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ARTICLE

STARTUP GOVERNANCE

ELIZABETH POLLMAN[†]

Although previously considered rare, over three hundred startups have reached valuations over a billion dollars. Thousands of smaller startups aim to follow in their paths. Despite the enormous social and economic impact of venture-backed startups, their internal governance receives scant scholarly attention. Longstanding theories of corporate ownership and governance do not capture the special features of startups. They can grow large with ownership shared by diverse participants, and they face issues that do not fit the dominant principal-agent paradigm of public corporations or the classic narrative of controlling shareholders in closely held corporations.

This Article offers an original, comprehensive framework for understanding the unique combination of governance issues in startup companies over their life cycles. It shows that venture-backed startups involve heterogeneous shareholders in overlapping governance roles that give rise to vertical and horizontal tensions between founders, investors, executives, and employees. These tensions tend to multiply as the company matures and increases the number of participants with varied interests and claims. This framework of startup governance offers new insight into issues of current debate, including monitoring failures by startup boards and late-stage governance complexity, and suggests that more attention should be paid to how corporate law principles apply in the startup context.

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INTRODUCTION

The world's largest companies in 2019 by market capitalization—Apple, Alphabet, Microsoft, and Amazon—all began as venture-backed startups.¹ They defied existing theory by growing to significant size with ownership shared between founders, investors, executives, and employees.² In the years

¹ NAT'L VENTURE CAPITAL ASS'N, 2017 NAT'L VENTURE CAPITAL ASS'N YEARBOOK 9 [hereinafter NVCA YEARBOOK], <https://nvca.org/blog/nvca-2017-yearbook-go-resource-venture-ecosystem> [<https://perma.cc/3HQ7-DR6Q>]; Stephen Grocer, *Biggest Public Company? Microsoft. Wait, Apple Again. Amazon? No, Back to Microsoft.*, N.Y. TIMES: DEALBOOK (Feb. 5, 2019), <https://www.nytimes.com/2019/02/05/business/dealbook/apple-amazon-microsoft-market-value.html> [<https://perma.cc/KD2A-KS24>]. This Article focuses on innovative, venture-backed startups, defined in Section I.A, *infra*.

² See HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 40-44 (1996) (observing the “nearly complete absence of large firms in which ownership is shared among two or more different types of patrons, such as customers and suppliers or investors and workers” and theorizing the high cost of collective decisionmaking that would result from having different types of owners).

since these trailblazing startups crossed over into public company status, record-breaking amounts of capital have flowed into new private companies.³

Over three hundred “unicorn” startups have reached private valuations described as one billion dollars or more.⁴ Many of these companies have also reached the ten-year mark and face critical inflection points in their life cycles.⁵ Thousands of other startups are following on their heels or hope to do so. Our economy and society are increasingly dominated by companies that start in the proverbial garage or dorm room and, for a critical period, operate with a venture-capital style of ownership and governance.

Corporate law and theory have not kept pace in giving due attention to this development and adapting general principles to fit the special features of startups.⁶ Courts apply traditional contract strictures to the preferred stock that venture capitalists hold not as public company debt, but rather as a stake in a distinctive system of shared equity and governance.⁷ Recent case law requires startup directors to maximize value for common shareholders, without recognizing that in startups these shareholders do not have a monolithic set of interests and do not represent the firm value.⁸

Corporate law literature remains similarly rooted in traditional paradigms of public and closely held corporations that do not map on well to startups. Landmark works on the separation of ownership and control in public

³ See Begum Erdogan et al., *Grow Fast or Die Slow: Why Unicorns Are Staying Private*, MCKINSEY (May 2016), <https://www.mckinsey.com/industries/high-tech/our-insights/grow-fast-or-die-slow-why-unicorns-are-staying-private> [<https://perma.cc/S8CU-HGQM>] (noting that the influx of capital to private companies tripled from \$26.5 billion to \$75.3 billion between 2013 and 2015).

⁴ Venture capitalist Aileen Lee coined the term “unicorn” in 2013 to capture the elusive and rare nature of mega-hit ventures in a fund that are worth a billion dollars or more. Aileen Lee, *Welcome to the Unicorn Club: Learning from Billion-Dollar Startups*, TECHCRUNCH (Nov. 2, 2013), <https://techcrunch.com/2013/11/02/welcome-to-the-unicorn-club> [<https://perma.cc/SP4S-4SXA>]. In just several years, the list of unicorns rose to over three hundred private technology companies. *The Global Unicorn Club*, CB INSIGHTS, <https://www.cbinsights.com/research-unicorn-companies> [<https://perma.cc/DS5A-ET7T>] (last visited Aug. 11, 2019).

⁵ See Alfred Lee, *Delayed IPOs Undercut Startup Employee Options*, THE INFO. (July 13, 2018), <https://www.theinformation.com/articles/delayed-ipos-undercut-startup-employee-options> [<https://perma.cc/AD59-EPBD>] (noting that fifty-two unicorns hit the ten-year mark by 2018 and that more would follow in 2019). Notable examples in this batch of unicorns include Airbnb, Uber, Pinterest, Palantir, and SpaceX—some of which have since transitioned to public company status. *Id.*

⁶ See Robert P. Bartlett & Eric Talley, *Law and Corporate Governance*, in 1 THE HANDBOOK OF THE ECONOMICS OF CORPORATE GOVERNANCE 177, 185-86 (Benjamin E. Hermalin & Michael S. Weisbach eds., 2017) (“Th[e] increasing concentration of economic value in private companies poses something of a challenge for corporate governance scholars, both empirically and theoretically To the extent this trend continues, the study of governance in privately held firms is likely to become more critical to important policy debates.”).

⁷ See *infra* subsection II.A.2.b.

⁸ See *infra* Section III.B.

corporations and a principal-agent theory of the firm have oriented the field to view reducing managerial agency costs “as the essential function of corporate law.”⁹ A smaller body of work on controlled and closely held corporations has, by contrast, highlighted that these corporations do not share the hallmark feature of widely dispersed shareholders and instead face the potential problem of minority shareholder oppression.¹⁰

Amid this dichotomous approach to corporations,¹¹ a separate body of venture capital and entrepreneurship literature has emerged to examine specific governance issues in startups. Key work in this field includes, for example, the study of venture capital financing¹² and the use of preferred stock.¹³ Some scholars have recently begun studying unicorns, the largest startups by valuation, and have advocated for increasing disclosures and strengthening mechanisms that impose discipline on founders.¹⁴ Yet, despite

⁹ Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 769 (2017); see ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 2-4 (1932) (identifying the separation of ownership and control in corporations with dispersed share ownership as a key governance issue); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308-09 (1976) (theorizing that the misalignment between shareholders and managers gives rise to agency costs).

¹⁰ See, e.g., Lucian A. Bebchuk & Assaf Hamdani, *Independent Directors and Controlling Shareholders*, 165 U. PA. L. REV. 1271, 1279-80 (2017); see generally Benjamin Means, *A Contractual Approach to Shareholder Oppression Law*, 79 FORDHAM L. REV. 1161 (2010); Douglas K. Moll, *Shareholder Oppression and “Fair Value”: Of Discounts, Dates, and Dastardly Deeds in the Close Corporation*, 54 DUKE L.J. 293 (2004).

¹¹ Robert P. Bartlett, III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 37 (2006) [hereinafter Bartlett, *False Dichotomy*] (“On one side of the dichotomy rests the publicly held corporation suffering from a significant conflict of interest between its managers and dispersed shareholders; on the other side, the closely held corporation plagued by intershareholder conflict.”).

¹² See, e.g., Bartlett, *False Dichotomy*, *supra* note 11, at 61-64 (examining horizontal issues between venture capital investors); William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 914-16, 939-44 (2002) (discussing why venture capitalists use preferred stock and how they contract for protections from downside failure); Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1082 (2003) (discussing how venture capital contracts respond to agency costs between venture capitalists and entrepreneurs); D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 316-20 (2005) [hereinafter Smith, *Exit Structure*] (examining potential conflicts between venture capitalists and entrepreneurs regarding exit).

¹³ The literature on the conflict between the preferred and common shareholders in startups includes: Robert P. Bartlett, III, *Shareholder Wealth Maximization as Means to an End*, 38 SEATTLE U. L. REV. 255 (2015) [hereinafter Bartlett, *Shareholder Wealth*]; William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815 (2013); Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967 (2006); Charles R. Korsmo, *Venture Capital and Preferred Stock*, 78 BROOK. L. REV. 1163 (2013); Leo E. Strine, Jr., *Response, Poor Pitiful or Potently Powerful Preferred?*, 161 U. PA. L. REV. 2025 (2013).

¹⁴ See Jennifer S. Fan, *Regulating Unicorns: Disclosure and the New Private Economy*, 57 B.C. L. REV. 583, 583 (2016) (arguing “for enhanced disclosure requirements that will alleviate the risks of unicorns without restraining their innovation”); Renee M. Jones, *The Unicorn Governance Trap*, 166

growing influence and concern, no article has provided a full account of the unique features of startups and their governance.

This Article takes aim at that goal. With their focus on technology and innovation, and their correspondingly high levels of risk and emphasis on growth, startups are different from both public corporations and traditional closely held corporations. As a result, their governance is also different. This Article provides an in-depth, holistic analysis of the governance problems in venture-backed startup companies that exist through various stages of their life cycles. Specifically, it offers a framework showing that startups involve heterogeneous shareholders in overlapping governance roles that give rise to vertical and horizontal tensions between founders, investors, executives, and employees. These tensions tend to multiply as a company matures and increases the number of participants with varied interests and claims.

This original account of startup governance shares features with traditional models but also differs in significant ways that have wide-ranging implications for corporate law and theory. Prevailing accounts, whether focused on public corporations and their shareholder-manager conflicts, or closely held corporations and their issues of controlling shareholder opportunism, present the corporation in static terms as facing one essential governance issue that is either vertical or horizontal in nature.¹⁵ Corporate law literature has also often characterized shareholders as homogeneous in their interests and has excluded employees from analysis, recognizing their relevance to the corporation in only contractual terms.¹⁶

U. PA. L. REV. ONLINE 165, 169 (2017) (arguing that “recent market trends and deregulatory reforms have weakened or eliminated the principal mechanisms that imposed discipline on start-up company founders”).

¹⁵ One notable exception is work by Robert Bartlett that provides a dynamic account showing that the staged and syndicated financing that venture capitalists (VCs) use to constrain shareholder-manager agency costs can give rise to a new dimension of horizontal conflict among preferred shareholders in startups. See Bartlett, *False Dichotomy*, *supra* note 11, at 108-14. This Article builds on this insight and is the first to provide a comprehensive dynamic account of the multiple vertical and horizontal tensions in startups and argue, in contrast to Bartlett, that startups have unique governance features and do not present the same agency problems and investment risks as all other firms. See *id.* at 37-40 (asserting that “all firms—public and private—often face the same agency problems” and “all firms—public and private—frequently face the same structural investment risks”).

¹⁶ See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 1-39 (1991) (providing a contractarian theory of corporate law and characterizing employees as creditors protected by contract and external regulation); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 440-41 (2001) (“[The] emerging consensus [is] that ultimate control over the corporation should rest with the shareholder class; . . . [and] other corporate constituencies, such as creditors, employees, suppliers, and customers, should have their interests protected by contractual and regulatory means rather than through participation in corporate governance.”); Henry Hansmann, *Worker Participation and Corporate Governance*, 43 U. TORONTO L.J. 589, 591-92 (1993) (“Shareholders have highly homogeneous interests with respect to most corporate decisions: they all basically want to maximize

This approach is a poor fit for startups. Participants in startups often occupy overlapping and shifting roles. For example, a venture capital (VC) firm is a shareholder and may additionally hold a designated seat on the board. This complicates conventional applications of principal-agent theory as participants may have a dual status as both principal in one context and agent in another.

In addition, startup shareholders are heterogeneous. In light of extreme levels of uncertainty and asymmetric information, startups typically issue common stock to founders and raise money from investors by issuing rounds of convertible preferred stock with varying terms and layered contractual rights.¹⁷ This capital structure creates significant divergences in preferences among shareholders. Furthermore, employees make essential investments of human capital and hold common equity or options.¹⁸ In many instances the interests of founders and executives align with those of employees, but in some situations they diverge because of differences in control, potential deal payouts, and post-exit opportunities. Conflicts therefore arise not only between preferred shareholders, and between preferred and common shareholders, but also between common shareholders—a point that even scholars focused on startups have generally left unexplored.¹⁹

Setting out the full picture of vertical and horizontal tensions highlights the distinctiveness of startups and also uncovers an important pattern: The governance tensions tend to multiply as the startup business evolves and the complexity of its capital structure grows. Unlike public companies and other closely held corporations, which do not display predictable or linear patterns

the net present value of future distributions.”); *but see* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 253 (1999) (including employees in the “corporate ‘team’”); Kent Greenfield, *The Place of Workers in Corporate Law*, 39 B.C. L. REV. 283, 283-88 (1998) (critiquing the exclusion of workers from corporate law doctrine); Brett H. McDonnell, *Employee Primacy, or Economics Meets Civic Republicanism at Work*, 13 STAN. J.L. BUS. & FIN. 334, 334-37 (2008) (arguing for “employee primacy” in corporate governance).

¹⁷ See *infra* subsection I.B.2.

¹⁸ Scholars have largely overlooked the role of non-founder employees in startup governance. For an excellent essay that considers the vulnerability of startup employees to risk in mature startups, see Abraham J.B. Cable, *Fool’s Gold? Equity Compensation & The Mature Startup*, 11 VA. L. & BUS. REV. 613 (2017). Other startup employee-related literature has primarily focused on theorizing stock options and analyzing legal issues such as taxation. See Victor Fleischer, *Taxing Founders’ Stock*, 59 UCLA L. REV. 60, 75-100 (2011) (arguing for reform to the preferential tax treatment of founders’ stock); Saul Levmore, *Puzzling Stock Options and Compensation Norms*, 149 U. PA. L. REV. 1901, 1924-40 (2001) (offering an explanation for the popularity of stock options as part of compensation packages).

¹⁹ As Section II.A explains, in startups this divergence between common shareholders typically occurs between the management and employees. Scholars are beginning to explore interinvestor conflicts in public companies that might offer a parallel. See Bartlett & Talley, *supra* note 6, at 8 (“[T]he nature of governance disputes within public companies has itself begun to migrate in recent years to ‘horizontal’ disputes between shareholders (e.g., activists versus long-term investors).”).

of governance change, venture-backed startups that survive foreseeably face increasing potential conflicts.

