VENTURES AND INTELLECTUAL PROPERTY GROUP

LETTER

2005 4th Quarter

ANGELS

Not Just a Holiday Tradition

We hear much about the funding gap for emerging companies, particularly the lack of seed and start-up capital. Angel investors have long invested in the gap and in recent years have been receiving increased attention and visibility. A start-up or early stage company looking for seed or start-up capital (typically $100,000 to $3,000,000) should take note. The Center for Venture Research at the University of New Hampshire estimates that 48,000 businesses received some form of angel investment in 2004, *sixteen* times the number of venture-backed businesses.

What is an Angel?

An angel investor is a high net worth individual investor, typically with industry or entrepreneurial experience. Angels tend to invest where they have personal experience or in growth industries. Angels should be distinguished from family and friend investors, primarily based on motivations and intended role with the company post-investment.

What is Unique about Angels?

The typical angel investor is a seasoned entrepreneur or industry executive whose motivation for investing is not solely financial. In addition to seeking financial returns, many angels want to mentor less experienced entrepreneurs, vicariously enjoy the excitement of building a successful company and otherwise want to find ways to put to good use their skills and experience. Angels most often invest close to home, within easy travel distance.

With these motivations comes a desire to be active in the company post-closing. Angels offer added value in the form of post-closing advice and assistance in recruiting directors and advisors and recruiting and coaching management. Angels can also assist with customer and partner relationship building, provide input on financial and capital strategy, provide counsel on sales and marketing efforts and make a personal network of contacts available, including introductions to venture capitalists.

Angel Networks

Angel investors are increasingly organized into angel investor networks. By joining with other angel investors, individual investors can leverage contacts; pool capital, expertise and resources; share best practices; spread the deal sourcing, due diligence and investment management obligations; and diversify risk. Networks vary, but, in general, investment opportunities are screened, better opportunities are presented to the group and individual members decide whether to participate on a case-by-case basis. Expect to see increased networking of angels and regional cooperation of existing angel networks.

From a company perspective, angel networks provide a contact point for the entrepreneur who otherwise would need to rely on personal networking to reach potential angels.

Terms of Angel Investments

Traditionally, the terms and conditions of angel investments have varied widely, with personal preferences and experiences of individual angels reflected in differing approaches to deal terms. With the growth of angel networks and various surveys and studies of angel investment terms, more uniformity has developed.

While it is still difficult to generalize, angel investments are usually structured as convertible preferred stock or bridge debt. Where a larger, venture capital round of investment is expected to follow, the angel preferred stock may by its terms convert into that future round of venture capital preferred stock at a discount. Bridge debt is generally used where a venture capital equity round is expected

VENTURE BRIEFS

Wireless Carriers Announce Voluntary "Wireless Content Guidelines": On November 8, 2005, CTIA - The Wireless Association® and the nation's leading wireless carriers unveiled the "Wireless Content Guidelines," a voluntary pledge by the industry to provide tools to restrict wireless content offered by the carriers or available via Internet-enabled wireless devices. The Guidelines promulgate a Content Classification Standard, which divides content that wireless subscribers may access into two categories: Generally Accessible Carrier Content and Restricted Carrier Content. The content will be categorized using criteria based on the movie, television, music and games rating systems that are already in use. The Wireless Content Guidelines create standards intended to ensure carrier-offered content either excludes or requires parent or guardian permission to access any material inappropriate for subscribers under 18, such as lotteries, gambling or material that is excessively violent or sexually explicit. The participating wireless carriers have pledged not to offer any Restricted Content until they have provided controls to allow subscribers (or parents) to restrict access to this type of content. Going forward, the carriers have also agreed to develop and implement Internet Content Access Control technologies that will enable wireless subscribers to block access to the Internet entirely or provide tools to block access to specific websites. Although wireless carriers have no control over the Internet content that is accessible from wireless devices, this step is intended to give consumers the ability to limit what Internet content can be accessed through these devices. The Guidelines are available at www.CTIA.org. *Marcus Wilkinson, (860) 251-5937 or mwilkinson@goodwin.com*

Mickey Mouse's Business Judgment Prevails: In our 4th Quarter 2003 VIP Letter, we reported that an interim decision of the Delaware Chancery Court emphasized the necessity that directors of a corporation use *good faith* in considering material corporate decisions. In *In re Walt Disney Company Derivative Litigation*, the Court had denied the defendant directors' motion to dismiss the plaintiff stockholders' derivative suit alleging that the directors of The Walt Disney Company breached their fiduciary duties in hiring and terminating the corporation's former president, Michael Ovitz. On August 9, 2005, the Chancery Court released its final decision in the case, entering judgment in favor of the directors on all counts. The plaintiffs claimed that the directors breached their fiduciary duties to the company by first approving Mr. Ovitz's employment agreement and then by not considering the terms of his termination. Mr. Ovitz's salary and termination package combined to amount to approximately $140 million of compensation for one year of service. Plaintiffs also claimed that Mr. Ovitz breached his fiduciary duties to the company by putting his own interests before that of the company in his termination negotiations. In its opinion, the Court stated that it is unclear under Delaware law whether directors of a corporation have an additional fiduciary duty to act in *good faith*. The Court did, however, characterize the *business judgment rule* as a presumption that directors acted in *good faith*

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to follow, with the bridge debt converting into the equity round at a discount.

