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Exec more likely now to sue if they feel wronged by backers

By Matt Marshall
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Some founders and executives of venture-backed companies aren't going to take it anymore.

If they feel venture capitalists have big-footed them, they've grown bolder about suing.

One such suit was filed recently by the former management team at San Francisco online wine retailer Wine.com, where ousted chairman Chris Kitze and a dozen others allege they were cheated out of up to $30 million.

Filed mid-December in San Francisco County Superior Court, the suit says a New York venture capital firm, Baker Capital, breached its responsibilities to other shareholders when it rejected an acquisition offer last year by an outside firm, Liberty Media.

The case resembles a number of other lawsuits in Silicon Valley in recent years, where founders broke with investors at companies such as online review company Epinions and network storage company Nishan Systems. Another legal dispute, involving storage company Intransa, has yet to be resolved.

In the Wine.com case, the suit alleges that Baker, which had effective control of the company, spurned the Liberty Media offer, at $4 a share for major classes of Wine.com's stock. Instead, Baker pushed Wine.com to the brink of bankruptcy, forcing it to raise more cash on unfavorable terms, the suit contends.

Baker then chose to raise more money last year at a mere 62 cents per share -- effectively wiping out most of the value of the other shareholders -- but securing majority ownership on terms favorable to itself, the suit alleges.

The suit says that while Baker initially didn't have majority control of shares to make such decisions, it did have effective control under special rights it gave itself after a 2004 investment. These included a veto over shareholder and board-level decisions, ability to hire and fire high-level corporate officers and to appoint new board members, and the right to approve the company's operating plan.

And Delaware law, where Wine.com is incorporated, stipulates that a controlling shareholder has a fiduciary duty to look after other shareholders, the plaintiffs say.

Baker has not responded in court with legal briefs to the suit, and the firm did not respond to requests for comment. Wine.com also did not respond. Kitze would not comment.

But Kitze's suit, an uncommon action in Silicon Valley just a decade ago, is part of an increasing trend, say some lawyers who have been involved with tech companies.

It used to be that entrepreneurs feared standing up to venture capitalists. If they dared to go against the once close-knit group of venture capitalists, the community would close ranks, label them pariahs, and freeze them out of future deals, the lawyers say.

``There was this unwritten rule in venture capital: If you were a founder, you'd never sue an investor,'' explains Michael Rhodes, a litigator for law firm Cooley Godward, who started practicing in 1984. ``There was a perception, it would be more difficult to raise money later.''

He's handling up to a dozen cases that concern a break between management teams and institutional investors, and his firm counted about 50 such cases last year nationwide.

The increase stems in part from the massive amount of money that flowed into venture capital during the 1990s. Personalities changed, the tight VC industry network began to loosen, and wealthy entrepreneurs had more clout to stand up to them. Add to this the bad news and disappointments of failed companies from the post-bubble era, which resulted in internal disagreements ending up in court.

Indeed, others note that the overall number of such cases is still very small. ``I don't see these lawsuits increasing. It's just that we hear of those lawsuits, because we've gotten out of the down cycle,'' said Jeff Clavier, a Palo Alto investor who provides seed money to start-ups. ``If you're suing a venture capitalist, then you're likely shooting yourself in the foot. It's more likely someone else isn't going to back you,'' Clavier said.

In the Wine.com lawsuit, former chairman Kitze is joined by plaintiffs including Barry Schuler, former chief executive of

AOL and former Wine.com board member; Linda Graebner, chief executive of Tilia, a kitchen appliance company and former Wine.com independent board member who had recommended acceptance of the outside offer; and George Garrick, a former chief executive of Wine.com who previously was CEO of Flycast Communications.

Francis Juliano, the former chief technology officer at Wine.com and also a plaintiff in the suit, says he has worked at Silicon Valley companies for 20 years. But it is the first time he feels wronged by a venture capital firm. ``I spent two years working 70-hour weeks, spent a tremendous amount of time to grow the business, and wake up to find two years of sacrifice, of being away from the family, has no upside to it,'' he said.

Another case involves Naval Ravikant, co-founder of online review site Epinions, who was part of a suit filed last year by 51 employees against two high-profile venture firms in the valley, Benchmark and August Capital. The case was settled for an undisclosed amount.

Despite battling his venture backers, Ravikant wasn't excluded from future deals. He was able to raise venture capital for a new start-up, Omni-Explorer Technologies. ``There might be cliques and groups, but there's no single VC cabal that runs the valley,'' Ravikant says.

Peter Rip, venture capitalist at Leapfrog Ventures, who backed Ravikant at his new company, said he attributes the recent lawsuits to financings of the past few years having tough terms for entrepreneurs. ``I don't have the sense that there's been a big uptick'' in such suits, he said.

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