While it may seem intuitive that startups increase in governance complexity as they continue to operate, this account is missing from the existing literature. Because startups are often unprofitable for long periods while they develop innovative products or services, they usually raise outside investment and continue to do so to fuel growth.²⁰ Each round of financing may bring investors with different terms and interests into the capital structure, adding to potential governance conflicts.²¹ Further, employees are typically hired on an ongoing and increasing basis, and become staggered in their option vesting schedules and exercise prices. Thus, as a startup company matures, it expands the number of participants with varied interests and claims affecting its governance structure.²²

These central contributions of the Article help elucidate vexing issues of current debate and open future directions for corporate law. Part I discusses the distinctiveness of startups and their paradigmatic life cycle. It sets out legal boundaries and definitions, and identifies two dimensions of the startup life cycle that drive governance issues: the evolving nature of the business and capital structure. Part II provides a holistic analytical framework of the recurring issues of startup governance, both vertical (such as between the board and founders) and horizontal conflicts (such as between shareholders). It includes all startup participants and shows how they have diverging interests and might be involved in more than one type of governance issue, serving overlapping roles. Furthermore, it observes that governance issues tend to increase over time because of the evolving stage of business and increased complexity of the capital structure.

Part III explores how these observations help to explain current developments and illuminate implications for lawmakers. First, with scandals at companies such as Uber and Theranos making headline news, recent accounts of startups have bemoaned unaccountable companies with large social footprints and compliance failures.²³ This Article's framework helps show how a startup's evolving governance structure pushes toward prioritizing growth and puts key participants in overlapping roles, which can result in conflicts of interest and weaken oversight. This explanation solves a puzzle left open by existing literature, which assumes that VCs will serve as strong monitors. Further, it reveals cause for concern that likely cannot be solved with the standard corporate governance proposal for greater board

²⁰ See *infra* Part I.

²¹ See *infra* Section II.A.

²² See *infra* Section II.B.

²³ See *infra* subsection III.A.1.

independence. Startup governance may insufficiently constrain the social costs created by growing, innovative companies.

Second, the law and finance literature has examined various reasons for companies to go public but has overlooked what the framework offered here posits—complex governance dynamics in the extreme late stage of the startup life cycle.²⁴ Staying private with an increasingly diverse group of shareholders involves significant difficulty and cost in negotiating new rounds of financing, managing information flows, and meeting the liquidity needs of not just early investors but also large numbers of employees who constitute a crucial part of the workforce. This closer examination of the dynamics of startups in the extreme late stage provides a contemporary, governance-based account explaining why liquidity is so critical and why companies like Spotify and Slack go public even when private capital is available. Going public can enable companies to simplify their governance complexity while providing liquidity.

Third, Part III suggests that corporate law should adapt in its application to startups in recognition of their distinctive features. Corporate law has largely developed to deal with the classic shareholder–manager and controlling–minority shareholder conflicts arising in public and traditional closely held corporations. Courts have applied these conventional frames of reference in cases involving startups, treating preferred shareholders as creditors with respect to their contractual preferences and characterizing common shareholders as the residual claimants of the corporation. A key example of this approach arises with fiduciary duty doctrine that is at the heart of corporate law. The last section examines *In re Trados*,²⁵ Delaware’s most notable fiduciary duty case involving a startup, and shows how the court overlooks the heightened need of heterogeneous shareholders to resolve complex governance issues by contract and a board with constituency directors that is renegotiated over time.²⁶ A better approach would recognize the corporation itself as the beneficiary of the fiduciary duties, representing the firm value and the interests of all startup participants.

I. THE DISTINCTIVENESS OF STARTUPS AND THEIR LIFE CYCLE

To start at the beginning of understanding startup governance is to recognize that despite widespread reference to companies by the moniker of “startup” and recognition of their economic importance,²⁷ the law does not

²⁴ See *infra* subsection III.A.2.

²⁵ *In re Trados Inc. S’holder Litig.*, 73 A.3d 17 (Del. Ch. 2013).

²⁶ See *infra* Section III.B.

²⁷ See, e.g., Gilson, *supra* note 12, at 1068 (noting that startup companies and the venture capital market are “among the crown jewels of the American economy”); Simone M. Sepe, *Intruders in the Boardroom: The Case of Constituency Directors*, 91 WASH. U. L. REV. 309, 314–15 (2013) [hereinafter

create such a category. This Part begins with definitional background and then sets out the unique combination of business and finance features in innovative venture-backed startups, which give rise to several recurring fundamental governance issues.

A. Legal Boundaries and Definitions

The law does surprisingly little to formally define startups or mandate their governance. Federal securities law draws a line between “public” and “private” corporations.²⁸ A company becomes “public” by making a public offering of securities, listing securities on a national securities exchange, or by reaching a certain asset size and number of shareholders of record.²⁹ Once a company is public, it is subject to a wide variety of governance requirements provided by federal statutes and by the securities exchange on which the company’s stock is traded.³⁰ For example, a public corporation’s board must have a majority of independent directors and must give shareholders a non-binding “say-on-pay” vote on executive compensation.³¹

If a company does not become public by one of the established paths, it is “private.”³² Some private corporations are referred to as “closely held” or

Sepe, *Constituency Directors*] (noting that venture-backed startups “are growing exponentially in importance in the U.S. economy”).

²⁸ A.C. Pritchard, *Revisiting “Truth in Securities” Revisited: Abolishing IPOs and Harnessing Private Markets in the Public Good*, 36 SEATTLE U. L. REV. 999, 1000 (2013). Venture-backed startups typically organize as corporations. See Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737, 1738 (1994) (“In Silicon Valley, notwithstanding the concomitant loss of tax benefits, a substantial number of new ventures are carried out by newly-formed corporations.”); Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-Ups*, 57 TAX L. REV. 137, 137 (2003) (“A typical start-up is organized as a corporation under state law, which means that it is treated as a separate entity from its owners for tax purposes.”); Gregg Polsky, *Explaining Choice-of-Entity Decisions by Silicon Valley Start-Ups*, 70 HASTINGS L.J. 409, 411 (2019) (noting lawyers who advise startups “stubbornly prefer C corporations”).

²⁹ 15 U.S.C. §§ 78l(a), 78o(d) (2018); see also Donald C. Langevoort & Robert B. Thompson, “Publicness” in *Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337, 351 (2013) (noting the ways a company may become public). Congress raised the Exchange Act’s section 12(g) threshold in the Jumpstart Our Business Startups (JOBS) Act of 2012, triggering public reporting obligations when a company has total assets exceeding \$10 million and 2,000 or more shareholders of record, of which no greater than 499 are unaccredited investors. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 501, 126 Stat. 306, 325 (2012).

³⁰ Langevoort & Thompson, *supra* note 29, at 381-83 (discussing corporate governance requirements on public companies); see, e.g., Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453 (1997) (discussing the role of securities exchanges).

³¹ *Developments in the Law—Corporations and Society*, 117 HARV. L. REV. 2169, 2182-94 (2004); Jill E. Fisch, *Leave It to Delaware: Why Congress Should Stay Out of Corporate Governance*, 37 DEL. J. CORP. L. 731, 752-54 (2013) [hereinafter Fisch, *Delaware*].

³² To maintain this status, companies issue their securities in private placements conforming to the rules for exemptions from registration requirements. Stephen J. Choi & A.C. Pritchard, *SECURITIES REGULATION: THE ESSENTIALS* 297-98 (2008).

“close,” and are generally partnership-like businesses involving family or personal ties.³³ The Internal Revenue Service defines a closely held corporation as having more than half of the value of its outstanding stock owned by five or fewer individuals.³⁴

Common usage often refers to startups with their own title or the broader term “private” rather than “closely held,” suggesting that startups connote different characteristics.³⁵ Startups are typically started by entrepreneurs and backed by outside investment with the goal of developing an innovative product or service, creating high growth, and exiting through a trade sale of the company or initial public offering (IPO).³⁶ Unlike traditional closely held corporations, startups are aimed at eventually being acquired by another corporation or transforming to a public corporation—their existence in startup form is understood to be ephemeral like a caterpillar in its chrysalis.

After an initial seed stage, startups often have more than a small handful of shareholders, with the numbers increasing as the company raises capital from syndicates of investors, including VCs, and grants restricted stock and stock options to employees which vest over the course of employment.³⁷ Like traditional closely held corporations, startups have stock that is not publicly

³³ Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 J. CORP. L. 913, 916 (1999); see also Benjamin Means, *Nonmarket Values in Family Businesses*, 54 WM. & MARY L. REV. 1185, 1192 (2013) (highlighting the “distinctive features” of family businesses, which constitute a “vital part of the [United States] economy”).

³⁴ INTERNAL REVENUE SERV., U.S. DEP’T OF TREASURY, PUB. NO. 542, CORPORATIONS 3 (Feb. 2019), <https://www.irs.gov/pub/irs-pdf/p542.pdf> [<https://perma.cc/TDY5-FPEJ>].

³⁵ See, e.g., *Telecom-SNI Inv’rs, L.L.C. v. Sorrento Networks, Inc.*, No. Civ.A. 19038-NC, 2001 WL 1117505, at *1 (Del. Ch. Sept. 7, 2001) (“Sorrento-California, as a startup corporation with no immediate prospects of profitability, required constant and significant cash infusions to sustain it until an initial public offering (“IPO”) could be accomplished.”); JOHN B. VINTURELLA & SUZANNE M. ERICKSON, *RAISING ENTREPRENEURIAL CAPITAL* 33 (2d ed. 2013) (distinguishing the “closely held” corporation from the “private” corporation by the number of shareholders and stating that “[a] start-up company with high growth aspirations will typically go through a period as a private corporation”).

³⁶ See, e.g., SCOTT KUPOR, *SECRETS OF SAND HILL ROAD: VENTURE CAPITAL AND HOW TO GET IT* 2, 21, 27 (2019) (noting that “tech startups are basically innovative product or service companies” and that taking VC financing affects their governance and leads to exit through trade sale, IPO, or bankruptcy); Joseph Bankman & Ronald J. Gilson, *Why Start-Ups?*, 51 STAN. L. REV. 289, 289 (1999) (describing a “prototypical start-up” as comprising a founder with an idea and outside investment from venture capital). Exits through trade sales greatly outnumber exits through IPOs. NAT’L VENTURE CAPITAL ASS’N, 2018 NAT’L VENTURE CAPITAL ASS’N YEARBOOK 29-31, <https://nvca.org/no-access/download-id/67488> [<https://perma.cc/38UY-LUEH>] (providing historic data on U.S. venture-backed exit activity, including 2017 data indicating 750 acquisitions versus 59 IPOs).

³⁷ Startups typically manage the number of their holders of record to maintain private status, but the numbers may be significantly greater than the definition of “closely held” provided by the IRS. See Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. PA. L. REV. 179, 191-93 (2012); cf. *supra* note 34 and accompanying text.

traded.³⁸ But even in this regard, startups are different in that outside demand for the high-growth asset class exists and startups may facilitate partial liquidity events.³⁹ This Article focuses on these companies—innovative, venture-backed startups and their distinctive governance features.⁴⁰

In short, corporate and securities laws do not define or provide special rules for startups. From a legal perspective, startups simply represent part of the universe of private companies, subject to general principles of corporate law but otherwise free to privately order their affairs.⁴¹ It is therefore the nature of the startup business and its life cycle that significantly drive governance arrangements and conflicts.

B. *Two Dimensions of the Startup Life Cycle*

Startups evolve in predictable ways across two dimensions that ultimately affect their governance. The first is the nature of the startup business, which progresses through stages of maturity. The second is the complexity of the capital structure, which increases with additional rounds of financing that are required to build and grow the company. Each of these dimensions underlies the framework of startup governance that this Article offers.

1. The Nature of the Business

Although any particular company's trajectory may involve fits and starts, bumps and detours, in the larger picture of startups there are recognizable

³⁸ See DOUGLAS K. MOLL & ROBERT A. RAGAZZO, 1 THE LAW OF CLOSELY HELD CORPORATIONS § 1.01 (Matthew Bender & Co. 2017 ed.) (“A closely held corporation can be generally defined as a corporation whose stock is not publicly traded on an established market.”).

³⁹ For discussions of regulatory and technological changes that have facilitated liquidity and capital formation in startups outside of exchange listings and public offerings, see, for example, Langevoort & Thompson, *supra* note 29; Pollman, *Information Issues*, *supra* note 37; Robert B. Thompson & Donald C. Langevoort, *Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising*, 98 CORNELL L. REV. 1573 (2013).

⁴⁰ Silicon Valley is famous for producing startups, but the framework offered here is not specific to any geographic location. Rather, the governance issues arise from the structures typically used by VCs, such as staged financing and preferred stock, and the common practice of granting stock options to employees, which together combine to form a structure that has varied participants and interests aimed at growth and exit.

⁴¹ State corporate law is generally enabling in nature. See Fisch, *Delaware*, *supra* note 31, at 742 (“[T]he structure of Delaware’s corporate law is largely enabling rather than mandatory.”); see also Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1481 (1989) (“Delaware is usually taken as the apotheosis of enabling states.”).

and predictable patterns. Startups famously fail at high rates.⁴² Those that succeed generally proceed through well-established business phases.⁴³

Early-stage startups are highly entrepreneurial and focused on innovation and technology. Startups are typically founded or cofounded by entrepreneurs who have an invention, technological idea, or discovery, and a desire to pursue commercial development.⁴⁴ Cofounders Larry Page and Sergey Brin started in their Stanford dorm rooms by building an internet search engine that they brought to market as Google.⁴⁵ The “two Steves”—Jobs and Wozniak—started by building a computer circuit board, Apple I, and selling Jobs’ VW microbus and Wozniak’s calculator to begin funding its production.⁴⁶ Companies that are started to pursue existing business models based on known products or services are replicative and not typically referred

⁴² See Deborah Gage, *The Venture Capital Secret: 3 out of 4 Start-Ups Fail*, WALL ST. J. (Sept. 20, 2012), <https://www.wsj.com/articles/SB10000872396390443720204578004980476429190> [<https://perma.cc/7QZZ-LLQP>] (finding that “about 60% of startups survive to age three and roughly 35% survive to age 10”); Mary Jo White, Chair, Keynote Address at the SEC-Rock Center on Corporate Governance Silicon Valley Initiative (Mar. 31, 2016), <https://www.sec.gov/news/speech/chair-white-silicon-valley-initiative-3-31-16.html> [<https://perma.cc/7SQ2-DGVY>] (noting that nine out of ten startups fail and seventy percent of failed startups die within twenty months after their last financing, having raised an average of \$11 million).