Deal size varies from as little as $25,000 to as much as $1 million to $3 million, with the typical investment probably in the $150,000 to $300,000 range. Angel rounds often include three to five investors, with the average individual participation ranging from $10,000 to $100,000.

In summary, companies in search of seed and start-up capital should consider the availability of angel investment. Entrepreneurs can seek out angels through an established angel network or through more traditional networking. A company should understand the motivations and intended role of an angel and be sure that these match the company's desires and intentions. While the rise of angle networks has helped to bring more uniformity to deal terms, companies should expect to see a wide variety of deal terms. Having the assistance of experienced professional advisors can help companies sort out the deal terms and reach a mutually satisfactory arrangement with the angels. *For more information, please contact Thomas P. Flynn at (860) 251-5938 or tflynn@goodwin.com.*

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and in order to rebut that presumption, plaintiffs must prove that the directors acted in *bad faith* by a preponderance of the evidence. The Court found that *good faith* requires "honesty of purpose and a genuine care for the fiduciary's constituents" and that *bad faith* consists of "acting for some purpose other than a genuine attempt to advance corporate welfare." While sharply criticizing the directors for their actions, the Court also noted that Delaware law does not hold fiduciaries liable for a failure to comply with the "aspirational ideal of best practices." Applying the *business judgment rule*, the Court held that the directors' actions, while not ideal, did not breach their fiduciary duties or constitute *bad faith*. *Carol McVerry, (860) 251-5839 or cmcverry@goodwin.com*

Sale Below Market Price Does Not Overcome the Business Judgment Rule: In another business judgment rule case, the Delaware Chancery Court recently ruled that in the context of a sale of a corporation and a board of directors' responsibility to secure the maximum value reasonably possible for stockholders in such sale, if a court resolves that the facts do not support an inference of disloyalty or lack of due care, the board's actions are entitled to the protections of the business judgment rule regardless of whether a sale below market price occurred. In *In re CompuCom Systems Inc. Stockholders Litigation*, minority stockholders challenged the sale of CompuCom as a violation of the corporation's former board's fiduciary duties. Among other things, the stockholders attacked the adequacy of the corporation's sale price alleging that the sale price essentially provided a discount to the acquiring company and raised the "ire of the investment community." The Court pointed out that although the sale price for the company's shares of $4.60 per share was less than the closing price of $4.84 the day before the proposed acquisition, the public trading price for the company's shares ranged anywhere from $4.16 to $5.99 during negotiations. The Court found that the sale price was not so inadequate as to overcome the business judgment rule and went on to note that there were no strong lock-ups or other deal protection provisions in the merger agreement that prevented the emergence of a competing bid even though one failed to emerge in this transaction. The Court concluded that the board of the corporation undertook its fiduciary duty of care with all seriousness and diligence given that it had formed a special committee to evaluate all sale prospects, it had relied on a fairness opinion regarding the fairness of the sale price and had not hastily approved the transaction. The Court specifically noted that it had taken two years to approve and conclude the transaction and indicated that such a time frame was a direct contradiction to the minority stockholder's allegations that the sale of the corporation had been a "fire sale." *Lina McKinney, (860) 251-5660 or lmckinney@goodwin.com*

