUB. POL'Y RES. (Apr. 1997)).

5. *See id.* (noting that Harvard University replaced the required first year course of General Management with a class entitled "The Entrepreneurial Manager").

your business is barely off the ground and your limited funds will only last you so long. Where do you turn? Not to venture capitalists, at least not yet. No, a startup company's first decent-size investment often comes from a group of early-stage investors known as angel investors.[6] Typically holding funds much smaller than venture capitalists, angel investors generally consider themselves the driving force of innovation in America, willing to take a great risk with the prospect of an even greater reward.[7] It is usually not until the startup makes more progress and is ready to take that next step that venture capitalists finally enter the picture as financial investors.

Founders and angel investors "allow" venture capitalists to invest enough funding to give the venture capitalists a controlling majority of the company. "Control of the company in this manner often appears fair and reasonable at the time of the [venture capitalists'] initial investment when each of the company's founders, angel investors, and [venture capitalist] investors are aligned in interest to grow their exciting new venture."[8] However, the reality of the situation is that venture capitalists are extremely sophisticated investors who fully understand the necessity of this control.[9] A startup company's progression is often not steady; rather, it is filled with problems that challenge the survival of the company. It is when these problems arise that the interests of the three shareholders begin to diverge, often resulting in venture capitalists invoking their majority control.[10]

Venture capitalists' ability to take advantage of a company's minority shareholders is a function of how startups are often set up—as "close corporations." Although there are many similar definitions for a close corporation, one that is commonly used in the venture capital context comes from *Donahue v. Rodd Electrotype Co*.[11] According to the court, a close corporation is typified by: "(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."[12] Based on this structure, it is easy to see how the combination of extensive power on the majority shareholder's side and the lack of

6. *See* Jeffrey M. Leavitt, *Burned Angels: The Coming Wave of Minority Shareholder Oppression Claims in Venture Capital Start-Up Companies*, 6 N.C. J. L. & TECH. 223, 224–26 (2005).
7. *See id*. at 226.
8. *Id*. at 227.
9. *See id*. at 226–27.
10. *See id*. at 227. *See also* Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737, 1740 (1994) (explaining that these "problems" are often planned for, therefore requiring more capital and, thus, an adjustment in the stock ratio).
11. 328 N.E.2d 505 (Mass. 1975).
12. *Id*. at 511.

an easy exit on the minority shareholder's side can lead to oppressive results.[13]

Once a startup company reaches this "problem stage," a venture capitalist has a decision to make: either give up on its investment and swallow the "minimal" financing it has invested, or try and "save" the company. It is when venture capitalists choose the latter that majority shareholders begin to exert their influence negatively toward minority shareholders. While there are numerous forms of minority shareholder oppression, the three most common in the venture capital context are squeeze-outs, freeze-outs, and washouts.[14] A squeeze-out is where the majority shareholders use their "strategic position, inside information, or powers of control . . . to eliminate from the enterprise one or more"[15] of the minority shareholders, most often by forcing them "to sell [their] shares to the company at an unreasonably low price."[16] Likewise, a freeze-out occurs when the company is merged "with a shell corporation controlled by the majority shareholders under terms that force the minority to redeem their shares for cash at a low value."[17] Finally, a washout is where the majority shareholders "consumat[e] a financial restructuring that significantly dilutes a minority shareholder's holdings to the point of being worthless."[18] The commonality between each form of oppression is that, in order for the venture capitalist to secure more financing, both founders and angel investors are essentially pushed out of the company, leaving the venture capitalists to reap even more massive benefits once the company reaches its target exit strategy.

II. THE MINORITY OPPRESSION DOCTRINE

The minority oppression doctrine is "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 [venture capital] investors."[19] The doctrine is based on the idea of fiduciary duty and there are two general theories of liability that are often presented: "(1) a breach of fiduciary duty held by majority shareholders; and

13. *See* Manuel A. Utset, *A Theory of Self-Control Problems and Incomplete Contracting: The Case of Shareholder Contracts*, 2003 UTAH L. REV. 1329, 1339 (2003).

14. *See* Leavitt, *supra* note 6, at 236.

