



## **Arbitrating Private Investment Disputes Private Equity, Venture Capital and other Private Placements**

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Disputes over private investment can involve investments by individual investors, investment funds or corporate investors through a wide variety of investment mechanisms. Disputes can involve portfolio companies or their management, employees and business partners, finders and investment bankers, investment fund limited and general partners, co-investors or portfolio company acquirers, to name just a few.

Many kinds of private investment disputes benefit from resolution in binding arbitration. Factors that can make arbitration more advantageous than litigation for such disputes include both business and legal considerations. Private investment transactions often rely on customary terms and practices and complex legal corporate, securities and tax law considerations. Most judges and juries will have little, if any, appreciation for the workings of investment firms and the companies in which they invest, let alone more complex concepts such as VC fund carries, stock purchase liquidation preferences, private equity LBO strategies or hedge fund alpha.

Apart from business practicalities, private investors, their partners and the companies in which they invest almost always have a critical concern for business confidentiality and privacy. They favor time-efficient, business-practical decision making and, often, it is necessary to resolve disputes while preserving ongoing investor relationships. For international investors, it is often important to ensure a fair hearing and be able to enforce an award internationally. These concerns are best provided through arbitration rather than the courts.

This article will discuss the nature of private investment disputes that are commonly brought to arbitration, the issues that characterize these disputes, how they can best be resolved, and sample language for drafting an arbitration clause. The sample clause is suitable for a wide variety of investment disputes, including disputes between investors and the companies in which they invest, with management teams, with finders and investment bankers, with investment fund partners and with acquirers; however, the clause should be modified to meet particular requirements.

*Private investment arbitration involves private placement of funds into companies. It should not be confused with arbitration involving investment in publicly offered securities or investor-state arbitration, which involves investment in foreign government sponsored projects and is addressed through parallel but separate arbitration mechanisms.*

## **A. Overview of Private Investment Disputes**

Private investment disputes include disputes between companies and the companies in which they invest as well as disputes involving finders, angel investors, funds, corporate investors and acquirers. The investor may be a high net worth investor, a venture capital or other private equity fund, or a small or large company. In addition to claims between investors and portfolio companies, disputes can arise with company management, stockholders, fund partners, co-investors and investor syndicates, investment managers, investment bankers and acquirers, among others. The following list illustrates the broad range of topics that can be subject to disputes in the private investment sector:

- Corporate/Partnership/LLC formation;
- Founder ownership and rights;
- Angel investment terms, ownership and rights;
- Finder and investment banker claims;
- Investment fund formation (Venture Capital, Private Equity, Hedge funds, etc.);
- Investment fund strategy and management issues;
- Investment fund limited partner fundraising and marketing claims;
- Investment fund management, compensation and reporting issues;
- Confidentiality and conflict of interest issues;
- Loan repayment and performance disputes;
- Term sheet, due diligence and closing disputes;
- Stock rights and protections (vesting, Investor Rights Agreements (IRAs), preferences, dividends, protective provisions, registration rights, etc.)
- Portfolio company founder and management issues;
- Portfolio company issues employees, IP or other business issues;
- Portfolio company supplier and distributor contract and licensing disputes;
- Portfolio company joint venture and partnering disputes;
- Portfolio company strategy decisions and Board of Director disputes;
- Limited Partnership (LP) and Limited Liability Company (LLC) investment disputes;
- Ownership and control issues, including minority ownership issues;
- Fiduciary duty claims;
- Corporate governance considerations;
- Disputes over tranches and follow-on investment conditions, timing and strategy;
- Co-investor and investment syndicate disputes;
- Straight and convertible note obligations;
- Banking and bank debt terms;
- Portfolio company IP ownership, protection and infringement issues;
- Tax-related issues;
- Securities law and blue-sky-related issues;
- Fraud and negligence claims;
- Regulatory issues in telecom, healthcare, energy, defense and other regulated sectors;
- FCPA and other international trade issues;
- Antitrust and competition claims;
- Exit strategies and disputes over exit opportunities;

- Bankruptcy and restructuring issues;
- Dealings and disputes with potential acquirers;
- Valuation disputes;
- Accounting, earn-outs and other post-acquisition issues;
- Public offerings and public company reporting issues

## **B. Dispute Needs and Concerns for Private Investments**

### *1. Complexity of Private Investment Transactions and Expert Decision-making*

Private investment transactions vary considerably based on the parties, industry sector, investment objectives, type and size of the investment and the location of the parties involved. Although a wide variety of debt, equity, hybrid investment mechanisms can be implemented in effecting investments, many private investment sectors rely on standardized forms and follow customary practices in setting terms, raising funds and managing investments. Corporate and partnership structures and investment agreements contain complex legal terminology.