⁴³ Researchers have coined various terms and framed different numbers of phases, but generally track the discussion offered in this section. See, e.g., NOAM WASSERMAN, *THE FOUNDER’S DILEMMAS: ANTICIPATING AND AVOIDING THE PITFALLS THAT CAN SINK A STARTUP* 206-07 & n.* (2012) (identifying the stages as startup, transitional, and mature, and noting that “different functions within startups may go through them at different rates”); Max Marmer et al., *Startup Genome Report Extra on Premature Scaling* 14 (Mar. 2012), http://s3.amazonaws.com/startupcompass-public/StartupGenomeReport2_Why_Startups_Fail_v2.pdf [<https://perma.cc/Y6HS-PK9Q>] (gathering data from over 3,200 startups and identifying six stages: “Discovery, Validation, Efficiency, Scale, Sustain, and Conservation”).

⁴⁴ See, e.g., DANIEL F. SPULBER, *THE INNOVATIVE ENTREPRENEUR* 2 (2014) (identifying “invention” and “entrepreneurship” as the early stages of startup formation).

⁴⁵ *From the Garage to the Googleplex*, GOOGLE, <https://about.google/our-story> [<https://perma.cc/CB7B-HM7Q>].

⁴⁶ *Steve Jobs: An Extraordinary Career*, ENTREPRENEUR, <https://www.entrepreneur.com/article/197538> [<https://perma.cc/D3MS-AXRG>].

to as startups.⁴⁷ By their nature, startups pursue innovation—“something new that is introduced to the marketplace.”⁴⁸

The key early stage question is: Can we make a product or service that people want?⁴⁹ The nature of this challenge is typically both technological and operational because of engineering or scientific challenges involved in developing innovative technology and the need to raise money to fund this work.⁵⁰ Most founders do not have sufficient funds to bring an innovative product or service to market and the business may not be profitable for long periods of time.⁵¹ Founders therefore usually look to friends and family, angel investors, and VCs to finance the early and most uncertain stages of the startup.⁵² The company’s board, typically established in earnest upon the raising of a round of financing, is in a highly managerial phase—helping the

⁴⁷ See SPULBER, *supra* note 44, at 2 (“Innovative entrepreneurs differ from replicative entrepreneurs who imitate or purchase existing business models. The innovative entrepreneur combines inventions, initiative, and investment to create the start-up.”); see also WASSERMAN, *supra* note 43, at 6 (distinguishing “between the founding of high-potential startups and the founding of small businesses that are designed to remain small and owner-operated”); Darian M. Ibrahim & D. Gordon Smith, *Entrepreneurs on Horseback: Reflections on the Organization of Law*, 50 ARIZ. L. REV. 71, 84-85 (2008) (“Entrepreneurial opportunities may be novel in a strong sense, which typically implies a technological breakthrough backed by venture capital financing, or they may be novel in a weak sense, such as opening a new restaurant in a vacant building.”).

⁴⁸ SPULBER, *supra* note 44, at 10; see also JOSEPH A. SCHUMPETER, *THE THEORY OF ECONOMIC DEVELOPMENT* 74-83 (1934) (Redvers Opie trans., Transaction Publishers 2012) (describing entrepreneurs as introducing new goods or methods of production or opening new markets or supply sources); PETER THIEL, *ZERO TO ONE: NOTES ON STARTUPS, OR HOW TO BUILD THE FUTURE* 8, 10 (2014) (“Properly understood, any new and better way of doing things is technology New technology tends to come from new ventures—startups.”); Ibrahim & Smith, *supra* note 47, at 84 (“Entrepreneurship involves new products or services, new ways of organizing, or new geographic markets.”).

⁴⁹ GUY KAWASAKI, *THE ART OF THE START 2.0: THE TIME-TESTED, BATTLE-HARDENED GUIDE FOR ANYONE STARTING ANYTHING* 39 (2015); WASSERMAN, *supra* note 43, at 304.

⁵⁰ Biotechnology startups face costs and risks associated with new drug development that are on a different scale and timeline than other innovative startups, and accordingly reflect specialized patterns of startup governance such as the prevalence of VC financing and joint ventures with large pharmaceutical companies. See, e.g., Ronald J. Gilson, *Locating Innovation: The Endogeneity of Technology, Organizational Structure, and Financial Contracting*, 110 COLUM. L. REV. 885, 910-14 (2010) (observing that biotech often involves “a combination of venture capital and joint venture financing that reflects the nature of the technology being financed and the organizational structure through which the product is carried out”).

⁵¹ See PAUL GOMPERS & JOSH LERNER, *THE VENTURE CAPITAL CYCLE* 157 (2d ed. 2004) (“Entrepreneurs rarely have the capital to see their ideas to fruition and must rely on outside financiers.”); THIEL, *supra* note 48, at 45 (noting that startups “often lose money for the first few years: it takes time to build valuable things, and that means delayed revenue”).

⁵² BRAD FELD & MAHENDRA RAMSINGHANI, *STARTUP BOARDS: GETTING THE MOST OUT OF YOUR BOARD OF DIRECTORS* 4 (2014).

company with connections, resources, strategy, and expertise to succeed in launching its innovative product or service to the market.⁵³

After the early stage, startups typically become focused on refining product development to generate revenues and grow quickly. The key mid-stage question is: Can we scale the manufacture, distribution, and sale of our innovative product or service?⁵⁴ This question is often linked to the crucial issue of generating revenues or reaching profitability with a large market opportunity.⁵⁵ To ultimately reach large exits, startups need to be able to scale.⁵⁶ Venture capital firms that finance startups are based on a business model that depends on having a few “home runs” in the portfolio that account for much of the fund returns.⁵⁷ Sequoia Capital, for example, invested \$60 million in WhatsApp, which later sold to Facebook for \$16 billion—yielding a return to Sequoia of fifty times its investment.⁵⁸

As a startup evolves to late stage, its focus has typically shifted to managing a more complex organization and finding an exit to achieve liquidity for the participants holding equity stakes in the company. To have survived this long, the company has successfully developed some innovative product or service and generated customers and sales. The nature of the business may have become more complex, potentially involving global

⁵³ *Id.* at 5, 30, 68; see Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265, 286 (1997) [hereinafter Fisch, *Boards*] (“For a growth company in a developing field, faced with a variety of strategic decisions and an inexperienced CEO, the board’s role as manager may be an essential component of firm success. That role may require board members with developed industry expertise, business relationships with the firm, or even insiders.”).

⁵⁴ See, e.g., Ranjay Gulati & Alicia DeSantola, *Start-Ups That Last*, HARV. BUS. REV., Mar. 2016, at 54, 55-61 (discussing critical activities to scale a venture and transition to a mature firm).

⁵⁵ See KAWASAKI, *supra* note 49, at 37 (explaining that the term scale “refers to the concept that there are processes in place that are fast, cheap, and repeatable,” giving rise to the possibility that “there will soon be millions of customers who generate billions of dollars of revenue”); THIEL, *supra* note 48, at 21 (discussing product development and “viral growth”); *id.* at 54-55 (discussing scaling). Growth is often discussed as equal or greater in importance as profitability for startups. See Fred Wilson, *Profits vs Growth*, AVC (June 25, 2015), <https://avc.com/2015/06/profits-vs-growth/> [https://perma.cc/5S2J-YKRU].

⁵⁶ See KAWASAKI, *supra* note 49, at 38 (“[I]f Pierre Omidyar had to test every used printer offered for sale, eBay couldn’t scale. If Marc Benioff had to make every sales call, Salesforce.com couldn’t scale. If Steve Wozniak had to manufacture every Apple I, Apple couldn’t scale.” (emphasis omitted)).

⁵⁷ See THIEL, *supra* note 48, at 86-87 (noting that “the best investment in a successful fund equals or outperforms the entire rest of the fund combined,” and that therefore “every single company in a good venture portfolio must have the potential to succeed at a vast scale”); see also Bob Zider, *How Venture Capital Works*, HARV. BUS. REV., Nov.-Dec. 1998, at 131, 136 (“Given the portfolio approach and the deal structure VCs use, . . . only 10% to 20% of the companies funded need to be real winners to achieve the targeted return rate In fact, VC reputations are often built on one or two good investments.”).

⁵⁸ William Alden & David Gelles, *In WhatsApp Deal, Sequoia Capital May Make 50 Times Its Money*, N.Y. TIMES (Feb. 20, 2014), <https://dealbook.nytimes.com/2014/02/20/in-whatsapp-deal-sequoia-capital-may-make-50-times-its-money/> [https://perma.cc/9Z4K-VJYG].

operations, new opportunities, competition, and continued challenges in terms of cash flow and growth.⁵⁹ Founders who have not kept up with these needs may no longer occupy top executive positions.⁶⁰ For instance, Tesla was founded by Martin Eberhard, who was later fired and replaced by Elon Musk, a large investor and chairperson of the board.⁶¹

Indeed, by the late stage the number of participants has likely grown significantly and the needs of some have changed. Although some early employees may have left the company, others have stayed and fully vested their stock options, building pressure for an opportunity to sell.⁶² Different types of investors may have participated in financing the company, and the most common type of large investor—the VCs—likely need the startup to find a liquidity event so that they can return cash to their own investors and make money.⁶³ VC firms typically raise capital from passive limited partners, organized in funds with ten-year terms.⁶⁴ Not only are VC firms sensitive to liquidity within the timing of a particular fund’s term, but their business model also depends on raising successive funds and thus their ability to generate returns affects their reputation and ongoing operations.⁶⁵ As one partner explained, VCs are the “entrepreneurs behind the entrepreneurs.”⁶⁶

⁵⁹ See ROBERT COOTER & AARON EDLIN, *THE FALCON’S GYRE: LEGAL FOUNDATIONS OF ECONOMIC INNOVATION AND GROWTH 2.2-2.3* (2014) (discussing the life cycle of an innovative business venture including the rise of competition that eventually settles into equilibrium); WORKING GRP. ON DIR. ACCOUNTABILITY & BD. EFFECTIVENESS, *A SIMPLE GUIDE TO THE BASIC RESPONSIBILITIES OF VC-BACKED COMPANY DIRECTORS 1* (Oct. 2007), <https://www.levp.com/a-simple-guide-to-the-basic-responsibilities-of-vc-backed-company-directors/> [<https://perma.cc/X2Y9-S5LP>] [hereinafter *VC Director Guide*] (noting that “business processes become more complex” through the startup stages).

⁶⁰ See WASSERMAN, *supra* note 43, at 299 (finding that more than half of startups have replaced their CEO-founders by the time of their third rounds of financing); Brian J. Broughman & Jesse M. Fried, *Do Founders Control Start-Up Firms That Go Public?* 1, 9-10 (Eur. Corp. Governance Inst., Law Working Paper No. 405, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3171237 [<https://perma.cc/M3HH-JKPA>] (finding that in almost sixty percent of venture-backed firms that go public, the founder is no longer CEO at IPO).

⁶¹ Dana Olsen, *Ousted CEO Club: Founders Who Left Startups They Helped Build*, PITCHBOOK (June 21, 2017), <https://pitchbook.com/news/articles/ousted-ceo-club-founders-who-left-startups-they-helped-build> [<https://perma.cc/2NBP-H935>].

⁶² See Pollman, *Information Issues*, *supra* note 37, at 194-96 (discussing employees and former employees participating in online marketplaces for trading private company stock).

⁶³ See, e.g., Philippe Aghion et al., *Exit Options in Corporate Finance: Liquidity Versus Incentives*, 8 REV. FIN. 327, 331 (2004) (discussing the VC cycle which requires liquidating the proceeds of investment); Gilson, *supra* note 12, at 1070-76 (explaining the VC business model).

⁶⁴ Gilson, *supra* note 12, at 1071.

⁶⁵ *Id.*

⁶⁶ ROCHELLE KOPP & STEVEN GANZ, *VALLEY SPEAK: DECIPHERING THE JARGON OF SILICON VALLEY 15* (2016) (quoting Keith Rabois from Khosla Ventures, with original attribution to Sequoia Capital).

In sum, a mature startup faces complex business challenges as well as growing pressure to sell the company or go public. Thus the key issues may range from particular strategic needs in addressing competitors or improving financial metrics, but will ultimately always come down to one essential question: Can we find an exit?⁶⁷ Of course, the startup aims for success by not only finding an exit, but one that is lucrative for its participants and meets with their approval.

2. The Complexity of the Capital Structure

The nature of the startup business drives the forms and structure of entrepreneurial finance. Both of these dimensions of the startup in turn set the stage for governance.

At the founding, entrepreneurs usually split the entire ownership pie by issuing the initial common equity to themselves as founders' stock.⁶⁸ Founders generally pay a nominal amount for this stock because the company has minimal assets and business operations at the time of founding, and the stock is often structured to include a company repurchase right that lapses over time.⁶⁹ In terms of initial capital, founders often 'bootstrap' the business using their own funds, and those of family and friends, to finance development efforts and early operations.⁷⁰ One study found that in seventy-seven percent of founding teams, at least one founder contributed seed capital early in the life of the startup.⁷¹

High-potential innovative startups typically need far greater capital than founders can self-fund or raise through family and friends, however, and startups therefore seek alternate sources of capital.⁷² Traditional banks do not lend to startups, particularly in their early stages, due to their lack of a track record, negative cash flow, lack of tangible assets, and high failure rate.⁷³ Two types of investors specialize in financing startups: angel investors and VCs.

⁶⁷ See, e.g., GOMPERS & LERNER, *supra* note 51, at 28 ("A venture capitalist must liquidate a return in private firms to make money."); PITCHBOOK & NAT'L VENTURE CAPITAL ASS'N, VENTURE MONITOR 1Q 2018, at 13 [hereinafter NVCA, VENTURE MONITOR 1Q 2018], <https://nvca.org/research/venture-monitor/> [<https://perma.cc/5N59-9ULT>] (follow "1Q 2018 PitchBook-NVCA Venture Monitor" hyperlink) ("As companies move along the venture lifecycle, exits at some point move to the forefront of discussion and business positioning.").

⁶⁸ CONSTANCE E. BAGLEY & CRAIG E. DAUCHY, *THE ENTREPRENEUR'S GUIDE TO LAW AND STRATEGY* 90-92, 95-96 (5th ed. 2018).