15. 1 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL AND THOMPSON'S OPPRESSION OF MINORITY SHAREHOLDERS AND LLC MEMBERS 1–2 (rev. 2d ed. 2007).

16. Leavitt, *supra* note 6, at 232.

17. *Id.* at 232–33. *See generally* Sullivan v. First Mass. Fin. Corp., 569 N.E.2d 814 (Mass. 1991); Leader v. Hycor, Inc., 479 N.E.2d 173 (Mass. 1985). *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, 12–14 (2001).

18. Leavitt, *supra* note 6, at 232. *See generally* Padilla, *supra* note 2.

19. Leavitt, *supra* note 6, at 229.

(2) a breach of fiduciary duty held by the board of directors."[20] Since the latter is generally addressed in relation to public corporations, the relevant duty in the context of venture capital is that held by majority shareholders.[21] Nevertheless, there are numerous opinions in different jurisdictions as to how this particular duty should be applied.

A. Massachusetts: The Majority Shareholder Perspective

The Massachusetts Superior Judicial Court is generally recognized as the first court to establish a cause of action for oppressed minority shareholders against their majority shareholder counterparts.[22] In *Donahue v. Rodd Electrotype Co.*,[23] the plaintiff alleged that the majority shareholders had breached their fiduciary duty by unlawfully distributing corporate assets to controlling stockholders without the plaintiff's knowledge and without an option for the plaintiff to distribute her assets as well. Although the lower courts dismissed the plaintiff's claims, the Massachusetts Superior Judicial Court reversed, explaining that "[t]he rule of equal opportunity in stock purchases by close corporations provides equal access to [those] benefits for all stockholders," and that when minority stockholders are denied such equal opportunity, they "shall be entitled to appropriate relief."[24] Furthermore, 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."[25] Recognizing that traditional remedies such as derivative suits and the easy ability to liquefy one's assets were unavailable to oppressed minority shareholders in the close corporation context, the court used this opportunity in *Donahue* to establish a direct cause of action.[26]

However, amidst concerns that the court's decision would unfairly limit how majority shareholders managed their own company, the court reassessed its holding in *Donahue* only one year later.[27] In *Wilkes v. Springside Nursing Home, Inc.*,[28] the court explained that the majority has certain rights to manage their company in a "selfish" manner, which must then be balanced against its fiduciary obligation to minority shareholders.[29] Consequently, the court concluded that a controlling shareholder has ful-

20. *Id.* at 237.
21. *See id.* at 238.
22. *See id.* at 240.
23. 328 N.E.2d 505 (Mass. 1975).
24. *Id.* at 519.
25. *Id.* at 515; *see also* Leavitt, *supra* note 6, at 240.
26. *See* Leavitt, *supra* note 6, at 241.
27. *See id.* at 24–42.
28. 353 N.E.2d 657 (Mass. 1976).
29. *Id.* at 663.

filled its fiduciary duty if it (1) can "demonstrate a legitimate business purpose for its action" and (2) the minority shareholder is unable to present an alternative course of action that would be less detrimental to the minority's interest.[30] Thus, the court created a two-part, burden-shifting test for analyzing minority shareholder oppression that has been reinforced by subsequent cases.[31] The reasoning and test based on these two cases has led to the growing nationwide trend of recognizing a fiduciary duty on behalf of the majority shareholder toward its minority counterpart.[32]

B. New York and California: The Minority Shareholder Perspective

While the Massachusetts courts set the stage for relief actions in the oppressed minority shareholder arena, both the New York and California courts have subsequently taken the lead in providing the most widely followed rule.[33] The case of *In re Kemp & Beatley, Inc.*[34] set forth the original minority perspective rule. The rule does not focus on the intention of the majority shareholder, but rather on the impact majority shareholder conduct has on the minority shareholder.[35] The Court in *Kemp* explained:

> Majority conduct should not be deemed oppressive simply because the petitioner's [expectations in entering a] 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 petitioner's decision to join the venture.[36]

By reversing the focus from the legitimacy of the majority's actions to the "reasonable expectations" of the minority, the court established an analytical test that is far from perfect.[37] Nevertheless, this approach has still become the leading view throughout much of the United States.[38]

