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Resolution Provisions; Growth Provisions - Identification of Rights and Responsibilities of Participants in Entrepreneurship including Allocation of Risks - Discussion Following the Remarks of Gail Lilley and Michael Wager

Discussion

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DISCUSSION FOLLOWING THE REMARKS OF GAIL LILLEY AND
MICHAEL WAGER

MS. ALZETTA-REALI: Okay. Before asking the audience if they have any questions, I actually have a question, which ran to my mind based on the chicken and egg casualty article and the answer to that question. I had no idea it was the egg, but keeping that in mind, then, with an entrepreneurial metaphor, what would be the chicken and what would be the egg and, therefore, what would be the answer?

MR. WAGER: Well that is interesting. I, as you said, served as vice chair of the Port Authority here in Cuyahoga County. There is a belief in this region, and not unlike the belief of many of us in the rust belt cities, that if we create capital, if we build pools of funds, that we will have the entrepreneurs come to us. That is, in fact, not what the literature says and, in effect, has not necessarily been the experience. This is not to say that pools of capital provided by government or by the NGO sector do not have a positive effect. I am just wondering whether it is transformative. I do not know whether it is an either/or because I think it is a multi-dimensional process.

You need all the resources together, as David Morgenthaller said, the jockey and the horse, and that is what is going to make it work. When you have fallen behind the curve of economic development, the way someone will mature, you try to replicate what, at least, the picture is of the healthy entrepreneurial environment. This includes a lot of seed capital and other investment capital, and ultimately this creates the glue of entrepreneurial activity.

MS. ALZETTA-REALI: I suppose the egg in this analogy is the capital for you, but we have the other answer, and I think David Morgenthaller actually said that capital may not necessarily follow entrepreneurs. I am not sure I have an answer, and it is a difficult question to answer. However, we will receive further questions from the audience. Any questions? Yes, Dr. King?

DR. KING: I noticed on the dispute resolution provisions there, you did not amplify it, is this a perfect case for mediation, or should that be arbitration? This is addressed to Michael Wager with comments by our Canadian friend also. What is the best way to resolve the disputes?

MR. WAGER: I have to make an admission here – the dispute resolutions part of the agreements in funding entrepreneurial businesses do not get that much attention from corporate and corporate finance lawyers. We think it is boilerplate.¹¹³ It probably deserves more consideration by people involved in

¹¹³ See generally Boilerplate, InvestorWords.com, <http://www.investorwords.com/516/boilerplate.html> (last visited Oct. 27, 2007) (stating that

actual dispute negotiation and resolution. The mediation, arbitration, and litigation are all the potential bad outcomes that seem to be on the back of the agreements, so I do not know that I have a really insightful answer to the question.

DR. KING: Do you have any comments on that?

MS. LILLEY: Well, it is interesting. There was a great wave of enthusiasm for arbitration as an alternative to litigation in Canada because it was perceived as being speedier and less expensive.¹¹⁴ However, I think as large complex disputes have moved into the arbitration field, arbitration has become as expensive and time consuming as litigation.

It is interesting – your comment about mediation. In our litigation process, if there is a lawsuit that the parties have to arbitrate, they can go to a nonbinding mediation process.¹¹⁵ I recently had a situation where a client had been negotiating with a municipality for a number of years to finalize something, and they were just stuck. I had asked them whether they wanted to consider voluntary nonbinding mediation, and they were not enthusiastic about it. I thought it would have been a good idea.

MS. ALZETTA-REALI: At Coca-Cola, when I think about our joint venture negotiations, we do not place an executive committee amongst the joint venture partners. So, if we end up in a dispute, it will first go to an executive committee to negotiate the dispute. Consequently, since the negotiation is between the partners, the negotiation might go on for a long period of time.

However, there are designated officers and a designated time period to resolve the dispute. If these constraints do not work, we then attempt other methods of dispute resolution. This may involve bringing in a technical expert, depending on what the issue is, banker expertise, investment bankers, accounting firms, just about anything. The last resort is arbitration because it is expensive, but it may end up there.

DR. BARBER: This is a question about the funders. I have to sense that in Canada the amount of funding that supports new ventures from angels is about twice the amount that comes from venture capital. I do not know whether the angels have the same problems that venture capitalists have. I

boilerplate language is a “standard form or template used in a contract or other legal document.”).

¹¹⁴ See generally Tom Pedreira, *Arbitration*, LAWYERS.COM, <http://canada.lawyers.com/lawyers/C~1001557~CND/Arbitration.html> (last visited Oct. 28, 2007) (“Arbitration can be fast, quick and easy, whereas lawsuits can drag on for years and years.”).

¹¹⁵ See generally News & Information, ADR Institute of Canada, <http://www.adrcanada.ca/news/faq.html> (last visited Oct. 27, 2007) (stating that one of many significant reasons to mediate, is because the “process is non-binding; the outcome is within the control of the parties.”).

have a sense that venture capitalists are very much more advanced in financing, legalities, and governance. Angels are big players and they are a group of financiers or funders. Any comments?

