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Rise of ICOs brings new questions for directors and officers

By Marc Boiron

The rapid rise of initial coin offerings (ICOs) has caused directors and officers of corporations with stockholders who are not officers, directors or advisors to the corporation to question their obligations to those stockholders. Directors and officers of corporations incorporated as Delaware corporations (and in most other jurisdictions) owe fiduciary duties to the corporation and its stockholders, including in an ICO. Any person that owns a majority of the stock of, or controls, the corporation also owes the fiduciary duties to the corporation and its other stockholders.

An ICO, also known as a token generation event, is a new way to raise capital. In an ICO, the corporation sells tokens to participants in exchange for fiat currency or virtual currency, generally either bitcoin or ether. The tokens are generated pursuant to a smart contract on the blockchain, which is a digital, decentralized ledger used to securely and permanently record transactions in chronological order among a network of participants synchronized via the internet. The token entitles its purchasers to certain rights related to a venture managed by the corporation launching the ICO, such as use of a product or service, voting rights, rights to profits, or fractional interests in assets. The tokens could result in additional revenue and profit being generated for the corporation or could divert rights, including rights to revenue and profit, to purchasers of tokens. The tokens often are listed on virtual currency exchanges, which provide liquidity for the tokens.

Any time a director, officer or controlling stockholder takes any action, the action may be scrutinized to make sure it was consistent with fiduciary duties of care and loyalty. Those fiduciary duties mean that directors, officers and controlling stockholders must act on an informed basis, in good faith, and in the honest belief that the action taken is in the best interests of the corporation and its stockholders.

When making a business decision, directors and officers have significant leeway. Most of the time, they only need to make sure that their actions are reasonable. Courts test most business decisions under the "business judgment rule" so that directors and officers will satisfy their fiduciary duties unless their decisions are not rational and constitute "corporate waste" (i.e., so bad that no reasonable business person would conclude that the corporation received adequate consideration in the transaction), in which case the directors and officers may be liable to the stockholders for breach of fiduciary duties. The business judgment rule is not a difficult standard to meet.

In an ICO in which all tokens are sold to people and corporations unrelated to the corporation selling the tokens, the board of directors' decision to complete an ICO and officers' actions in furtherance of the ICO would be protected under the business judgment rule. The directors and officers are highly unlikely to be found to have breached their fiduciary duties even if some of the tokens are sold to people unrelated to the corporation at a discount in the ICO.

The analysis changes when the directors and officers or controlling stockholders are either interested or not independent in the transaction. A person is interested in a transaction when he or she will receive a benefit that the stockholders as a whole will not receive, and a person is not independent in a transaction when someone close to him or her (like a family member or close friend) is interested in a transaction.

When a director, officer or controlling stockholder is interested or not independent in a transaction, the test for determining whether any fiduciary duties have been breached is whether the transaction is "entirely fair." A transaction is entirely fair when a fair price was paid in the transaction and a fair process was followed in the transaction. A fair price will end up being somewhere close to what two reasonable people negotiating at arms' lengths would have agreed to in the transaction. A fair process involves putting procedures in place to ensure that negotiations and decisions made related to the transaction were sufficient so that the person who is interested or not independent in the transaction did not simply take the bull by the horn and make all decisions without a process in place to consider the interests of others.

Of course, in almost every ICO, the directors, officers and controlling stockholders are receiving tokens at a discount or without making any payments. If all of the stockholders of the corporation fall into those buckets, then there is no fiduciary duty issue, assuming the tokens are given based on the proportional ownership of those stockholders. However, in situations where there are outside stockholders or one of the people in those buckets received a disproportionate benefit relative to other stockholders, the transaction must be entirely fair for the person receiving the benefit to avoid being in breach of his or her fiduciary duties.

In that situation, the transaction could be entirely fair if the person receiving the benefit has not been paid for services or is receiving a bonus and the amount paid in tokens is a reasonable payment for the services or as a bonus, compensating the individual for the risk of nonpayment. However, in many instances, large payments in the form of a percentage of the tokens sold in the ICO may result in a transaction that is not entirely fair to the stockholders, which would likely constitute a breach of fiduciary duties.

The situation may be exacerbated when the token sold in the ICO is not a utility token, especially when it represents a right to future revenues or profits of the corporation. Under those circumstances, the value of stockholders' equity will be lower because future cash flows will be lower. Any ICO that decreases the value of the stockholders' equity and gives a benefit to certain directors, officers or controlling stockholders to which all stockholders do not consent is highly likely to result in litigation for breach of fiduciary duties, and the stockholders would have a very strong case against those receiving the benefits.

Importantly, fiduciary duties are not the only considerations when determining whether to do an ICO after having raised capital from investors in an earlier round of financing. It is important to have discussions with those investors who are now stockholders in the corporation. A corporation's dynamics change entirely after an ICO, and it is not an undertaking that can be taken lightly. If everyone involved with the corporation has taken the time to build a successful corporation, then the goal of any ICO should be to continue building on that success. If that is the goal, then the directors and officers will inherently be looking out for the best interests of the corporation and its stockholders, which should eliminate potential fiduciary duty liability for them.

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