⁶⁹ THERESE H. MAYNARD ET AL., *BUSINESS PLANNING: FINANCING THE START-UP BUSINESS AND VENTURE CAPITAL FINANCING* 374, 375 (3d ed. 2018).

⁷⁰ WASSERMAN, *supra* note 43, at 252.

⁷¹ *Id.*

⁷² *Id.* at 253-54.

⁷³ GOMPERS & LERNER, *supra* note 51, at 6-7; Paul Gompers & Josh Lerner, *The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 39 J.L. & ECON. 463, 465 (1996);

Angel investors are frequently the first source of outside funding—wealthy individuals, often with backgrounds as successful entrepreneurs, who invest their own money in early-stage companies.⁷⁴ Angels tend to rely on informal relationship-driven methods of screening and monitoring, or to aggregate their investments and efforts through regional angel groups.⁷⁵ They fill a critical funding gap in the beginning of a startup's life, often coming in earlier and in smaller amounts than VCs are willing to entertain because of the size of their funds and costs.⁷⁶ Angels are generally forward-looking: they invest with the hope that the company can show enough business promise to attract subsequent financing by VCs. Angels typically receive common stock for their capital or invest through convertible notes or similar debt instruments that provide a means of making deferred equity investments with minimal transaction costs.⁷⁷

Thus, in the early stage of a startup, when it is highly focused on innovation, its capital structure is relatively simple: basic debt or equity granted to founders, family and friends, and angel investors. A startup will also usually adopt a stock option plan and establish a pool of options to grant employees an incentive-based ownership stake.⁷⁸ Stock options for startup employees have become a norm because of cash constraints for high salaries,

see also KUPOR, *supra* note 36, at 28 (noting that equity-based VC financing typically backs companies that are very risky and expect long periods of illiquidity and a lack of near-term cash flow). For a discussion of specialized venture lenders that follow venture capital investment, *see* Darian M. Ibrahim, *Debt as Venture Capital*, 2010 U. ILL. L. REV. 1169 [hereinafter Ibrahim, *Venture Debt*].

⁷⁴ *See* Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1406, 1408-09 (2008) [hereinafter Ibrahim, *Angel Investors*]. A notable alternative or additional source of capital and expertise for early-stage startups is a startup incubator or accelerator program. For a discussion of investment accelerator programs, *see*, for example, Brad Bernthal, *Investment Accelerators*, 21 STAN. J.L. BUS. & FIN. 139 (2016).

⁷⁵ Ibrahim, *Angel Investors*, *supra* note 74, at 1408-09.

⁷⁶ *Id.* at 1416-18; Joshua Lerner, "Angel" Financing and Public Policy: An Overview, 22 J. BANKING & FIN. 773, 778 (1998). Recent years have also witnessed the development of an institutional seed market. KUPOR, *supra* note 36, at 271.

⁷⁷ *See* Bratton & Wachter, *supra* note 13, at 1882 ("Significantly, angels tend to take common stock stakes, foregoing board seats, negative covenants, vetoes, and exit rights."); *see also* John F. Coyle & Joseph M. Green, *Contractual Innovation in Venture Capital*, 66 HASTINGS L.J. 133, 165-73 (2014) (describing convertible securities, simple agreements for future equity, and preferred seed stock). A typical debt instrument used in angel investing is the convertible note: "a debt instrument that may be converted into equity" and "pays interest, has a formal maturity date, gives the holder priority over equity holders, and puts the holder on an equal footing with other unsecured debt holders and trade creditors in liquidation." Coyle & Green, *supra*, at 151.

⁷⁸ MAYNARD ET AL., *supra* note 69, at 337-38; *see* Will Gornall & Ilya A. Strebulaev, *Squaring Venture Capital Valuations with Reality*, J. FIN. ECON. (forthcoming) (manuscript at 6), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2955455 [<https://perma.cc/S39X-6ZRF>] ("The rank and file employees of VC-backed companies often receive much of their pay as stock options.").

the potential for stock options to incentivize employees, and the uncertainty that employees accept in joining the startup.⁷⁹

In light of capital needs for continued growth, many startups next seek additional financing from venture capital investors.⁸⁰ VCs are professional investors—general partners of funds organized as limited partnerships—who put other people’s money to work.⁸¹ The passive limited partners include pension funds, endowments, foundations, banks, insurance companies, and others seeking access to a high-growth alternative asset class.⁸² The VC, acting as general partner of the fund, makes and monitors the investments in a portfolio of startup companies.⁸³ As noted, funds have a fixed term, typically ten years, and the VC makes money by receiving an annual management fee plus carried interest—a right to receive a percentage of the profits made from the investments in the portfolio of startup companies.⁸⁴

A significant body of research examines the key issues that VCs face of great uncertainty combined with incomplete contracting problems, information asymmetry, and agency costs.⁸⁵ Particularly through its early stages, a startup’s success is highly uncertain: Countless things can go wrong and cause failure, but extraordinary returns are also possible.⁸⁶ VC contracts with entrepreneurs will inevitably be incomplete because of bounded rationality and the inability to foresee and resolve all potential contingencies

⁷⁹ See, e.g., Levmore, *supra* note 18 (discussing norms in stock option practices).

⁸⁰ Not all startups seek, or succeed at, raising money from VCs. WASSERMAN, *supra* note 43, at 255; see Darian M. Ibrahim, *Should Angel-Backed Start-Ups Reject Venture Capital?*, 2 MICH. J. PRIV. EQUITY & VENTURE CAP. L. 251, 251-52 (2013) (arguing that some startups should avoid venture capital to lower transaction and agency costs). Strategic investors such as corporate venture capital might provide an alternative source of financing. See Josh Lerner, *Corporate Venturing*, HARV. BUS. REV., Oct. 2013, at 86, 88-90; see generally Paul Gompers & Josh Lerner, *The Determinants of Corporate Venture Capital Success: Organizational Structure, Incentives, and Complementarities*, in CONCENTRATED CORPORATE OWNERSHIP 17 (Randall K. Morck ed., 2000).

⁸¹ Gilson, *supra* note 12, at 1068, 1069 (explaining that VCs are “tailored to the special task of financing [the] high-risk, high-return activities” of startup companies, which are “peculiarly suited to commercializing innovation”).

⁸² *Id.* at 1070.

⁸³ *Id.* at 1071.

⁸⁴ *Id.* at 1071-72. Many VC funds provide for the possibility of a one- or two-year extension at the discretion of the general partner VC managing the fund. J. Brad Bernthal, *The Evolution of Entrepreneurial Finance: A New Typology*, 2018 BYU L. REV. 773, 843 n.276.

⁸⁵ See, e.g., GOMPERS & LERNER, *supra* note 51; Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281 (2003); Joseph A. McCahery & Luc Renneboog, *Venture Capital Financing of Innovative Firms: An Introduction*, in VENTURE CAPITAL CONTRACTING AND THE VALUATION OF HIGH TECHNOLOGY FIRMS 1-26 (Joseph A. McCahery & Luc Renneboog eds., 2003); William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473 (1990).

⁸⁶ See Strine, *supra* note 13, at 2037 (“Venture-backed companies are the kind of companies that can become wildly successful or fail entirely.”).

and outcomes.⁸⁷ Further, “some information is observable by only one party (the entrepreneur) who cannot credibly communicate it to others (information asymmetry),” and “the parties cannot control post-financing behavior by contract because either the behavior itself or future states of the world cannot be verified by third party arbiters (agency problems).”⁸⁸

In response to these fundamental challenges, VCs screen, monitor, and control their startup investments.⁸⁹ They use staged financing that can incrementally transfer control and threaten abandonment if the company falters.⁹⁰ They contract for convertible preferred stock that comes with voting rights, liquidation preferences, and other protective terms.⁹¹ They negotiate for designated board seats for information, monitoring, and voice or control.⁹² They contract for covenants to guard against certain unfavorable outcomes and for specific exit rights.⁹³

Consequently, the typical pattern is for a startup to engage in sequential rounds of issuing convertible preferred stock with various protective terms and designated board seats.⁹⁴ In contrast to public companies, which generally have a single class of common equity, startups usually issue a new class of equity every twelve to twenty-four months in order to raise money to grow the company.⁹⁵ Each round of financing varies with regard to its participants and the contract provisions associated with the new class of equity (valuation,

⁸⁷ OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE 23-24 (1995); *see also* Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473, 473 (1992) (recognizing “that financial contracts are inherently incomplete” and that “founders of the firm must determine how future investment and operating decisions left out of the corporate charter ought to be taken”).

⁸⁸ George G. Triantis, *Financial Contract Design in the World of Venture Capital*, 68 U. CHI. L. REV. 305, 307 (2001).

⁸⁹ *See* Michael Klausner & Kate Litvak, *What Economists Have Taught Us About Venture Capital Contracting*, in BRIDGING THE ENTREPRENEURIAL FINANCING GAP 54, 55-64 (Michael J. Whincop ed., 2001); Bratton & Wachter, *supra* note 13, at 1878-82; Paul A. Gompers, *Optimal Investment, Monitoring, and the Staging of Venture Capital*, 50 J. FIN. 1461, 1464 (1995) [hereinafter Gompers, *Optimal Investment*]; Smith, *Exit Structure*, *supra* note 12, at 318-55; *supra* note 85.

⁹⁰ Smith, *Exit Structure*, *supra* note 12, at 323-24.

⁹¹ *Id.* at 346-54. A liquidation preference typically entitles the holder to its original investment amount, or a multiple of this number, in certain events before payments are made to other security holders. KUPOR, *supra* note 36, at 155.

⁹² *Id.* at 318-19. Venture capital firms have traditionally used this model of convertible preferred stock financings, however it is possible that with the rise of new technologies such as blockchain and crypto, the industry will evolve. *See, e.g.*, Alex Konrad, *Blowing Up the Venture Capital Model (Again)*, FORBES (Apr. 30, 2019), at 64, 67-68 (discussing how the prominent VC firm Andreessen Horowitz has registered the firm as a financial advisor to enable it to pursue additional models of investments).

⁹³ Gilson, *supra* note 12, at 1074, 1082, 1084-85.

⁹⁴ Funding rounds are traditionally ordered alphabetically: Series A, Series B, Series C, and so on. Gornall & Strebulaev, *supra* note 78, at 3.

⁹⁵ *Id.* at 2.

liquidation preferences, exit rights, etc.).⁹⁶ Each round of financing generally also brings changes to the company's governance structure, such as the size and composition of the board.⁹⁷

As the company takes on additional capital, the founders' and other earlier investors' ownership percentage in the company is diluted.⁹⁸ According to the National Venture Capital Association, using data from Capshare, the capital structure "evolve[s] in fairly predictable ways as the company grows."⁹⁹ Specifically, "employee ownership decreases from 100% at founding to approximately 70% in the seed round and starts to level off around 38% by Series C financings. Employee ownership (and by extension, investor ownership) is so predictable that it almost perfectly fits a log trend line."¹⁰⁰

Altogether, over its life cycle, a venture-backed startup will have an increasingly complex capital structure. It includes not only founders and employees, but also a variety of shareholders with different associated valuations, cash flow, and control rights.¹⁰¹ Consider an example. In its startup days, payment-technology company Square Inc. raised \$150 million by issuing 9.7 million Series E Preferred Shares for \$15.46 per share to a variety of investors.¹⁰² These shares would convert to common shares if the company did well and the holders wanted to participate in the upside, but came with downside protections that provided Series E investors at least \$15.46 per share in a liquidation or acquisition and at least \$18.56 per share in an IPO, with both of those claims senior to the claims of all other shareholders.¹⁰³ The Series E shares followed several other classes of equity (common, Series A, B-1, B-2, C, and D Preferred Shares), each with different cash flow, liquidation, control, and voting rights.¹⁰⁴

⁹⁶ Multiple VCs or other investors form a syndicate to participate in each round of financing. BRAD FELD & JASON MENDELSON, *VENTURE DEALS* 10-11 (2d ed. 2013). VCs often specialize in early-, mid-, or late-stage financings, and other investors may participate, such as from private equity, family offices, or strategic partners. *See id.* at 6 (advising that "VCs come in many shapes, sizes, and experience levels"); NVCA, *VENTURE MONITOR* 1Q 2018, *supra* note 67, at 5, 12 (observing that private equity, family offices, and strategic partners have gotten involved in early financing of startups).

⁹⁷ WASSERMAN, *supra* note 43, at 307.

⁹⁸ *See* MAYNARD ET AL., *supra* note 69, at 577 (noting that dilution can result whenever a company issues more shares of stock). Investors can avoid dilution by negotiating for a right of first refusal in future rounds of financing. D. Gordon Smith, *Team Production in Venture Capital Financing*, 24 J. CORP. L. 949, 969 (1999) [hereinafter Smith, *Team Production in VC*].

⁹⁹ NVCA, *VENTURE MONITOR* 1Q 2018, *supra* note 67, at 9.

¹⁰⁰ *Id.*

¹⁰¹ FELD & RAMSINGHANI, *supra* note 52, at 43; Gornall & Strebulaev, *supra* note 78, at 3; *see also* FELD & MENDELSON, *supra* note 96, at 95-97 (discussing startup capitalization tables).

¹⁰² Gornall & Strebulaev, *supra* note 78, at 3.

¹⁰³ *Id.*

¹⁰⁴ *Id.* Square's IPO price was \$9 per share and Series E holders received extra shares per their negotiated protective terms. Leena Rao & Dan Primack, *Square Prices IPO at Just \$9 Per Share, Valued*

Adding to this traditional venture-backed structure has been the entrance into late-stage startups of different types of investors: mutual funds, pension funds, hedge funds, corporate investors, and sovereign wealth funds.¹⁰⁵ Startups in previous times did not generally have access to these kinds of investors until going public on a national stock exchange.¹⁰⁶ Due to a confluence of factors, including an unprecedented influx of available private capital, startups are staying private longer on average and raising larger late-stage funding rounds from this greater diversity of investors.¹⁰⁷

Late-stage rounds of investments also have various protective terms, including in some instances IPO veto rights or ratchets that can dilute other shareholders, and thus add to the “extreme complexity of VC-backed companies’ financial structures.”¹⁰⁸ A notable recent study of 116 unicorn companies found that the average unicorn has eight share classes, and many have a wide mix of equity holders including founders, employees, VC funds, mutual funds, sovereign wealth funds, corporate investors, and others.¹⁰⁹

In addition to new entrants, another recent trend is for startups to use proceeds from a fundraising round to repurchase stock or to facilitate third-party buyers such as large institutional investors in making secondary tender offers.¹¹⁰ These transactions allow certain shareholders to sell some of their

at \$2.9 Billion, *FORTUNE* (Nov. 19, 2015), <http://fortune.com/2015/11/18/square-prices-ipo/> [<https://perma.cc/U7Z2-UA34>].