MS. LILLEY: Well, that is actually interesting because I do not know any statistics, but in my mind there are two kinds of angel groups: one being the family member angels and the other being sort of professional angels. Professional angels are people who have a pool of capital and are interested in making small and personal contributions. As family member angels, their investments are personal and small for startups, and I know for the family angels the documentation tends to be somewhat light, and the formality tends to be somewhat light. But in truth, the repercussions for a failed business involving family angels are fairly significant.

Whereas professional angels, with the documentation and the formality, are a little bit closer to a venture capital model, but there is no emotional investment. So, if the business fails, it is one of the 999 type deals that did not work out so well. You are right, there is a bottom layer, and it is just so much trouble to get money from professional funders, from banks, et cetera, even from government programs, and much easier to find people who are prepared to put a small amount of capital at a high risk.

MR. HERMAN: I realize we are discussing the appropriate form of business entity for entrepreneurial activity, and the availability of capital as the key ingredient, and we will be discussing some other aspects involved in entrepreneurial growth and in the encouragement of new forms of business later today and tomorrow. However, there are aspects missing, which we will discuss later in the program, but can you address the importance of the rule of law, the ability of the entrepreneur to have his or her intellectual property protected, the availability of appropriate infrastructure and a whole range of other things that affect entrepreneurial growth and development?

We take the issue that Michael talked about, development of entrepreneurial activity in this region, the United States. What role does infrastructure play? What role does the rule of law and the ability to protect entrepreneurial enterprise have on the growth of entrepreneurship in any particular area?

Let me just throw this out: It may be a lot easier to develop entrepreneurial activity in, say, the United States, than it might be in some country or some region in Eastern Europe where the rule of law does not allow entrepreneurial activity to flourish and grow without the appropriate protection.

MR. WAGER: That is a very good point. These aspects are not part of the program that we had planned for today, but as I look out in the audience, I see one of my colleagues, and she and I are now engaged in a new venture in [Eastern Europe] for very significant dollars.

While it is a very hotly negotiated transaction between two very sophisticated players who are creating a joint venture in the emerging Eastern European economy, the rule of law issue, as you put it, is something which is of great concern to both of the parties. It does not necessarily affect the negotiation between the operator and the funder, but it does certainly affect the decision-making with regard to embarking in this joint venture. For instance, it is uncertain what kind of returns you would expect for taking this kind of additional risk because you have less stable legal protection, a less mature legal system.

I think it affects the risk and reward decision-making. I do not know if it necessarily affects the kind of structural issues we were talking about for entrepreneurial businesses, except perhaps a recognition that you can set it up, use whatever best practice you want to establish the entity, and negotiate the relative rights of the parties. Nevertheless, if they are not enforceable in the local jurisdiction, I am not certain exactly what the benefit of the hard work will be on the front end.

MS. LILLEY: This is actually an interesting discussion because if I think about an entrepreneur, I am not sure in our current legal environment that small business people can really afford to enforce their rights to take advantage of the rule of law in their home jurisdiction. It is just so time consuming and expensive to enforce legal rights these days that I think unfortunately, it undermines the system a little bit. That is a bit of a controversial remark.

MR. GROETZINGER: In the written materials, I was surprised to come across things to avoid in setting up ventures, and one of the most common mistakes is asking potential investors to sign a nondisclosure agreement. They say it is a risky move, and they would not sign anyway. That is a surprising statement. I just wonder what you have to say about that.

MR. WAGER: Those are materials which I did not provide because it would be contrary to the advice that I would give an entrepreneur, sharing his or her proprietary observations and information, and I also do not think it is an unrealistic expectation. You have to find some level of confidentiality to be able to observe business.

I am struck by that, and I would love to have an argument to make if I am on the side of the professional investor, which I usually am, to say, "No, we do not sign confidentiality agreements," but I do not think we are going to be seeing that many business plans if we do not.

MS. ALZETTA-REALI: I definitely agree with that.

MR. ABRAHAMS: Michael, on one of your earlier power point screens, there was a statement "Economic Freedom Drives Economic Activity Relating to Government Controls."

I would like to know, are you advocating some type of laissez-faire capitalism or different government regulatory controls or scheme, depending on the size or innovative issues of small or startup companies?

MR. WAGER: I am going to give you a lawyer's answer. No. It is not a yes or no answer because, as relates to the issue of rule of law and protection of intellectual property, clearly we need rules. What I was making reference to, and I am really borrowing from the literature, is that we are sitting in a state that has this issue in starting businesses. Oftentimes, depending on what business you are in, there are so many levels of compliance that the issue becomes prohibitive or a decision is made to basically ignore the compliance, which is a liability that funders are not going to enjoy.

That is what I was getting at – there needs to be some level of regulatory and paperwork reduction or reform. So, starting new businesses will not be quite as burdensome and, frankly, as costly. For instance, entrepreneurs pay law firms in order to make sure they can start a business, without a dollar of revenue of profit that already has significant legal compliance costs.