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30. *Id.*
31. *See, e.g.*, Zimmerman v. Bogoff, 524 N.E.2d 849, 853 (Mass. 1988); Smith v. Atl. Props., 422 N.E.2d 798, 801 n.5 (Mass. App. Ct. 1981). *But see* Hunt v. Data Mgmt. Res., Inc., 985 P.2d 730, 732 (Kan. Ct. App. 1999) (holding that a shareholder may act in a self-interested manner without the burden of strict fiduciary duties). *See also* A.W. Chesterton Co. v. Chesterton, 128 F.3d 1, 5–7 (1st Cir. 1997) (noting that the fiduciary duty runs from the minority shareholder to the majority shareholder as well).
32. *See* Leavitt, *supra* note 6, at 242–43.
33. *See id.* at 244.
34. 473 N.E.2d 1173 (N.Y. 1984).
35. *See* Leavitt, *supra* note 6, at 244.
36. 473 N.E.2d at 1179.
37. Leavitt, *supra* note 6, at 245.
38. *See, e.g.*, 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); Maschmeier 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. Mei-

California's approach to the minority oppression doctrine was originally established by its supreme court in *Jones v. H.F. Ahmanson & Co.*[39] While this particular approach does not follow New York's rule exactly as defined in *Kemp*, it is still a minority-centered view.[40] The court explained that "majority shareholders do not have an absolute right to dissolve a corporation . . . because their statutory power is subject to equitable limitations in favor of the minority."[41] Furthermore, since California has adopted a rule of inherent fairness, the court should first look at whether the minority's treatment has been fair and then subsequently address whether the majority's action was in "genuine pursuit of a proper corporate purpose."[42]

Minority perspective jurisdictions are typically considered the most favorable for potentially oppressed minority shareholders. Under this perspective, majority shareholders can theoretically be held liable even when they act with good intentions.[43] As long as the minority shareholder can show that its expectations were reasonable and that the majority's actions frustrated those expectations, then the majority has breached its duty.[44] Consequently, California has been home to numerous large settlements on behalf of minority shareholders.[45]

C. The Delaware View

Since 1992, Delaware has managed to follow several different standards when addressing the fiduciary duty of majority shareholders towards minority shareholders. In *Litle v. Waters*,[46] the Delaware Court of Chancery applied New York's minority perspective view of the oppression doctrine in finding for the plaintiff.[47] Shortly thereafter, however, the Delaware Supreme Court overturned a lower court decision in *Nixon v. Blackwell*[48] and consequently rejected the notion of the minority oppression doctrine. Specifically, the court explained that all shareholder protection should be determined through contract negotiation and not through judicial

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selman, 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).

39. 460 P.2d 464 (Cal. 1969).
40. *See* Leavitt, *supra* note 6, at 246.
41. *Jones*, 460 P.2d at 473.
42. Leavitt, *supra* note 6, at 246 (citing *Jones*, 460 P.2d at 471).
43. *See* Leavitt, *supra* note 6, at 248.
44. *See id*.
45. *See* Constance Loizos, *Entrepreneur Settles Suit with Lightspeed, Com Ventures*, PRIVATE EQUITY WK., Feb. 14, 2005, at 1.
46. No. 12155, 1992 WL 25758 (Del. Ch. Feb. 11, 1992).
47. *Id.* at *8–9.
48. 626 A.2d 1366 (Del. 1993).

intervention.[49] Three years later, the Delaware Supreme Court was faced with the same issue in *Riblet Products Corp. v. Nagy*.[50] Although the lower court determined that the Massachusetts majority perspective rule should apply, the Delaware Supreme Court avoided the issue by reformulating the certified question in an extremely narrow fashion.[51] Consequently, since the court went to such lengths to avoid the issue directly, many commentators believe that Delaware's stance on the minority oppression doctrine is still up for debate.[52]

Nevertheless, while Delaware's position on the minority oppression doctrine may be unsettled, many commentators also believe that the same result may be achieved through a slightly different form. Rather than focus *solely* on the breach of a shareholder's duty, it is possible to still reach the same result through shifting the focus to the breaching of duties held by the board of directors. Typically, directors of Delaware corporations are bound to duties of care and loyalty. Should a director fail to uphold either of these duties,[53] Delaware courts then apply their "entire fairness" test, which requires the board of directors to prove that it was fair to all shareholders through its actions.[54] If the court determines that the directors were not fair to all of their shareholders, then the directors can be held liable to the adversely affected shareholders.[55]