¹⁰⁵ Sergey Chernenko et al., *Mutual Funds as Venture Capitalists? Evidence from Unicorns 2* (Nat’l Bureau of Econ. Research, Working Paper No. 23981, 2017), <https://www.nber.org/papers/w23981> [<https://perma.cc/3C96-Y88Y>]; Sungjoong Kwon et al., *Mutual Fund Investments in Private Firms*, J. FIN. ECON. (forthcoming) (manuscript_id = 1), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2941203 [<https://perma.cc/KJR8-LV6Q>]; see Jeff Schwartz, *Should Mutual Funds Invest in Startups? A Case Study of Fidelity Magellan Fund’s Investments in Unicorns (and Other Startups) and the Regulatory Implications*, 95 N.C. L. REV. 1341, 1341 (2017) (discussing how “mutual funds, including some of the most prominent, are allocating portions of their portfolios to private venture-stage firms”).

¹⁰⁶ See Kwon et al., *supra* note 105, at 1-3 (tracing data on mutual fund investment into startups over the 1995–2016 period and finding that such investment has “become increasingly widespread”).

¹⁰⁷ Erdogan et al., *supra* note 3; PITCHBOOK & NAT’L VENTURE CAPITAL ASS’N, VENTURE MONITOR 2Q 2018, at 11, <https://nvca.org/research/venture-monitor/> [<https://perma.cc/5N59-9ULT>] (follow “2Q 2018 PitchBook NVCA Venture Monitor” hyperlink).

¹⁰⁸ Gornall & Strebulaev, *supra* note 78, at 2; see also Barry J. Kramer et al., *Unicorn Survey As of December 2016*, FENWICK & WEST (Jan. 27, 2017), <https://www.fenwick.com/publications/Pages/Unicorn-Survey-As-of-December-31-2016.aspx> [<https://perma.cc/98YK-FS2Q>] [hereinafter *Fenwick Unicorn Survey*] (surveying IPO upside and downside protections in unicorns).

¹⁰⁹ Gornall & Strebulaev, *supra* note 78, at 2.

¹¹⁰ For an overview of secondary transactions in private company stock, see Pollman, *Information Issues*, *supra* note 37, and for recent developments, see Eliot Brown & Greg Bensinger, *The Latest Path to Silicon Valley Riches: Stake Sales*, WALL ST. J. (Nov. 19, 2017), <https://www.wsj.com/articles/investment-firms-buy-stock-in-startups-long-before-ipos-1511045818> [<https://perma.cc/WRQ3-XG4N>]; Telis Demos, *Tech Pain: Startups Are Buying Back a Lot More Employee Stock*, WALL ST. J. (Feb. 2, 2016), <https://www.wsj.com/articles/tech-pain-startups-are-buying-back-a-lot-more-employee-stock-1454457599> [<https://perma.cc/7X57-PLZJ>]; Tess Stynes & Bradley Hope, *Nasdaq Acquires SecondMarket, Profit Rises 12%*, WALL ST. J. (Oct. 22, 2015),

holdings and bring new investors into the company, but do not provide complete liquidity or involve a fundamental change, and thus the company's private, venture-backed status remains unchanged absent an exit event.¹¹¹ As the next Part shows, these companies can reach a size and level of governance complexity that strains continued use of the term "startup" to describe them, but they still differ in distinctive ways from traditional closely held corporations and public corporations.

II. A FRAMEWORK OF STARTUP GOVERNANCE

Startups demonstrate unique features and challenges through the nature of their business and the complexity of their capital structure. Prevailing models of corporate governance have not fully captured the special dynamics of startups.

Most notably, one general model has dominated the discussion of corporate law and governance for decades: agency costs.¹¹² Set out in a seminal paper by Michael Jensen and William Meckling, the agency problem arises when one party, the "principal," relies on actions taken by another, the "agent," which will affect the principal's welfare.¹¹³ As a theory of corporate governance, shareholders are envisioned as the principals and managers as the agents.¹¹⁴ Agency costs arise in a corporation because of the separation of equity ownership and managerial control—managers may shirk or pursue

<https://www.wsj.com/articles/nasdaq-acquires-secondmarket-profit-rises-12-1445511644> [<https://perma.cc/R2PD-2TRD>].

¹¹¹ See, e.g., Theodore Schleifer, *Uber Employees Will Get a Second Chance to Make Some Money By Selling Their Shares*, VOX: RECODE (May 23, 2018), <https://www.recode.net/2018/5/23/17386314/uber-employees-tender-offer-ipo> [<https://perma.cc/6P7W-FAG7>] (discussing unmet demand from Uber employees for liquidity through secondary tender offers).

¹¹² See, e.g., Blair & Stout, *supra* note 16, at 248 (describing the principal-agent model as the dominant analytical framework in corporate governance literature); Goshen & Squire, *supra* note 9, at 769 ("For the last forty years, the problem of agency costs has dominated the study of corporate law and governance."); Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 623 (2004) ("Agency cost theories of the firm dominate the modern literature of corporate law and economics.").

¹¹³ Jensen & Meckling, *supra* note 9, at 308. Jensen and Meckling did not limit their theory to agency relationships under the law, but rather used the concept as a metaphor and basis for economic theory. See *id.* (discussing agency costs as an economic theory); see also Kenneth J. Arrow, *The Economics of Agency*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 37 (John W. Pratt & Richard J. Zeckhauser eds., 1985) (undertaking economic modeling of certain problems encountered in a principal-agent relationship); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 289-90 (1980) (explaining the efficiency of the separation of ownership and control in the "large modern corporation" in terms of agents providing management and shareholders serving as risk bearers).

¹¹⁴ Jensen & Meckling, *supra* note 9, at 310.

their own agenda at the expense of shareholder interests.¹¹⁵ As set out by Jensen and Meckling, three types of agency costs exist in the principal-agent relationship: monitoring costs that principals incur in overseeing their agents, bonding costs to better align agents' interests with those of the principals, and the residual loss that cannot be avoided.¹¹⁶ As other scholars have noted, the concept of reducing shareholder-manager agency costs pervades corporate law scholarship.¹¹⁷

Jensen and Meckling's framing of the agency cost problem has thus proven enormously influential, but they did not explore differences across corporations.¹¹⁸ They envisioned the corporation only in vertical, hierarchical terms, and they collapsed the board and executives into a single managerial agent, obscuring management conflicts.¹¹⁹ They assumed outside shareholders have homogeneous interests.¹²⁰

Two key scholarly contributions challenge and build on the agency cost model, bringing it closer to descriptive power for startups. First, Margaret Blair and Lynn Stout's well-known team production model provided the critical insight that stakeholder interests conflict and are resolved within the corporation.¹²¹ Blair and Stout claimed to provide only a theory of public corporations, with an independent board unlike that found in startups, but

¹¹⁵ *Id.* at 308-09; *see also* Goshen & Squire, *supra* note 9, at 769 ("Agency costs result from the separation of control and ownership that occurs when managers run a firm but must share its profits with equityholders.").

¹¹⁶ Jensen & Meckling, *supra* note 9, at 308.

¹¹⁷ *See* Goshen & Squire, *supra* note 9, at 769 ("Many scholars—we refer to them as *agency-cost essentialists*—treat the reduction of agency costs as . . . an unalloyed good toward which all aspects of corporate law and governance should be directed."); Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 *YALE L.J.* 560, 570 (2016) ("The existing corporate-law literature focuses solely on protecting minority shareholders from agency costs.").

¹¹⁸ *See* Jensen & Meckling, *supra* note 9, at 309 (describing the corporate agency problem in general terms); *see also* Philippe Aghion & Richard Holden, *Incomplete Contracts and the Theory of the Firm: What Have We Learned over the Past 25 Years?*, 25 *J. ECON. PERSP.* 181, 182 (2011) (noting that Jensen and Meckling's agency-cost approach "typically did not seek to explore why such agency problems are different within and across firms"); *cf.* EASTERBROOK & FISCHER, *supra* note 16, at 228 ("We employ a dichotomous treatment [of public and closely held corporations] to illustrate the different kinds of incentives and structures in play, not to suggest that all firms were cast in one of these two molds.").

¹¹⁹ *See* Jensen & Meckling, *supra* note 9, at 309 ("[T]he relationship between the stockholders and manager of a corporation fit the definition of a pure agency relationship . . ."); *cf.* Goshen & Squire, *supra* note 9, at 767, 784-85 (introducing a principal-cost theory positing that firms trade off the costs produced when investors exercise control against the costs produced when managers exercise control, and treating the board and officers as "a unified agent").

¹²⁰ *See* Jensen & Meckling, *supra* note 9, at 312 (analyzing the agency costs of "outside equity" by distinguishing between the "owner-manager" and "outside shareholders"); *see also* Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 *STAN. L. REV.* 1255, 1271 (2008) ("Shareholders in public corporations traditionally have been perceived not only as being passive but also as having largely homogenous interests.").

¹²¹ Blair & Stout, *supra* note 16, at 250-51.

they contributed a vision of the corporate “team” that includes “shareholders, managers, [and] rank and file employees” and identified the board as playing a critical role in coordinating corporate activity and mediating disputes between these team members.¹²²

Second, Robert Bartlett added the essential observation that “an interinvestor conflict can exist among a company’s investors and thereby give rise to a horizontal agency problem.”¹²³ Not only can stakeholder interests conflict, as Blair and Stout observed, but intragroup tensions may also develop.

Bartlett’s model showed that in seeking to constrain shareholder-manager agency costs, VCs stage their financings and syndicate their investments—but in so doing, the VCs create a new dimension of conflict among themselves, for example regarding the timing and price of future financings and exit.¹²⁴ Put simply, Bartlett showed that the way in which VCs manage a vertical conflict with founder-entrepreneurs can create a horizontal conflict among VCs. Bartlett focused on the conflicts between VCs as preferred shareholders, but suggested the model had broader applicability, arguing that corporate theory had created a “false dichotomy” between public and private firms.¹²⁵ In his view, “this dichotomy obscures how all firms—public and private—often face the same agency problems.”¹²⁶

Building on these important insights, this Part seeks to provide what is missing from existing models: an in-depth, holistic account of the governance issues that arise in startups and how they evolve over time. This account is tailored to the special features of startups and intragroup tensions that Blair and Stout did not examine in their theory of public corporations. Further, it builds on Bartlett’s insight of conflicts between preferred shareholders and offers a comprehensive account of the complicated and overlapping sets of vertical and horizontal tensions. And it departs from both by setting out to show what makes startups different and the implications that follow.

A. *Fundamental Startup Governance Issues*

All startup participants play a role in governance: founders, executives, investors, and employees. These participants typically all have a stake in the

¹²² *Id.* at 251, 253. Blair and Stout espoused a “model of the public corporation” and envisioned a board with “independence from individual team members” unlike that found in startup corporations. *See id.* at 251. For discussion of the aspects of team production theory that bear similarity to startups, see Elizabeth Pollman, *Team Production Theory and Private Company Boards*, 38 SEATTLE U. L. REV. 619, 626 (2015) [hereinafter Pollman, *Private Company Boards*]; Smith, *Team Production in VC*, *supra* note 98.

¹²³ Bartlett, *False Dichotomy*, *supra* note 11, at 61.

¹²⁴ *Id.* at 63, 108-09.

¹²⁵ *Id.* at 40.

¹²⁶ *Id.* at 37; *see also id.* at 44 (providing “groundwork for a new model . . . that applies to all firms, public and private”).

equity and have closely aligned objectives at the highest level: they are all economically incentivized to grow the value of the company and to reach a highly valued exit.¹²⁷ However, in a great variety of circumstances their interests diverge. The below discussion elaborates on the conflicts that can arise *between* and *among* each of these startup participants because of differences in types and classes of stock and options, liquidity time horizons, and potential private benefits and incentives.¹²⁸ The costs of these conflicts include value-reducing opportunistic behavior, inefficiencies stemming from divergent preferences for company actions, bargaining and enforcement costs to minimize misalignment, and potentially a higher cost of capital.¹²⁹

1. Vertical Issues

At core, governance challenges are born when a company becomes jointly owned. If there is more than one founder, the potential exists for conflict.¹³⁰ The governance issues in the cofounder relationship generally pale in comparison, however, to the conflicts that can arise when the founders take outside investment. The balance of power between founders and investors is one of the key tensions that runs through startups. This section explores those governance issues in the context of the corporate hierarchy, most notably involving the board, which is the primary governing body and locus at which founders and investors determine control.

a. *Shareholders vs. Board*

Startup boards are negotiated. The board is formally constituted at the first round of venture capital financing, if not before, and its agreed-upon size and composition are typically specified in the financing term sheet and then enshrined in a voting agreement or in the corporation's certificate of incorporation.¹³¹ VCs seek board seats as part of their investment—for access

¹²⁷ Steven E. Bochner & Amy L. Simmerman, *The Venture Capital Board Member's Survival Guide: Handling Conflicts Effectively While Wearing Two Hats*, 41 DEL. J. CORP. L. 1, 2 (2016); NVCA YEARBOOK, *supra* note 1, at 8-9.

¹²⁸ Experienced startup entrepreneurs and investors recognize the potential for both inter- and intra-group governance conflicts. See FELD & RAMSINGHANI, *supra* note 52, at 42 ("Transactions often have conflicting interests between classes of stock, investors with different liquidity time horizons, and management versus investment interests.")

¹²⁹ See Oliver Williamson, Richard T. Ely Lecture, *The Economics of Governance*, 95 AM. ECON. REV. 1, 2 (2005) ("Maladaptation to disturbances is where the main costs of governance reside."); see also Bartlett, *False Dichotomy*, *supra* note 11, at 111-12 (discussing how governance conflicts might raise the cost of capital).

¹³⁰ See, e.g., Scott Kupor, *Prenups for Co-Founders*, ANDREESSEN HOROWITZ (Oct. 19, 2015), <https://a16z.com/2015/10/19/prenups-for-co-founders> [<https://perma.cc/2QMD-WSSG>] (discussing planning for problems between startup co-founders).