MS. ALZETTA-REALI: Obviously, Coca-Cola is not a starting business, but one of the impediments I find working in the Canadian office, when it comes to the company attempting to continue to be entrepreneurial, is the innovation. Innovation is what is going to keep us being as productive as possible. What would be wonderful, furthermore, speaking from a North American perspective, would be to have some harmonization in rules; this lacking is an impediment for us in Canada.

It may not be our innovative idea, but it is an innovative idea coming from R & D, from another company, or it could be from Asia, Africa, or the U.S. When we try and create the innovative leverage in Canada, the regulations and the landscape is so different from that in the United States that we either take the air out of the balloon or just do not launch the product, because it takes too much time. So, some harmonization in laws, not necessarily less regulation, but harmonization, would really help the entrepreneurial spirit.

MR. WAGER: There is actually some good news on this front. There was a time when you raised capital in several states in the U.S., notwithstanding the fact that you met federal exemption, you still had a variety of filings.¹¹⁶ There are still some filings for raising capital, like blue sky compliance.¹¹⁷

¹¹⁶ See generally Matt Storms, *Securities Compliance is Part of Raising Capital*, WIS. TECH. NETWORK (2006), <http://wistechology.com/article.php?id=3495> (discussing the various federal securities exchange commissions requirements for companies that are raising capital).

¹¹⁷ See generally Richard Alvarez & Mark Astarita, *Introduction to the Blue Sky Laws*, SEC LAW.COM, <http://www.seclaw.com/bluesky.htm> (last visited Oct. 28, 2007) (explaining that Blue Sky Laws are securities laws and rules of each state).

For the most part, if you need federal exemption today, you are likely to have an exemption at the state level.¹¹⁸ A dozen or so years ago that was not the case.

MR. HERMAN: I have a question on dispute settlement. This always gets lawyers active and engaged on dispute settlement, and you touched on dispute settlement. I think mention was made of the lack of support for nonbinding mediation. I can understand that because why would the clients want to go through the cost of a process that ultimately was nonbinding? It really does not make sense, and I think in a commercial document it is probably something that, as counsel, I certainly would not recommend.

One of the problems in contractual dispute settlement like arbitration, lawyers advising clients to not pay enough attention to the bind. At the end of the negotiation, something is thrown in that says the parties will arbitrate in accordance with arbitration rules, without realizing those are very complex rules, and if they are not specifically tailored to the agreement, you can get into long and complex processes.

The lesson seems, and I would like to have comment from the panel, for counsel to address dispute settlement provisions and to make sure that they tailor the dispute settlement provisions to the needs of the clients and the entrepreneurial activity that is involved. In other words, you can construct fast, efficient, effective, and binding arbitration provisions. The issue that I see often is that you have to convince the clients that they need to pay a little more to get those provisions drafted, and that it is in their interests, particularly when we are talking about small businesses, it is in their interests to spend a bit of money, their money, to ensure the arbitration provisions are lean, effective and efficient, rather than just throwing in a boilerplate arbitration provision in the agreement. Comments?

MR. WAGER: I am guilty of the latter.

MS. LILLEY: That is a very interesting comment because obviously one of the approaches for arbitration is to effectively draft your own procedure and attach it as a schedule to the document, but it is kind of interesting because clients frequently don't have a lot of heart. That sometimes is the kind of thing that gets left to the end of the process.

It is important because, of course, when you have a cross border deal, your client will say, "What do you mean we have to go to New York to do our arbitration? It is going to cost us this. It is going to cost us that."

Moreover, if you are working with a foreign jurisdiction, "What do you mean we do not have a right to have it in English?" So your point is very well taken. What I think many law firms are doing is trying to create some standard documents that can be, at least, used as a template starting point so

¹¹⁸ See generally Storms, *supra* note 116 (describing federal and state Blue Sky securities laws for issues of securities).

you are not always reinventing the wheel, but where you can have a separate negotiation on the arbitration provision.

MR. ROBINSON: Just a small comment: Observation that harmonization would help between the U.S., Canada, and also certainly Mexico, entrepreneurship and everything else. I have been very disappointed to see that the committees and working groups under NAFTA, I think we have got twelve formal ones, do not meet and do not work and they were supposed to harmonize all kinds of things.

In 2005 with a lot of publicity, we created this Security and Prosperity Partnership between the three countries.¹¹⁹ To the best of my knowledge, nobody yet can figure out what the heck it does, but maybe one of the things it could do is to get those committees and working groups to do what they are supposed to do and start harmonizing things. So call your MP and complain.

MS. ALZETTA-REALI: I will do.

DR. KING: It was a good session.

¹¹⁹ Security and Prosperity Partnership of North America, <http://www.spp.gov/> (last visited Nov. 6, 2007) (discussing the background of the formation and purpose of the Security and Prosperity Partnership of North America).