Although the remedy of director liability is generally used in the large corporation context because of the concentration of control held by these directors, it can also be transferred to the close corporation context. Specifically, "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.'"[56] Consequently, majority shareholders are bound by the same responsibilities as directors.[57] And while an oppressed minority shareholder has yet to formally attempt this approach against majority shareholders, it nevertheless provides another avenue for protection under the right circumstances.

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49. *Id*. at 1380.
50. 683 A.2d 37 (Del. 1996).
51. *Id*. at 39.
52. *See* Leavitt, *supra* note 6, at 252, 255.
53. Several have suggested that it is impossible to fulfill the duty of loyalty in the venture capital/startup company context. *See* Joseph W. Bartlett & Kevin R. Garlitz, *Fiduciary Duties in Burnout/Cramdown Financings*, 20 J. CORP. L. 593, 617–20 (1995).
54. Leavitt, *supra* note 6, at 253.
55. *See id*.
56. *Id*. at 254 (quoting WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 1.13 (7th ed. 2002)).
57. *See id*. at 255.

III. PRO-PROTECTION DEVELOPMENT: *ALANTEC*

While both the majority and minority perspectives addressed above provide for minority relief, it does not necessarily follow that oppressed minorities will succeed in achieving it. Until recently, many plaintiffs' claims often ended by either dismissal or a decision in favor of a defendant corporation.[58] More common, however, was a minimal out-of-court settlement or the withdrawal of the suit altogether.[59] The venture capital industry is a close-knit community, and entrepreneurs have often been hesitant to see claims through due to the fear of branding themselves as a litigious party and thus weakening their chances of receiving funding for their next project.[60] Nevertheless, with a changing economic climate and a technological boom that is curbing, more and more claims are weaving their way through the judicial system.

The most publicized of these cases was *Kalashian v. Advent VI Limited Partnership* (*Alantec*).[61] Alantec, Inc. (originally Kalvij Telecom) was founded in 1987 from an initial $30,000 investment by its two founders.[62] Based on its quick success, venture capital companies invested over $16 million into the company, giving them both a majority stake in the company and its board of directors.[63] Soon after, however, the venture capitalists ousted the two original founders from their managerial positions and commenced washout financing that reduced the founders' stock from 8% to 0.007%.[64] Consequently, when the company rebounded and proved successful, the founders were left with very little. After Alantec, Inc. was later acquired by Fore Systems, Inc., the founders only received $600,000, as opposed to the $40 million they would have been entitled to if the washout had not taken place.[65]

While the case was ultimately settled after eighteen days of trial testimony for approximately $15 million,[66] *Alantec* served a very important purpose. First, it exposed how bad-faith transactions may infiltrate washout financings without the knowledge of minority shareholders. During trial testimony, the plaintiffs claimed that the venture capitalists had secretly worked with outside parties unknown to the founders (who, at the time, still owned all of the company's common stock) in order to redistribute the common stock and avoid a necessary vote on behalf of the found-

58. *See, e.g.*, Nixon v. Blackwell, 626 A.2d 1366 (Del. 1993); Horton v. Benjamin, No. 92-06697, 1997 WL 778662 (Mass. Super. Ct. Nov. 26, 1997).
59. *See* Leavitt, *supra* note 6, at 270.
60. *See id.* at 270 n.164.
61. No. 739278, 1996 WL 33399950 (Cal. App. Dep't Super. Ct. Oct. 4, 1996).
62. *See* Padilla, *supra* note 2, at 276.
63. *See id.* at 277.
64. *See id.*
65. *See id.*
66. *See id.* at 278.

ers.[67] Furthermore, if this redistribution were true, the founders would have not even known that the washout had taken place until long after it had been completed.[68]

Second, based on the publicity surrounding this case,[69] *Alantec* has provided present and future entrepreneurs with a cautionary tale that may better serve them in the future. Not only did it expose how manipulative some venture capitalists can be in their determination to maximize profits, but it also helped provide a framework to avoid being taken advantage of. Finally, and most importantly, the recognition of such bad-faith transactions has put other courts on notice of such behavior. Based on this, it seems probable that courts will be less likely to dismiss claims at such early stages of litigation without at least allowing some discovery to take place.