Acquirer of Preferred Stock Has Immediate Right to Elect Director: A recent Delaware Chancery Court decision in *FGC Holdings Ltd. v. Teltronics Inc.* held that an acquirer of Series B Preferred Stock did not need to wait until the next annual meeting of stockholders of the company in order to elect its designee to the company's board of directors. The charter of Teltronics Inc. provided that the holders of the Series B Preferred Stock had the right to elect one member of the company's board of directors. The charter also provided that the size of the board could not exceed five directors while any of the Series B Preferred Stock was outstanding. The plaintiff, FGC Holdings Ltd., acquired all the company's outstanding shares of Series B Preferred Stock from FINOVA Mezzanine Capital Inc. FINOVA had not elected a member to the board because it believed that electing a board member may cause a conflict of interest since FINOVA was also a creditor of the company. In the absence of FINOVA's designee, the holders of the company's common stock elected the fifth member to the board at the company's recent annual meeting. When FGC acquired the Series B Preferred Stock from FINOVA, it immediately sought to elect its designee to the board of directors. The company declined to install FGC's designee on the board claiming that FGC had to wait until the company's next annual meeting. The Delaware Chancery Court disagreed and held that FGC had an immediate right to elect its designee to the board notwithstanding that the fifth director had been properly elected at the last annual meeting by the holders of common stock since to do otherwise would limit the right of the holders of Series B Preferred Stock to elect a director "at any time" contrary to the terms of Teltronics' charter. Notwithstanding the Court's determination, it did not require the removal of an incumbent director to make room for FGC's designee, but instead required the holding of a meeting within six weeks of the Court's ruling to re-elect the board, including the FGC designee, so as not to overly complicate the company's corporate governance. In the meanwhile, the Court ordered that the FGC designee be afforded observer rights. *Jeff Hussey, (860) 251-5814 or jhussey@goodwin.com*

Sunrise Period Starts for NEW .EU Internet Top-Level Domain: The process for reserving and registering domain names under the new Internet top-level domain name .EU began on December 7, 2005 for companies doing business in Europe. The process has three phases. In Sunrise Period I (12/7/2005 to 2/6/2006), public institutions and holders or licensees of registered European Community and European national trademarks can apply for domain names under .EU. The domain name to be registered should correspond to the registered trademark or the name of the public institution. In Sunrise Phase II (2/7/2006 to 4/6/2006), registration is expanded to individuals resident in the European Community and companies based in the European Community that can show that they hold unregistered rights protected under their relevant state to register those names under .EU. In Phase III, the "Land Rush" Period (after completion of the Sunrise Periods starting 4/7/2006 forward), other entities and individuals may register .EU domain names. During any phase, to register an .EU domain name, a company's registered office, central administration or principal place of business must be within the European Community. If more than one valid application is received for an .EU domain name, the registrations will be handled on a first come, first served basis. *Cathy Intravia, (860) 251-5835 or cintravia@goodwin.com*

Excessive Executive Compensation Is "Proper Purpose" for Stockholder Review of Records: In *Haywood v. AmBase Corp.,* the Delaware Chancery Court held that a request by two sophisticated stockholders to inspect a Delaware corporation's books and records in order to investigate the circumstances under which the corporation's board permitted an executive's "lavish" $2.2 million annual compensation is a "proper purpose,"

where such compensation implicates "possible mismanagement, breaches of fiduciary duty, waste of corporate assets and fraud" by the board and lack of board independence.

The plaintiff stockholders owned about 13% of AmBase, a publicly held, former bank holding company, whose bank subsidiary was placed into receivership after it was deemed insolvent, leaving AmBase with the primary purpose of prosecuting a suit against the U.S. government based on claims stemming from the receivership. In 2003, the plaintiffs became aware of the "patently excessive" compensation paid to the AmBase CEO, Richard Bianco, as salary and under various retirement and bonus plans (even though AmBase failed to meet various performance objectives). The plaintiffs made repeated demands, which AmBase denied, to review the AmBase books and records to "investigate possible mismanagement, breaches of fiduciary duty, waste of corporate assets and fraud" at AmBase, and additionally to "assess the independence" of the non-management members of the board of directors.

The issue for the court was whether the stockholders' request to review the records and books of AmBase constituted a "proper purpose" under section 220 of the Delaware General Corporation Law. In order to prove a "proper purpose," a plaintiff must demonstrate a "credible basis to find probable wrongdoing" by a preponderance of the evidence, and the court found that the stockholders satisfactorily proved their case. The court viewed Bianco's annual compensation between 2001 and 2003 to be lavish with respect to Bianco's limited duties of overseeing the litigation against the U.S. government, which was primarily performed by outside counsel. For Bianco to receive such compensation "for performing what appears to be an unremarkable amount of work, itself, raises some concern." This level of concern was found by the court to be sufficient to indicate a "credible basis to find probable wrongdoing." Further, a report by Graef Crystal, an expert analyst in the field of executive compensation that had concluded that Bianco's compensation far exceeded the compensation of his counterparts at 71 companies with a similar financial profile, constituted credible and unrefuted evidence buttressing the stockholders' assertion of the lack of the personnel committee's independence and calling into question its decision making process and ability, further supporting the claim that there was a "proper purpose" behind the desire to review the books and records of AmBase. According to the court, "while there may be instances in which a board may act with deference to corporate officers' judgments, executive compensation is not one of those instances. The board must exercise its own business judgment in approving an executive compensation transaction." *Rita Graham, (860) 251-5835 or rgraham@goodwin.com*

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