¹³¹ FELD & RAMSINGHANI, *supra* note 52, at 65-66, 81.

to information, to monitor against opportunistic behavior, for voice or control on important decisions such as future financings or exit, and to add value to the company.¹³²

VCs are in fact sometimes called “smart money” in reference to the value-adding services that they provide, such as serving as a sounding board to the founders and team, helping to recruit management personnel, formulating business strategies, and providing contacts.¹³³ Further, VCs serve as reputational intermediaries, lending credibility and legitimacy to startups, particularly in their early stages.¹³⁴ Because they take an equity stake that involves a long-term relationship with the entrepreneurs, they have an incentive to provide strategic guidance and invest in efforts to bridge the information gap.¹³⁵ Serving on the board is one of the means by which VCs provide this value and monitor their investment.¹³⁶

Advice to entrepreneurs regularly includes the admonition to carefully choose board members, and therefore from which VCs to take money. For example, a partner from the prestigious VC firm Andreessen Horowitz explained: “The best board members aren’t elected by default. CEOs that set themselves up with their choice of board member—which means getting more than one term sheet and doing extensive reference checking—are better off. You want to find a coach, not a lever puller.”¹³⁷ Accordingly, the potential benefits of being backed by reputable VCs are well known—but so are stories of entrepreneurs being fired from their own companies.¹³⁸ Most famously, Steve Jobs, one of the cofounders of Apple, was ousted from the company he helped to start a few years after the company went public.¹³⁹ Entrepreneurs generally want to maintain control of the company they have started for as long as possible and thus negotiations over board seats are critical governance points to both investors and founders.

¹³² See Brian Broughman & Jesse M. Fried, *Carrots and Sticks: How VCs Induce Entrepreneurial Teams to Sell Startups*, 98 CORNELL L. REV. 1319, 1329 n.39 (2013); Fried & Ganor, *supra* note 13, at 989-93; *supra* subsection I.B.2.

¹³³ WASSERMAN, *supra* note 43, at 273; Smith, *Team Production in VC*, *supra* note 98, at 953, 956-67.

¹³⁴ WASSERMAN, *supra* note 43, at 271; Gilson, *supra* note 12, at 1075.

¹³⁵ See GOMPERS & LERNER, *supra* note 51, at 3 (noting the “novel checks and balances” the VC industry has developed to respond to information problems).

¹³⁶ See, e.g., FELD & RAMSINGHANI, *supra* note 52, at 68 (describing this participation as the “VC value add”).

¹³⁷ *Id.* at 56.

¹³⁸ See *id.* at 12 (noting that from the entrepreneur’s perspective, taking VC money means “it’s no longer your company—you are now working for somebody else. If you don’t perform, you will get fired.”).

¹³⁹ See Matt Weinberger, *This is Why Steve Jobs Got Fired From Apple—And How He Came Back to Save the Company*, BUS. INSIDER (July 31, 2017), <http://www.businessinsider.com/steve-jobs-apple-fired-returned-2017-7> [https://perma.cc/3UKS-ZXWL].

Three basic types of startup boards exist: founder-controlled, investor-controlled, and shared control.¹⁴⁰ The first two are straightforward in referring to situations in which one group outnumbers the other in allocated board seats or board votes.¹⁴¹ The third type, shared control, can be structured in various ways such as with an even split between founder and investor board seats, with a split board and one or more independent directors, or as contingent control with the tie-breaking seat filled by the preferred and common shareholders voting together as a single class.¹⁴²

Researchers have found a general trend in the evolution of a typical startup board over its life cycle—frequently starting out dominated by founders and transforming to shared or investor control at some time within the first few rounds of venture financing.¹⁴³ This pattern occurs because investors typically build their voting power and seek additional board seats with each round of financing.¹⁴⁴ Furthermore, shared control arrangements provide a solution to problems of noncontractibility by deferring decisions until they are known.¹⁴⁵ But there is a great deal of variety and some founders maintain control of the board even as the company matures to late stage.¹⁴⁶

¹⁴⁰ WASSERMAN, *supra* note 43, at 285-87; *see* KUPOR, *supra* note 36, at 173 (“Any configuration is permissible; where we end up is simply a function of the negotiating positions of each of the parties.”).

¹⁴¹ A founder-controlled board may occur through seats allocated to a common stock vote or by founder appointment. An investor-controlled board may occur through seats allocated to different series of preferred stock. The lead investor of a financing round typically negotiates for a board seat. *See* WASSERMAN, *supra* note 43, at 285-88 (describing board control and changing composition).

¹⁴² *See* Brian J. Broughman, *The Role of Independent Directors in Startup Firms*, 2010 UTAH L. REV. 461, 462 (discussing the use of independent directors in startups); Kaplan & Strömberg, *supra* note 85, at 289-90 (finding that board control is shared 61% of the time); Smith, *Exit Structure*, *supra* note 12, at 326 (discussing contingent control).

¹⁴³ *See* WASSERMAN, *supra* note 43, at 285 (observing that in one sample of startups, “after the A-round of financing, founders were already a minority within the average board, holding 34% of the seats, while outside directors already held 59%. After the B-round, founders were down to 21% of the seats, with 72% held by outside directors, the clear majority of whom were investors.”); Smith, *Exit Structure*, *supra* note 12, at 326-27 (“Because venture capitalists typically gain additional board seats with each round of investment, over time the board composition provisions of venture-backed companies tend to move from ‘entrepreneur control’ or ‘contingent control’ to ‘investor control.’”).

¹⁴⁴ Smith, *Exit Structure*, *supra* note 12, at 324-26. VCs also protect themselves with regard to exits or opportunistic action by securing negative contractual covenants that require VC approval for important transactions such as acquisitions. *Id.* at 319-20.

¹⁴⁵ Bratton, *supra* note 12, at 896; *see* Margaret M. Blair, *Boards of Directors as Mediating Hierarchs*, 38 SEATTLE U. L. REV. 297, 335 (2015) (discussing how a solution to the problem of “productive activity that requires complex, difficult to measure, and difficult to contract inputs” is “[t]he delegation of key decision rights to a ‘mediating hierarchy’”).

¹⁴⁶ *See* Bratton, *supra* note 12, at 901 (“VC[s] and [entrepreneurs] each have boardroom control in significant numbers of portfolio companies.”); *see also* FELD & RAMSINGHANI, *supra* note 52, at 47 (“A few [founders], like Mark Zuckerberg, have become, in Noam Wasserman’s words, both rich and king. To do this, you need to have a large stock position and voting control, which can be achieved [through a dual-class structure] even if you don’t own more than 50 percent of the company.”).

In some instances, startups have implemented dual-class structures that give supervoting shares to founders and management, providing another mechanism by which founders and managers control the board and strategic decisions.¹⁴⁷ For example, while still a startup, Airbnb implemented a dual-class structure of common stock in which one class holds ten votes per share and the other holds just one vote per share.¹⁴⁸ Such structures are relatively commonplace in the highest echelon of unicorns but are otherwise rare, suggesting that only a small portion of founders have enough leverage and investor competition to implement this feature.¹⁴⁹ Key aspects of the nature of the business, discussed in Section I.B—high market potential, growth, and scalability—may impact whether or not entrepreneurs can get the founder-friendly terms they covet.¹⁵⁰

The board and voting control are therefore the product of multi-party sequential negotiations. Control can change over time and it is frequently separated from ownership or, more precisely, from cash flow rights using contracts.¹⁵¹ This process of heavily negotiating boards, contractually

¹⁴⁷ See Kaplan & Strömberg, *supra* note 85, at 7 (“Board rights and voting rights can be different from cash flow rights and from each other.”); Fenwick *Unicorn Survey*, *supra* note 108, at 1, 6 (surveying thirty-one United States-based, venture-backed unicorns and finding that thirty-nine percent of their financings had dual-class supervoting common stock); Alfred Lee, *Inside Private Tech Voting Structures*, THE INFO. (Oct. 29, 2015), <https://www.theinformation.com/articles/inside-private-tech-voting-structures> [<https://perma.cc/ZL2F-XXNW>] (finding that as of October 2015, nine out of ten of the highest valued private tech companies had supervoting structures and the one exception had a founder with extra voting rights on the board that gave the founder control).

¹⁴⁸ Lee, *supra* note 147.

¹⁴⁹ See Alfred Lee, *Where Supervoting Rights Go to the Extreme*, THE INFO. (Mar. 22, 2016), <https://www.theinformation.com/articles/where-supervoting-rights-go-to-the-extreme> [<https://perma.cc/6NYQ-UX2C>] (summarizing a study of more than one hundred private companies, thirty of which had supervoting shares); see also Rolfe Winkler & Maureen Farrell, *In ‘Founder Friendly’ Era, Star Tech Entrepreneurs Grab Power, Huge Pay*, WALL ST. J. (May 28, 2018), <https://www.wsj.com/articles/in-founder-friendly-era-star-tech-entrepreneurs-grab-power-huge-pay-1527539114> [<https://perma.cc/JM4C-S7PY>] (“Last year, 67% of U.S. venture-backed tech companies that staged IPOs had supervoting shares . . . , up from 13% in 2010 The proportion rises as tech companies get larger: 72% of founders of U.S. tech startups valued over \$1 billion that had IPOs over the past 24 months have supervoting shares”). For an examination of dual-class IPOs, see Andrew William Winden, *Sunrise, Sunset: An Empirical and Theoretical Assessment of Dual-Class Stock Structures*, 2018 COLUM. BUS. L. REV. 852.

¹⁵⁰ See Alfredo De Massis et al., *What Big Companies Can Learn from the Success of the Unicorns*, HARV. BUS. REV. (Mar. 14, 2016), <https://hbr.org/2016/03/what-big-companies-can-learn-from-the-success-of-the-unicorns> [<https://perma.cc/XM36-HLYX>] (“Unicorns get big fast.”). This point raises potential explanations for dual-class structures not fully explored in the literature. See Goshen & Hamdani, *supra* note 117, at 560 (“[E]ntrepreneurs value corporate control because it allows them to pursue their vision . . . in the manner they see fit.”); Dorothy Shapiro Lund, *Nonvoting Shares and Efficient Corporate Governance*, 71 STAN. L. REV. 687, 687 (2019) (arguing that nonvoting stock can “make corporate governance more efficient”).

¹⁵¹ See Kaplan & Strömberg, *supra* note 85, at 281 (“We find that VC financings allow VCs to separately allocate cash flow rights, board rights, voting rights, liquidation rights, and other control rights.”); Paul A. Gompers, *Ownership and Control in Entrepreneurial Firms: An Examination of*

separating ownership and control, and using designated seats provides a sharp contrast to public companies which typically lack negotiations, lack voting agreements, and lodge nominating power in the board itself.¹⁵²

In startups, the board is not only the site of value-adding managerial guidance, but also one of the key arenas in which conflicts are resolved and investments are protected.¹⁵³ VCs and founders often diverge with respect to risk level, liquidity needs, and private benefits, which are often implicated in critical board-level decisions on financings, strategic direction, and exit.

To the extent a party in these battles did not get a decision resolved in its favor or consistent with its position, conflicts can arise between shareholders and the board. For example, shareholders might oppose a board decision regarding the timing or pricing of a round of financing that will affect their interests. These conflicts typically stem, however, from the divergence between the interests of founders and investors who are both shareholders and reflects a balance of control that was already negotiated in determining the size and composition of the board.¹⁵⁴ This understanding problematizes characterizing the shareholder-board relationship as simply vertical, according to standard convention.¹⁵⁵ The relationship is hierarchical in the sense that it is the shareholders who determine the board, but the relationship is not one of pure agency as commonly envisioned, with the founder-entrepreneur as the agent and the VC as the principal.¹⁵⁶

Convertible Securities in Venture Capital Investments 2 (Sept. 1997) (unpublished manuscript) (on file with author) (discussing how contracts that allocate control rights to VCs independent of cash flows create a “separation of ownership and control [that] has important implications for the efficiency of entrepreneurial firms”).

¹⁵² For a discussion of board elections and shareholder voting in public corporations, see Paul H. Edelman, Randall S. Thomas & Robert B. Thompson, *Shareholder Voting in an Age of Intermediary Capitalism*, 87 S. CAL. L. REV. 1359 (2014).

¹⁵³ WASSERMAN, *supra* note 43, at 284; Gilson, *supra* note 12, at 1077; Smith, *Exit Structure*, *supra* note 12, at 318.

¹⁵⁴ Protective provisions and other terms that VCs contract for in preferred stock financings can also give rise to conflicts between shareholders and the board. See KUPOR, *supra* note 36, at 201 (providing an example of a board-approved acquisition that could be blocked by “a preferred series of investor who has a small economic stake in the company but a disproportionate say in the acquisition outcome by virtue of having a series-specific protective provision vote”).

¹⁵⁵ See Blair & Stout, *supra* note 16, at 290 (“The notion that directors are shareholders’ agents has exerted enormous influence in the theoretical literature.”).

¹⁵⁶ See Smith, *Team Production in VC*, *supra* note 98, at 949-50 (discussing the standard convention of referring to the VC as principal and the entrepreneur as agent and arguing that the relationship is not in fact a “pure agency relationship” and instead has aspects of “team production” (internal quotations omitted)); cf. Stephen M. Bainbridge, Response, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791, 795 (2002) (characterizing the board as “not a mere agent of the shareholder, but rather . . . a sort of Platonic guardian serving as the nexus of the various contracts that make up the corporation”).

b. *Board vs. Founders or Executives*

Standard models of corporate governance often collapse the board and executives into a single category of managerial agents.¹⁵⁷ But startups involve participants in overlapping roles with dual status—participants with managerial control are therefore not simply agents of a monolithic body of principal-like shareholders. Conflicts can arise in startups between the board and the founders or executives that have significant governance dimensions.

The most typical scenarios involve the board firing a CEO-founder or deciding to change strategic direction over the objection of the founder or other executives. As discussed above, startups evolve through dramatically different business phases.¹⁵⁸ Because the skills and experience needed to start an innovative company are often different from those needed to grow and lead a large corporation, the board might decide that it needs to put a new executive in a leadership position that had been held by a founder. In a survey of 212 startups conducted by entrepreneurship scholar Noam Wasserman, by year three only fifty percent of founders were still CEO, with the percentage of CEO-founders declining further over time.¹⁵⁹ Studies that focus on companies that go public similarly find a significant rate of CEO-founder succession by the time of IPO.¹⁶⁰

The prevalence of founder departures makes sense in light of the fact that VCs attribute a large number of startup failures to problems with the CEO and management team.¹⁶¹ Monitoring the CEO is one of the key functions of the board—it should step in if a CEO is underperforming.¹⁶² And sometimes

¹⁵⁷ See *supra* note 119.