Investment terms and investment management practices are not be readily understandable to those with no experience in the field. Most judges will have little, if any experience in the details of private investment fund operations and transactions and jurors will almost certainly be ignorant, and in some cases hostile, to private investment activities. On the other hand, arbitrators who have legal or business experience handling private investments appreciate and understand the complex business arrangements and practices involved. With the right Arbitrator, arbitration can provide decision-making that is knowledgeable, accepting, practical and forward-thinking with respect to the business and legal context of the transaction and dispute.

### *2. Business Confidentiality and Privacy*

Typically, private investors have little desire for public scrutiny of their investment strategies or disputes. There is often a critical need to protect information on deal opportunities, strategies, valuations, returns and exit discussions. Even public reporting companies making investments need to ensure that proprietary business strategies and trade secrets are protected. The desire for privacy goes beyond fundamental protections. As a practical matter, privacy provides the parties an opportunity to negotiate and engage in efficient deal-making. There is limited opportunity for privacy in the courts, where disputes subject to public scrutiny. Arbitration offers private decision-making by legal experts and provides an opportunity for the parties to implement additional appropriate confidentiality protections.

### *3. Speed, Finality and Cost*

Disputes in the private investment sector can impose delay, increase transaction costs and interfere with new investments or exit opportunities. Often the parties cannot wait years for a court decision and the appeals that follow. The cost of litigation can be excessive and litigation processes (including depositions and other discovery) can be unduly distracting and burdensome. Arbitration offers the opportunity for much faster resolution of private investment disputes which, if managed properly, can be much less costly than litigation.

#### *4. International Investment*

International investment poses additional risks and concerns for investors and the companies in which they invest. Local courts have limited controls over foreign parties. For example, a US court judgment will not be recognized outside the US. Non-US parties may be concerned about the burdens of the US litigation process and the uncertainty of jury decision-making. Parties may be unwilling to have issues decided by foreign courts which, particularly in developing countries, may have little experience with private investment practices and may be subject to bias or corruption. Many international investors rely on offshore bases for legal and tax benefits. Arbitration provides solutions for parties in international investment transactions by offering a neutral forum where the parties can select the decision makers and define the procedure. Importantly, pursuant to international convention provisions, international arbitration agreements and awards are recognized and enforceable nearly worldwide.

#### **C. Examples**

##### **Example 1: Arbitration of a Stock Purchase Agreement or Loan Agreement Dispute**

A high net worth investor agrees to invest \$12M in a promising company: \$5M equity for 20% of the company, \$3M in convertible debt, and another \$4M in a year if certain performance milestones are met. A year later, the company contends milestones are met and wants the additional funding. Issues arise over anti-dilution rights, whether the milestones have been met, when the debt must be repaid and whether the second tranche is due.

In many ways, this is a straightforward dispute; less than ideal contract drafting may have complicated the issues. If both parties are in the US, the dispute presumably could be resolved in court; however, it will be a relatively costly exercise that may take years for resolution. After a long discovery process, a jury would hear the case. The jury would be expected to parse through the unclear contract language.

Arbitration offers a better solution: an arbitrator with experience in drafting investment contracts could analyze the contract and make decisions in the matter on an average of 6-9 months. The process may be an easier path for a continued business relationship. The process can also include mediation to assist the parties in trying to reach a settlement before or concurrent with the arbitration proceeding.

##### **Example 2: Arbitration of a Venture Capital Investment Dispute**

A venture capital firm participates in a C round financing. After the closing, material omissions regarding capitalization, IP ownership, revenue recognition and threatened litigation are disclosed. One of the issues involves another company owned by one of the original investors. The Series C investors have different views on how the issues should be addressed and there are potential conflict issues with respect to management representatives and investors on the Board.

Venture capital investing requires many skill sets. VC investors are advisors, investors, co-

investors, Board members, partners and fund managers. There are many opportunities for unresolvable disputes to arise. Contract disputes can escalate into allegations of breach of fiduciary duty, fraud, unfair competition, securities violations or other wrongdoing.