The irony of the *Alantec* situation is that it likely could have been avoided altogether if the venture capitalists would have been open with the founders about their intentions. While it is doubtful the founders would have agreed to such a drastic dilution, they would have most certainly agreed to some dilution if it meant keeping their dream alive. Founders are often much more attached to their projects than their venture capital investors, for better or for worse. This inherently gives venture capitalists considerable leverage—something that entrepreneurs must consider when bargaining for power and protection with such investors.

IV. Steps Minority Shareholders Can Take to Better Protect Themselves

It is obvious that the relationship between investors and venture capitalists is of a complex nature. Both serve necessary, yet independently insufficient, roles in the overall venture capital context, with the potential (and oftentimes likelihood) that the parties will grow adversarial to one another as the company begins to seriously consider its exit strategy.[70] Based on this understanding, entrepreneurs, who ultimately become the minority shareholders in this context, should take the highest level of precaution possible.

A. Create Opportunities to Increase Bargaining Power

While most entrepreneurs dream of the day that their innovative thinking will be rewarded, most also fail to consider the negative repercussions

67. *See id*. at 294–95.
68. *See id*. at 295.
69. *See id*. at 271 nn.7 & 8; Leavitt, *supra* note 6, at 247 n.87.
70. *See* Leavitt, *supra* note 6, at 279.

that could possibly follow. While this may be understandable, since many entrepreneurs lack the relative ability to foresee the evils that may await, it is nevertheless a major obstacle that future entrepreneurs should, and hopefully will, consider. In order to best protect oneself from the ills of minority shareholder oppression, there are many things that entrepreneurs can do before the venture is even off the ground.

Ultimately, a lack of bargaining power dooms most entrepreneurs. Consequently, it is important to retain, and in some cases create, as much bargaining power as possible.[71] As Professors Robert Sprague and Karen L. Page explain, there are three types of entrepreneurs: "novice" entrepreneurs, who have little or no prior experience; "serial" entrepreneurs, who have successfully created and sold a business venture in which they had ownership stake and have since begun a new enterprise; and "portfolio" entrepreneurs, who have an ownership stake in multiple independent businesses at one time.[72] If the entrepreneur falls into the first category, which is most often the case, then that person is likely to be subject to a weakened bargaining position and thus in danger of falling victim to minority shareholder tactics. Therefore, one way for an entrepreneur to bolster his or her position is by aligning himself or herself with another entrepreneur who has greater experience.[73] While this option may not seem ideal to the entrepreneur, since it will likely cut into an overall profit share, it is ultimately more important to level the playing field with more sophisticated investors. As Sprague and Page explain, "not only will experience help the entrepreneur to see the relationship with the investor and the actual terms in a more sophisticated light, experience will also allow the entrepreneur to be seen by the investor as more capable and credible."[74] Consequently, by creating an added—albeit arguably artificial—level of expertise, the entrepreneur will have a better chance of success further down the road.

Another element that can enhance an entrepreneur's bargaining power is the level of substantive expertise which they possess relating to the venture.[75] This is one the few areas that the "novice" entrepreneur may potentially have an advantage in, since most first-time entrepreneurs tend to focus on areas that they are more comfortable with. As Sprague and Page assert, "[w]here the value of the enterprise lies within the entrepreneur, it is less likely that the investor will jeopardize the relationship with the en-

71. *See* Robert Sprague & Karen L. Page, *The Private Securities Litigation Reform Act and the Entrepreneur: Protecting Naïve Issuers from Sophisticated Investors*, 8 WYO. L. REV. 167, 187 (2008).
72. *Id.*
73. *See id.*
74. *Id.*
75. *See id.* at 188.

trepreneur than if the value lay within physical assets."[76] Nevertheless, it is just as important for the entrepreneur to use his specific expertise to his advantage. By emphasizing the complexities of a particular venture, the entrepreneur establishes himself as an integral part of the process, thereby lessening his chances of being forced out.