¹⁵⁸ See *supra* subsection I.B.1.

¹⁵⁹ Noam Wasserman, *The Founder's Dilemma*, HARV. BUS. REV., Feb. 2008, at 102, 104. It is for this reason—prevalent CEO-founder succession issues—that this Article refers throughout to founders and executives.

¹⁶⁰ See Steven N. Kaplan et al., *Should Investors Bet on the Jockey or the Horse? Evidence from the Evolution of Firms from Early Business Plans to Public Companies*, 64 J. FIN. 75, 78 (2009) (finding that among all the nonfinancial startups that held IPOs in 2004, a founder was CEO of only forty-nine percent); Broughman & Fried, *supra* note 60, at 1 (finding with a sample of over 18,000 venture-backed companies that in almost sixty percent of startups that go public, the founder is no longer CEO at the time of the IPO).

¹⁶¹ See Michael Gorman & William A. Sahlman, *What Do Venture Capitalists Do?*, 4 J. BUS. VENTURING 231, 238-39 (1989) (surveying 49 VCs about 96 of their portfolio companies and finding that for ninety-five percent of those companies VCs cited problems within the management team as a top-three contributing factor to failure, and the most important contributing factor for sixty-five percent of companies); Steven N. Kaplan & Per Strömberg, *Characteristics, Contracts, and Actions: Evidence from Venture Capitalist Analyses*, 59 J. FIN. 2177, 2178, 2190 (2004) (analyzing sixty-seven internal investment memoranda from eleven VC firms and finding that concerns about the CEO and management team led the list of investment risks for sixty-one of the startups).

¹⁶² See Fisch, *Boards*, *supra* note 53, at 282-89 (discussing the monitoring and managing functions of the board); Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms,*

a board's replacement of the CEO-founder is paradoxically a sign of the founder's success in fundraising and getting the company to a stage at which it has outgrown the founder's abilities.¹⁶³

Many instances of a board replacing a CEO-founder are thus routine, but genuine disputes can also arise regarding whether the board is properly acting in the best interest of the corporation. VCs and other fund managers that have designated seats on a startup board are "dual fiduciaries" in that they are fiduciaries of the startup company by virtue of serving as directors, and they also owe duties to the VC fund they manage and its limited partners.¹⁶⁴ In many instances, the interests of the startup company and the VC fund will align, but in some circumstances they will not because of the liquidity needs of the fund and the terms of the preferred stock that the VC investor holds, such as liquidation seniority that entitles the VC investor to get paid back before other investors.

It is therefore possible for the board to act opportunistically in ousting a CEO-founder or in other decisions affecting founders or executives. For example, in one recent case involving a startup dispute the court noted:

Venture capitalists frequently replace the founder-CEO. It is self-evident that such a decision could be appropriate. But it is also true that a founder-CEO may have greater incentive and ability to resist strategies that favor the holders of preferred stock (the venture capitalists) over the holders of common stock (the founders and employees).¹⁶⁵

c. *Shareholders vs. Founders or Executives*

The preceding discussion has examined governance conflicts that involve the board of directors. Sometimes startup shareholders simply sidestep the board, however, when a conflict arises between shareholders and founders or executives. This is understandable in light of the fact that shareholders in startups generally lack one of the most commonly used mechanisms for

and the Unintended Consequences of Independence and Accountability, 89 GEO. L.J. 797, 801-03 (2001) (discussing board functions).

¹⁶³ See WASSERMAN, *supra* note 43, at 303-05 (discussing "the paradox of entrepreneurial success" in product development or fundraising that can manifest in CEO-founder succession).

¹⁶⁴ Bochner & Simmerman, *supra* note 127, at 1; see *In re Nine Sys. Corp. S'holder Litig.*, Consol. C.A. No. 3940-VCN, 2014 WL 4383127, at *30 (Del. Ch. Sept. 4, 2014) (discussing the standard for proving that a director faced a "dual fiduciary problem" under Delaware law), *abrogated on other grounds by* Sciabacucchi v. Liberty Broadband Corp., C.A. No. 11418-VCG, 2018 WL 3599997 (Del. Ch. July 26, 2018).

¹⁶⁵ Carsanaro v. Bloodhound Techs., 65 A.3d 618, 665 (Del. Ch. 2013), *abrogated on other grounds by* El Paso Pipeline GP Co. v. Brinkerhoff, 152 A.3d 1248, 1264 (Del. 2016).

dealing with governance problems—exit.¹⁶⁶ Unlike public company shareholders, they cannot easily sell their stock when they are dissatisfied with the management.

VC contracting is designed to reduce agency costs and information asymmetry and, while board seats are a significant part of this design, mechanisms that do not rely on the formal structure of the board are also used—both contractual and structural. One of the primary examples of such a control mechanism is staged financing.¹⁶⁷ VCs commit capital in sequential rounds rather than as a full upfront investment of the amount that the startup will foreseeably need.¹⁶⁸ By staging their investments, VCs have a lever to set milestones for the managers—reducing agency costs—and the option to periodically reassess and decide whether to invest in another round of financing or “abandon” the investment—reducing information asymmetry and the impact of uncertainty.¹⁶⁹ Existing investors are an important source for continued capital and introductions to other potential investors; many startups fail before getting to profitability.¹⁷⁰ Thus, staged financing can have a “disciplining effect” on founders, who typically fear running out of cash and having to shut down.¹⁷¹

Mechanisms such as staged financing cannot, however, eliminate all tensions between shareholders and founders or executives. Notably, the disciplinary effect of staged financing is nullified when private capital is readily available to the startup. Furthermore, shareholders, founders, and executives often have different interests with respect to allocation of control and critical corporate decisions such as those regarding the timing and form of financings and exit.¹⁷² A particular VC’s interests and position with respect

¹⁶⁶ See ALBERT O. HIRSCHMAN, *EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES* 46 (1970) (explaining that investors generally employ exit rather than voice if exit is available).

¹⁶⁷ WASSERMAN, *supra* note 43, at 290.

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*; see also Gompers, *Optimal Investment*, *supra* note 89, at 1462-63 (finding, in a sample of 794 venture-backed companies between 1961 and 1992, that VCs used smaller and more frequent rounds for startups with greater uncertainty).

¹⁷⁰ See Bratton, *supra* note 12, at 939-40 (contrasting VC-backed startups, for which “[o]utside capital is needed for survival,” with “poorly performing mature firms” that might nevertheless “survive for years”).

¹⁷¹ WASSERMAN, *supra* note 43, at 291. This fear can be counterbalanced by founders’ desire to avoid taking on more capital than needed and to achieve as much growth as possible between rounds of financing in order to minimize the dilution of their own percentage of equity ownership. See *id.* (observing that founders may resist outside investment in order to maintain control).

¹⁷² Smith, *Exit Structure*, *supra* note 12, at 356; see FELD & RAMSINGHANI, *supra* note 52, at 68-69 (“[A]t some point, . . . there starts to be a series of forces that drive pressure for exits, including the desire of most firms to raise another fund As a result, some VCs start to pressure the companies they are investors in to sell earlier than the entrepreneurs might otherwise desire . . .”).

to these issues may depend on the fund's age and performance.¹⁷³ An investor may even have a different strategic vision for business operations that creates tensions with founders and executives. For example, SoftBank reportedly pushed its portfolio company Brandless to change its retail strategy to accelerate its pathway to profitability, ultimately leading its cofounder and CEO to step down from her executive role.¹⁷⁴ And while parties are aligned in seeking a financial return, founders and executives may also receive private benefits, both pecuniary and nonpecuniary, from the continued operation of the startup or from particular exit opportunities.¹⁷⁵

Signs of these kinds of challenges between investors and founders have begun to fill courtrooms and grab national headlines. For example, before going public, ride-hailing giant Uber experienced “one of the biggest VC-founder disputes in history.”¹⁷⁶ An early VC investor in the company sued the then CEO-founder for seeking additional power on the board while also allegedly failing to disclose his “gross mismanagement and other misconduct.”¹⁷⁷ A series of scandals at the company had come to light, including the development of a secret tool to evade law enforcement agencies, a sexual harassment crisis that prompted a high-profile internal investigation, and the alleged theft of trade secrets from a competitor.¹⁷⁸ The contentious lawsuit among insiders shocked observers and ended as eventfully as it began, with a grand bargain tied to a multi-billion dollar investment from a new, major institutional investor that would restructure the company's governance to a seventeen-person board and provide liquidity to the plaintiff-VC and some of the other early investors and employees.¹⁷⁹ Notably, the solution to

¹⁷³ See KUPOR, *supra* note 36, at 84 (noting that “depending on how well the GP is doing converting her other portfolio companies into profit, she might think differently about liquidity with respect to your company. How the fund is doing may also influence your GP's willingness to invest additional money in your startup or . . . seek an exit.”).

¹⁷⁴ Zoe Bernard, *Inside the Turmoil at SoftBank-Backed Brandless*, THE INFO. (June 26, 2019), <https://www.theinformation.com/articles/inside-the-turmoil-at-softbank-backed-brandless> [<https://perma.cc/CK42-EMTP>]; Connie Loizos, *Report: SoftBank-Backed Brandless Gets a New CEO Amid Turmoil at the Company*, TECHCRUNCH (June 26, 2019), <https://techcrunch.com/2019/06/26/report-softbank-backed-brandless-gets-a-new-ceo-amid-turmoil-at-the-company/> [<https://perma.cc/GW4S-UN7L>].

¹⁷⁵ Smith, *Exit Structure*, *supra* note 12, at 341-42.

¹⁷⁶ Katie Roof, *Benchmark's Lawsuit Against Former Uber CEO Kalanick Dismissed*, TECHCRUNCH (Jan. 25, 2018), <https://techcrunch.com/2018/01/25/benchmarks-lawsuit-against-former-uber-ceo-kalanick-dismissed/> [<https://perma.cc/MW4M-FGD7>].

¹⁷⁷ Complaint ¶ 5, *Benchmark Capital Partners VII, L.P. v. Kalanick*, 2017 WL 3437765 (Del. Ch. Aug. 10, 2017) (No. 2017-0575) [hereinafter *Complaint*].

¹⁷⁸ *Id.*; Mike Isaac, *Uber's C.E.O. Plays With Fire*, N.Y. TIMES (Apr. 23, 2017), <https://www.nytimes.com/2017/04/23/technology/travis-kalanick-pushes-uber-and-himself-to-the-precipice.html> [<https://perma.cc/K4XS-MBTB>].

¹⁷⁹ Greg Bensinger, *Uber Board Settles Feud, Clearing Way for SoftBank Deal*, WALL ST. J. (Nov. 13, 2017), <https://www.wsj.com/articles/uber-set-to-announce-softbank-deal-after-kalanick->

one conflict gave rise to a broader group of investors with different terms and a larger board, increasing complexity and the likelihood of diverging interests among board members.¹⁸⁰

2. Horizontal Issues

The next fundamental set of governance issues are horizontal and concern the conflicts that arise between shareholders and the costs of collective decisionmaking.¹⁸¹ Because shareholders may hold different types of equity interests with varied terms and preferences, they may have conflicting interests and incentives to take actions that would harm other shareholders or make inefficient decisions that fail to maximize aggregate welfare.¹⁸² In startups, these costs can reach great size as different contributors to the corporation—founders, employees, and investors—hold various equity interests.¹⁸³ Furthermore, startups distinctively feature interrelated vertical and horizontal issues, as the same participants appear in both types of issues,

benchmark-reach-terms-1510516418 [<https://perma.cc/PU9Y-43Z9>]; Mike Isaac, *Uber Sells Stake to SoftBank, Valuing Ride-Hailing Giant at \$48 Billion*, N.Y. TIMES (Dec. 28, 2017), <https://www.nytimes.com/2017/12/28/technology/uber-softbank-stake.html> [<https://perma.cc/RX9T-XVU4>].

¹⁸⁰ Disputes also arise in the other direction, with founders suing their VC investors. See *Kalashian v. Advent VI Ltd. P'ship*, No. CV-739278, 1996 WL 33399950, at *1-2 (Cal. App. Dep't Super. Ct. Oct. 4, 1996) (denying VC-defendants' motion for summary judgment in a dispute involving founder-minority shareholders claiming harm from a dilutive financing); José M. Padilla, *What's Wrong With a Washout?: Fiduciary Duties of the Venture Capitalist Investor in a Washout Financing*, 1 HOUS. BUS. & TAX L.J. 269, 276-78 (2001) (discussing the *Kalashian* case).

¹⁸¹ Some scholars have broadly characterized all corporate governance conflicts as agency problems. See, e.g., Simone M. Sepe, *Corporate Agency Problems and Dequity Contracts*, 36 J. CORP. L. 113, 124 (2010) (describing three sets of conflicts as agency problems: vertical between shareholders and managers, horizontal between controlling and minority shareholders, and between the firm itself and the parties with whom the firm contracts such as creditors). Others have pointed out that horizontal conflicts in particular “could also be described as team production problems—each group of participants has made some contribution to the wealth generating capacity of the corporation.” Blair, *supra* note 145, at 322.

¹⁸² See HANSMANN, *supra* note 2, at 40 (discussing the “additional costs that result from heterogeneity of interests among the owners” as distinct from traditional agency costs). Zohar Goshen and Richard Squire have theorized these conflicts more broadly as “principal costs,” including both the conflicting interests among investors and the coordination and competence costs that arise from joint decisionmaking. Goshen & Squire, *supra* note 9, at 771.

