EARLY-STAGE TOKEN INVESTMENTS: CAREFUL DRAFTING NEEDED TO AVOID DISPUTES

Authored by: Chris Duncan, *Partner*, and Tim Baildam, *Counsel*, Carey Olsen



Start-up crypto companies frequently look to raise early stage capital by offering investors the right to receive tokens that will be issued by the company in the future. The point at which tokens are issued following the successful development of the relevant technology, the manner of delivery, and any lock-up restrictions, can be an area of uncertainty, particularly if the agreements are not carefully drafted with input from advisors familiar with tokens and crypto related transactions. Increasingly, we are seeing questions raised and potential disputes brewing concerning these issues involving crypto companies incorporated in offshore jurisdictions such as the Cayman Islands or British Virgin Islands, a trend we expect to continue as these types of agreement are more carefully scrutinised.

Investors in a "conventional" non-crypto company will typically contribute capital to the company by investing in return for the issue of shares in the company, and the investors will own part of the company as shareholders going forward. Whilst the shareholders may benefit through some control over the company through their shareholding, this typical structure limits the shareholders to obtaining a return linked to the value of the shares at the point they wish to exit the company (plus any dividends enjoyed through the duration of their shareholding). Opportunities to sell shares outside of a public offering or acquisition can be limited, especially for shares in private companies, and the process of transferring shares can be lengthy, typically involving extensive legal due diligence.

In contrast, early stage investors in a crypto company will frequently enter into a token purchase agreement[(1)], in which the investors and the company agree that, once the company has created the tokens, it will distribute tokens to the investors. This is relatively similar to the issue of shares in an equity investment, however token holders may be able to benefit from increased and earlier liquidity compared to the traditional equity market for the sale of shares.

Token purchase agreements will typically provide when, and how, the tokens will be distributed to investors. The agreements may also include restrictions on how the investors can deal with the tokens following their initial distribution. Each of these clauses must be carefully drafted to avoid misunderstandings or disagreements between the company and the investors, something which may be overlooked, on both sides, in a fast paced or oversubscribed fundraising context.

Firstly, there may be a dispute as to when the tokens should be distributed to investors. The relevant provisions in the token purchase agreement will typically set out a mechanism for the distribution of the tokens, which is commonly on the first distribution to investors or insiders, or a first public distribution or sale. If these provisions are not clearly drafted, there may be disagreements to whether the company's obligations to distribute tokens to a particular investor have been triggered at a particular point in time. This timing can be critical to investors, considering the price volatility that can attach to cryptocurrency (and, in particular, to new tokens that have recently been launched).

Secondly, the company may look to have the tokens subject to lock-up periods in the token purchase agreements, restricting the investors from selling their tokens immediately after they have been distributed. This aims to encourage long-term alignment between the particular project and the token holders, and to avoid any sudden price drops that can result if numerous investors look to sell their tokens in the market simultaneously. As the company will often hold the majority of the unissued tokens, and it will plan to use those tokens to further support the relevant ecosystem as well as to incentivise early team members, it is not in the company's interest for the token's price to be decimated shortly following launch.

(1) Such as a simple agreement for future tokens or SAFT.Token warrants that sit alongside an equity investment are also common.

If the token purchase agreement does seek to restrict the investors' ability to sell or freely trade the tokens for a lock-up period, it is important that the relevant clauses are clearly drafted to avoid any disputes between the company and the investors after the tokens have been distributed, for example if an investor wishes to sell the tokens during the lock-up period. Consideration should also be given to whether an investor might be able to exercise other rights associated with the tokens (such as staking or voting) during a lock up period.

There is also scope for further complexity if, as is fairly common, individual investors have negotiated different terms in their respective token purchase agreements. These specialist terms may have different dates for the tokens to be issued to individual investors, mechanisms for calculating the number of tokens to be distributed, the method of distribution of the tokens, and restrictions on when the individual investors can sell their tokens in the market. Whilst the company may have considered such concessions were necessary to obtain the investments at the time, such variance can land the company in a difficult situation and facing criticism or complaint from investors aggrieved at their treatment relative to other investors.

Our recent experience of token purchase agreements suggests that these types of dispute may increase in frequency, as a result of token purchase agreements that have been imprecisely drafted (and sometimes prepared without the assistance of legal advice) coupled with a likely overall increase in token value over time.

In order to avoid disputes such as these, it is important for crypto companies to aim for consistency and clarity across its token purchase agreements, with the input of legal counsel familiar with the crypto space, to avoid any disputes with its investors following the distribution of the company's tokens.

Chris Duncan, Partner,
Carey Olsen

Tim Baildam, Counsel,
Carey Olsen