A final suggestion Sprague and Page offer is that an entrepreneur should accumulate certain resources that will likely enhance his potential bargaining position.[77] Such resources include "strong intellectual property, loyal board members, high-status alliance partners, [and] high-status legal counsel."[78] While some of these resources may not apply in every situation, establishing high-status alliances and retaining high-status legal counsel should be a must for every entrepreneur. Many scholars argue that creating high-status alliances—whether it is with actors, politicians, philanthropists, or the like—allows the entrepreneur to "borrow" legitimacy or status that will prove beneficial at the bargaining table.[79]

Likewise, just as high-status alliance partners create a sense of quality for the entrepreneur, retaining recognizable general counsel can serve the same effect. In the venture capital industry, there are certain law firms that possess a "higher status" based on their connectedness, experience, and knowledge in the particular area; representation by such firms can provide the entrepreneur with another added level of power relative to investors in at least two ways.[80] "First, such law firms may suggest a certain sophistication on the part of the entrepreneur that will translate into more respect. Second, the expertise of the law firms themselves in the domain of venture capital should inure to the benefit of the entrepreneurs through good legal advice."[81] Entrepreneurs need every advantage they can get, and although such representation may be expensive, in the long run such expense will serve as a sound investment and protect the entrepreneur's potential profitability. Consequently, it is essential that the entrepreneur carefully consider all aspects of its venture prior to engaging with investors. In doing so, the entrepreneur will undoubtedly create a better situation—one that can withstand the ills of minority shareholder oppression if they were to arise.

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76. *Id.*
77. *See id.* at 189.
78. *Id.*
79. *Id.*
80. *Id.* at 190.
81. *Id.*

B. Proper Planning and Drafting

"The only surefire way [an entrepreneur can protect] against minority-shareholder oppression is through proper planning."[82] Unfortunately, many entrepreneurs initially lack the appropriate foresight and resources and thus fail to do so. However, in the event that the entrepreneur is inherently savvier than many in his same position, it is important to include both explicit protections and potential exit opportunities within the company's initial investment documents.

1. Adding Explicit Protections

Since venture capitalists generally have greater controlling power, it is essential that entrepreneurs initially structure their relationship with venture capitalists in a manner that keeps them the most protected. This process begins with the creation of the company's organizing documents, with the goal of trying to set up a structure that provides as much balance as possible.[83] As explained by authors Frank Easterbrook and Daniel Fischel:

> Drafters 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.[84]

"This balance can only be achieved by adding as much clarity and explanation to a company's legal documentation as possible."[85] Leavitt explains that the best way to achieve this clarity and explanation is to anticipate *from the outset of the relationship* any and all possible conflicts that may potentially arise.[86] In doing so, this will provide minority shareholders with the best opportunity to avoid disputes and potential litigation. Laying out these potential conflicts also serves an additional purpose, in that it provides the judiciary with something to grasp on to.[87] A detailed account of the anticipated conflicts and potential resolutions before the fact

82. Judd F. Sneirson, *Soft Paternalism for Close Corporations: Helping Shareholders Help Themselves*, 2008 WIS. L. REV. 899, 914 (2008).
83. *See* Leavitt, *supra* note 6, at 279.
84. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 238 (1991).
85. Leavitt, *supra* note 6, at 280.
86. *Id.*
87. *Id.*

would hopefully "take the guesswork out of the process for a reviewing court."[88] Furthermore, if a dispute arises in a jurisdiction that promotes the preservation of the reasonable expectations of investors, the judiciary will be more inclined to favor a minority position, since the minority has taken substantial steps to protect itself and has certain expectations that the investment should reasonably live up to.[89]

Ultimately, Leavitt provides excellent advice in theory, but it is still up to minority shareholders to fight for the protection they deserve. Consequently, it is important for minority shareholders, or at least their legal representation, to be exceptionally thorough in analyzing the consequences of majority-backed propositions. For example, when faced with a proposal regarding down-round financing, minority shareholders should make sure that the relevant documentation also includes sufficient antidilution protection.[90] By making sure that such compromises are met, minority shareholders can be confident that they have established a more fulfilling, and hopefully more profitable, relationship with a venture capitalist.