In this example, where there are issues with management and with other investors, a judge or jury might have a difficult task in properly evaluating disclosure obligations, the role of due diligence, the different hats venture investors wear in working with a company, and the relationships and conflict of interest issues that can arise with respect to board members.

An arbitrator with experience in the venture capital sector would be better suited than a judge or jury to understand the role of the parties and the technology context of the case and can enable the parties to reach the proper result in an efficient, private setting.

### **Example 3: Private Equity Fund Partnership Dispute**

A private equity fund limited partner introduces an investment opportunity to the fund and then takes an active management role in the portfolio company through another company. Disputes arise between the fund and the limited partner over conflicts of interest, investment calls and the distribution waterfall. The dispute complicates exit discussions.

Private equity firms engage in transactions that are beyond the experience level of most judges and juries. LP structures, preferred returns and carried interests, and the roles, restrictions and controls on GPs and LPs are complex matters. There is a risk juries considering such matters may reach the wrong decision for the wrong reasons.

Arbitration provides an opportunity for a legal expert or, in larger cases, a panel of experts in the field to properly assess and decide rights and obligations. The proceeding can be conducted privately and efficiently so that portfolio company and fund business activities are not unduly interrupted.

### **Example 4: International Investment Banking Dispute**

A large privately held South American industrials company seeks to raise \$800M through syndicated loan financing. Various local banks are approached and introductions are made to investment banks in the US and Europe as well as investment groups in Asia. Various non-disclosure agreements, letters of understanding and engagement agreements are signed. Ultimately investment is made by means of several bilateral loans, including by a Cayman entity associated with principals in Asia which was sourced through a US-based investment bank. Following the closing, one of the investment groups in Asia seeks a significant fee from the issuer claiming its introductions led to the placement of the investment. There is a risk lawsuits will be filed in the PRC, the US and in various South American jurisdictions that may be disruptive to the issuer's operations.

Arbitration provisions in private investment agreements limit the risk of being sued in unfavorable jurisdictions and having matters decided under unfavorable conditions and laws. In arbitration, the parties agree on a neutral location where all disputes will be resolved and on the

law that will govern the proceeding. By specifying the rules of one of several leading arbitral institutions, the parties will be able to select qualified arbitrators of their choosing. Arbitration allows for resolution of disputes among multiple international parties in a single forum and avoids conflicting court decisions. Properly drafted international arbitration agreements and awards are recognized and enforceable under international conventions nearly worldwide.

#### **D. Tips for Drafting an Arbitration Clause for Private Investment Disputes**

- Basic Clause for Private Investment Arbitration:

Often a standard arbitration clause, with minor additions, is the best choice for private investment contract drafting and negotiation. Leading arbitral institution providers offer standard clauses and clause building tools. The following standard clause includes provisions on governing law, locale and confidentiality:

*Any dispute, claim or controversy arising out of or relating to this Agreement or the breach thereof shall be settled by binding arbitration administered by the [insert arbitral institution] in accordance with its [insert the institution's Commercial or International Arbitration Rules] and judgment on the award rendered by the arbitrator(s) may be entered in any court having jurisdiction thereof. The place of the arbitration shall be [City, State, Country]. Except as may be required by law, there shall be no disclosure of the existence, content, or results of any proceeding hereunder without the prior written consent of all parties. This Agreement shall be interpreted in accordance with the law of [insert State or Country] without regard to its conflict of laws rules.*

- Optional Provisions for Private Investment Arbitration:
  - Mediation – Consider requiring the parties to try to settle the dispute by mediation before resorting to arbitration.
  - Number of Arbitrators/Selection Method – Many institutions have a default based on claim size; typically, a panel of three arbitrators is provided for in larger cases.
  - Disclosures – Specify what disclosures beyond exchange of documents to be offered at the hearing will be allowed: document requests, number of depositions, etc.
  - Arbitration and Attorney's Fees – Specify if fees and costs will be awarded to the prevailing party.
  - Appellate arbitration process – if applicable under the selected rules.
  - State or federal (FAA) arbitration procedures.
  - International disputes –Specify appropriate rules, arbitral site and language requirements.

The standard clause above is suitable for most private investment arbitration agreements. Care should be taken in selecting the arbitral institution and rules governing the proceeding. It is always recommended that qualified legal counsel review arbitration clauses.

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