2. Exit Opportunities

In addition to the protections described above, entrepreneurs should clearly set out certain exit strategies that may be available to them in the face of an unwanted minority shareholder oppression scenario. The most common and beneficial step that an entrepreneur should take is to include an enforceable buy-sell agreement within the company's organizational documents.[91] Specifically, the buy-sell agreement should be structured in a manner that allows for its institution upon the triggering of some event or events.[92] While it would be impossible to predict all possible scenarios, the agreement could be drafted such that it is invoked by the presence of minority oppression tactics, such as washouts and the like. Furthermore, the agreement should carefully define how the entrepreneur's share is to be valued, thus providing the entrepreneur with the proper compensation.[93] In taking these cautious, yet necessary, steps, the entrepreneur can potentially avoid the disastrous effects that tend to follow minority shareholder oppression.

88. *Id.*
89. *See id.*
90. *See id.*
91. *See* Sneirson, *supra* note 82, at 915.
92. *See id.*
93. *See id.*

C. Registering as a Limited Liability Company (LLC) as Opposed to a Corporation

While registering as an LLC is not necessarily a "method" a minority shareholder can use to protect itself against potential oppression, it is something that should be considered by entrepreneurs prior to initiating their venture. While LLCs typically retain many of the same problems as closely-held corporations, there is one theoretical advantage to using such a formation. If the LLC's setup is more in line with that of a general partnership, rather than that of a corporation, many courts will analyze fiduciary duties as if they were governed by partnership law.[94] This analysis is important primarily because general partners owe fiduciary duties to one another. Consequently, in the LLC context, many jurisdictions have determined that those same fiduciary duties run between each shareholder.[95]

This determination could be critical if dealing with minority shareholder oppression tactics. Many courts have interpreted the duty of loyalty to apply to such tactics and have found shareholders liable when they acted in bad faith. The scenario presented in *Alantec* provides a workable example.[96] Using washout financing to purposely and maliciously reduce another shareholder's share for the financial gain of other shareholders should constitute a clear violation of the duty of loyalty. Therefore, even though many states' LLC statutes do not provide specific minority shareholder protection through application of the minority oppression doctrine, some jurisdictions have ultimately concluded that judicial application of the doctrine is appropriate.[97] The added level of fiduciary duties that can be recognized in an LLC essentially provides minority shareholders with a greater level of protection and a better opportunity to succeed in litigation if it becomes necessary.

CONCLUSION

While oppressed minority shareholders obviously still face an uphill battle when bringing their claims in court, it seems that their ability to succeed is better than ever. With Massachusetts, New York, and California providing clear causes of action and Delaware still riding the fence, it is only a matter of time before entrepreneurs begin to fight back in waves. A single plaintiff verdict would send a shockwave through the venture capital industry, forcing them on the defensive.[98] Nevertheless, minority

94. *See* Douglas K. Moll, *Minority Oppression & the Limited Liability Company: Learning (or Not) from Close Corporation History*, 40 WAKE FOREST L. REV. 883, 951 n.221 (2005).
95. *See id*. at 965–67.
96. *See supra* Part III.
97. *See* Moll, *supra* note 94, at 957.
98. *See* Leavitt, *supra* note 6, at 287.

shareholders should take steps to better protect themselves from falling into such a situation. Primarily, minority shareholders should make sure that their interests are *contractually* protected to the same extent as majority shareholders.[99] Likewise, prior to engaging in the venture, minority shareholders should mandate that there be an understanding that all company decisions must be open to all shareholders and that all alternatives must be openly exhausted before any compromise of a minority shareholder's interest occurs.[100] Finally, minority shareholders—and especially entrepreneurs—must not allow venture capitalists to play the bully. While it is almost always necessary to turn over considerable power to the venture capitalists, since they are admittedly more experienced in this type of endeavor, such a grant is not a license to steal. One should be smart about decisions and contact their *own* legal representation if there is ever any doubt. By sticking to these guidelines, minority shareholders can place themselves in a powerful position if there is ever a need to bring forth litigation.

Brannan W. Reaves

99. *See id*. at 288.
100. *See id*.