¹⁸³ The possibility of a conflict between debt and equity also exists, for example, between angel investors who invest using debt instruments and common stockholders such as founders. See MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 33-44 (1995) (discussing the complexity of distinguishing between debt and equity for corporate governance analyses); Douglas G. Baird & M. Todd Henderson, *Other People's Money*, 60 STAN. L. REV. 1309, 1310-11 (2008) (“The common stockholder is merely one flavor of investor. Others, such as lenders, bondholders, and preferred stockholders, also stand to gain or lose with right or wrong decisions.”).

which highlights the heterogeneity of their interests and the shifting, overlapping nature of their roles.

a. *Preferred vs. Common*

The classic horizontal conflict in startups is between the holders of preferred and common stock. Both represent an equity stake and are thus aligned in desiring the startup to get as large of an exit as possible. Aside from this point of alignment, however, they often conflict in terms of how much risk they prefer, how and when to raise additional funding, how and when to go for an exit, and any number of other scenarios.¹⁸⁴ In addition, founders, who typically represent a significant portion of the common equity, may receive private benefits from retaining ownership of the company that preferred shareholders do not enjoy.¹⁸⁵

To illustrate, the preferred-common conflict may come to a head in a situation in which a startup is on the verge of running out of capital. Preferred shareholders might prefer to sell the company because of their liquidation preferences that give them a senior claim to be paid back all or a portion or multiple of their investment. Furthermore, because VCs have a business model that relies on a small number of home runs driving their returns, they might prefer to cut their losses when it has become clear that a particular startup in their portfolio will not likely reach a large exit.¹⁸⁶ But if the sale price is not higher than the aggregate liquidation preferences, the common shareholders would get nothing and would thus prefer to raise another round of financing or debt to prolong the possibility of upside gain, even if it means putting the preferred shareholders' investment at greater risk.¹⁸⁷

¹⁸⁴ See, e.g., Bochner & Simmerman, *supra* note 127, at 3 (explaining that down-round financings, recapitalizations, and sales of the company are transactions in which the interests of the preferred and common shareholders can conflict); Bratton, *supra* note 12, at 922-45 (discussing problems for preferred shareholders and contractual solutions that evolved in the VC context); Padilla, *supra* note 180, at 278-85 (discussing “washout financings” that can occur when startups are in financial distress and the diverging interests of investors and founders in this context).

¹⁸⁵ Smith, *Exit Structure*, *supra* note 12, at 318. Further, founders sometimes push for “early” acquisitions because they are undiversified and the payout is personally meaningful even if it does not maximize the expected value of the startup. See Matthew Wansley, *Beach Money Exits*, 45 J. CORP. L. (forthcoming 2019) (manuscript at 2-3), https://papers.ssrn.com/sol3/Papers.cfm?abstract_id=3436967 [<https://perma.cc/XZ5G-UPUH>].

¹⁸⁶ See Abraham J.B. Cable, *Opportunity-Cost Conflicts in Corporate Law*, 66 CASE W. RES. L. REV. 51, 53 (2015) (describing how “continued investment in a moderately promising start-up company may have a high opportunity cost for the venture capitalist”).

¹⁸⁷ Variations of this scenario have arisen in a number of real-world shareholder conflicts. See *In re Nine Sys. Corp. S’holder Litig.*, Consol. C.A. No. 3940-VCN, 2014 WL 4383127, at *30 (Del. Ch. Sept. 4, 2014) (discussing “the dual fiduciary problem” faced by constituency directors approving a recapitalization in which their interests as participants diverged from those of the non-participating common shareholders); *In re Trados Inc. S’holder Litig.*, 73 A.3d 17, 20 (Del. Ch. 2013)

Corporate law provides a mechanism that responds to the problem of opportunism within the corporation: fiduciary duties. Directors and officers owe fiduciary duties of care and loyalty to serve the best interests of the corporation and its shareholders.¹⁸⁸ Fiduciary duties are therefore understood as filling in the gaps of incomplete shareholder contracts.¹⁸⁹ But in venture-backed startups with multiple classes of equity, what is required by the duty to serve the best interest of the corporation and its shareholders?

Competing theories of how to interpret and apply fiduciary duties in the startup context highlight the divergence between the preferred and the common. Three views have emerged: common maximization, enterprise value maximization, and a contractual approach.

Delaware courts and jurists have to date adopted the first view, holding that in the circumstance of a preferred-common conflict, directors owe a duty to common shareholders as the residual claimants.¹⁹⁰ In the words of the Chief Justice of the Delaware Supreme Court: “[T]he law suggests that when push comes to shove, the board has a duty to prefer the common’s interests, as pure equity holders, over any desire of the preferred for better treatment based on some generalized expectancy that they will receive special treatment beyond their contractual rights.”¹⁹¹ Corporate law scholars have pointed out that this interpretation can give rise to inefficient outcomes that fail to

(explaining how VC investors incentivized management to achieve a sale “even if the transaction yielded nothing for the common stock”); *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040, 1041 (Del. Ch. 1997) (involving a conflict between preferred and common shareholders in a biopharmaceutical company facing insolvency but with “several promising technologies in research”); *Orban v. Field*, No. 12830, 1997 WL 153831, at *1-2 (Del. Ch. Apr. 1, 1997) (involving a merger in which “various classes of [the company’s] preferred stock were entitled to liquidation preferences that together exceeded the value of the consideration paid”).

¹⁸⁸ See, e.g., *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1989) (“[D]irectors owe fiduciary duties of care and loyalty to the corporation and its shareholders.” (internal citation omitted)); *Frederick Hsu Living Tr. v. ODN Holding Corp.*, C.A. No. 12108-VCL, 2017 WL 1437308, at *17 (Del. Ch. Apr. 24, 2017) (“In the standard Delaware formulation, fiduciary duties run not only to the corporation, but rather ‘to the corporation and its shareholders.’” (quoting *In re Rural Metro Corp. Stockholders Litig.*, 88 A.3d 54, 80 (Del. Ch. 2014))).

¹⁸⁹ Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1444-45 (1989) (“Corporate law—and in particular the fiduciary principle enforced by courts—fills in the blanks and oversights with the terms that people would have bargained for had they anticipated the problems and been able to transact costlessly in advance.”); Oliver Hart, *An Economist’s View of Fiduciary Duty*, 43 U. TORONTO L.J. 299, 301 (1993) (arguing that understanding fiduciary duty requires “depart[ing] from the comprehensive contracting world of principal-agent theory and incorporat[ing] the transaction cost of writing contracts and the consequent contractual incompleteness”).

¹⁹⁰ See *Frederick Hsu Living Tr.*, 2017 WL 1437308, at *17 (explaining that directors should “increase the quantum of value available for the residual claimants”); *In re Tradors*, 73 A.3d at 40-41 (stating directors should “maximize the value of the corporation for the benefit of its residual claimants”).

¹⁹¹ Strine, *supra* note 13, at 2028.

maximize aggregate welfare. Consequently, they argue for an understanding of fiduciary duty that requires directors to maximize the aggregate value of all classes of equity—otherwise stated as firm value—without regard to its allocation.¹⁹² Other scholars argue for an approach that reflects the norms of negotiating control in startups. This view would take into account the fact that the common had ceded control to the preferred or vice versa and would allow for favoring the interests of different types of shareholders so long as any decision can be defended as in the best interests of the corporation or on the basis of contract.¹⁹³

Taken as a whole, this debate shines light on the potential for opportunistic conduct and the difficulty of balancing the interests of the preferred and common. It is not the only horizontal conflict that arises in startups, however, as the following discussion shows.

b. *Preferred vs. Preferred*

Despite holding the same general type of equity, preferred shareholders are not always aligned in their interests. Each round of financing that a startup raises typically results in a different series of preferred stock with different pricing and terms. In certain scenarios, these differences put the preferred shareholders in conflict.¹⁹⁴ As a white paper written by prominent VCs acknowledged: “[D]ifferent investors even within the same round may have different exit valuations in mind; one investor may be happy selling the company for \$100M while another may need \$300M to even consider a deal.”¹⁹⁵

¹⁹² See Bartlett, *Shareholder Wealth*, *supra* note 13, at 290-95 (analyzing the *Trados* decision and concluding that it undermines the usefulness of the corporate form in maximizing firm value); Bratton & Wachter, *supra* note 13, at 1885-87, 1904-06 (arguing that common stock maximization may make the enterprise less valuable and create perverse incentives).

¹⁹³ See Baird & Henderson, *supra* note 183, at 1333 (“The founders and common shareholders agreed that if things went well, they would all get rich, but if things went badly, the investors would come first.”); Fried & Ganor, *supra* note 13, at 1021-22 (interpreting pre-*Trados* case law as a “control-contingent” approach and advocating for allowing corporations to opt into different approaches in their charters); Sepe, *Constituency Directors*, *supra* note 27, at 309 (advocating for “turning a director’s obligation of undivided loyalty to the common shareholders into a default rule”).

¹⁹⁴ Similarly, a strategic investor such as corporate venture capital that had an additional relationship with or interest in the startup might be differently positioned than other preferred shareholders. Bartlett, *False Dichotomy*, *supra* note 11, at 61-62.

¹⁹⁵ *VC Director Guide*, *supra* note 59, at 4. The white paper is the product of a group of thirty-three VC industry experts who “collaborated to examine recurring boardroom challenges” and promote director education because “[h]igh functioning boards maximize the potential for [VC-backed companies] to be a financial success.” *Id.* at 2. For a discussion of how misalignment can arise from interests outside of a particular investment, see Brian Broughman, Elizabeth Pollman & D. Gordon Smith, *Fiduciary Law and the Preservation of Trust in Business Relationships*, in *FIDUCIARIES AND TRUST: ETHICS, POLITICS, ECONOMICS AND LAW* (Matthew Harding & Paul B. Miller eds., forthcoming Cambridge Univ. Press) (on file with author).

The high-profile dispute in *Benchmark Capital v. Vague* brought to light the tension among preferred shareholders.¹⁹⁶ The VC firm Benchmark invested in the Series A and B preferred stock of Juniper Financial, an online bank startup.¹⁹⁷ Juniper subsequently raised a Series C financing entirely from one new investor, the Canadian Imperial Bank of Commerce (CIBC), which negotiated for a senior liquidation preference and majority voting power, subject to existing Series A and B veto rights which CIBC could waive if the waiver did not “diminish or alter [the Series A and B holders’] liquidation preference or other financial or economic rights.”¹⁹⁸ The Series A and B preferred shareholders, including Benchmark, seemingly agreed to these terms with the belief that they had veto rights and the Series C financing would be the company’s last.¹⁹⁹ Shortly after, however, Juniper announced additional capital needs and plans to raise a “down round” Series D financing from CIBC.²⁰⁰ This round was structured as a merger to strategically avoid the Series A and B veto rights and it significantly diluted their interests—dropping their collective equity interests from twenty-nine percent to seven percent and reducing their aggregate liquidation preference from \$115 million to \$15 million.²⁰¹ Benchmark sued in an attempt to enjoin Juniper from proceeding with the financing, but ultimately lost in a court battle which narrowly construed the contractual veto rights.²⁰²

Conflicts among preferred shareholders can arise not only regarding financing, as in *Benchmark v. Vague*, but also regarding an IPO or sale of the company. For example, a late-stage preferred shareholder who paid \$20 per share would view less favorably a proposed IPO at \$18 per share than an early preferred shareholder whose average price paid was \$2 per share.²⁰³ Diverging interests could stem from different returns that would be gained and differences in timing and liquidity horizons.²⁰⁴ Preferred shareholders respond to these potential misalignments by contracting for various

¹⁹⁶ *Benchmark Capital Partners IV, L.P. v. Vague*, No. Civ.A. 19719, 2002 WL 1732423, at *1-2 (Del. Ch. July 15, 2002), *aff’d sub nom.* *Benchmark Capital Partners IV, L.P. v. Juniper Fin. Corp.*, 822 A.2d 396 (Del. 2003) (unpublished table opinion).

¹⁹⁷ *Id.* at *2-3.

¹⁹⁸ *Id.* at *1-3.

¹⁹⁹ *Id.* at *2 & n.8.

²⁰⁰ *Id.* at *4.

²⁰¹ *Id.* at *4-5 & n.20.

²⁰² *Id.* at *2, *10, *16. For an additional example of a dispute between preferred shareholders involving a financing, in which preferred shareholders not participating in the transaction had their shares converted to common pursuant to a pay-to-play provision, see *WatchMark Corp. v. ARGO Global Capital, LLC*, No. Civ.A 711-N, 2004 WL 2694894 (Del. Ch. Nov. 4, 2004).

²⁰³ See Bartlett, *False Dichotomy*, *supra* note 11, at 74 (“[I]nvestors holding higher-priced securities may simply be more willing than holders of lower-priced securities to postpone an exit event until the next ‘up’ market.”).

²⁰⁴ *Id.*

protections, such as veto rights and automatic conversion provisions, but incomplete contracts are inevitable and the misalignment cannot be entirely eliminated: It will arise where the capital structure has preferred shareholders with different amounts of the company's differently priced securities and varying terms.²⁰⁵

c. *Common vs. Common*

Finally, the third type of horizontal conflict involves common shareholders. The potential for divergent interests between common shareholders in startups is remarkably undertheorized in the literature, with scholarly study of specific scenarios, but no broader identification and examination of the issue. Most accounts lump together founders, executives, and employees as the common shareholders and do not explore how their incentives become misaligned.²⁰⁶ Yet in the real world of startups, conflicts among common shareholders can arise at critical junctures for the corporation. Identifying horizontal conflicts among common shareholders in startups also spotlights another underappreciated governance feature—employees. Startup employees participate in equity arrangements and often represent part of the essential value of the company and influence its decisionmaking.

Traditional accounts of employees assume they are fungible and their inputs can be easily obtained through market contracts.²⁰⁷ Corporate theory often excludes employees from analysis, treating them as “nonshareholder constituencies” that are protected by contract and labor regulation.²⁰⁸ Scholars posit that employees will be accorded significant ownership stakes only in the rare circumstance in which they have highly homogeneous interests.²⁰⁹ But these assumptions about employees simply do not hold up in startups.

²⁰⁵ *Id.* at 70, 74-76.

²⁰⁶ An additional source of horizontal complexity can arise in startups that raise capital through convertible debt instruments or variants such as “Park-n-Ride” instruments. *See* Bernthal, *supra* note 84, at 850 (discussing anticipatory and post-investment conflicts that can arise for non-shareholder investors who have bargained for rights to future equity).

²⁰⁷ *See, e.g.,* Blair & Stout, *supra* note 16, at 266-67 (“[T]he Alchian and Demsetz model . . . assumed that employees were undifferentiated inputs that were hired, or at least could be hired, in atomized markets. In other words, it viewed employees as interchangeable units that brought no special skills to—and, more importantly, made no special investment in—the team.”).

²⁰⁸ *See, e.g.,* Hansmann & Kraakman, *supra* note 16, at 442 (explaining that the shareholder primacy view “merely indicates that the most efficacious legal mechanisms for protecting” workers, consumers, and the public “lie outside corporate law”).

²⁰⁹ *See* Hansmann, *supra* note 16, at 596 (“[W]orker ownership tends to arise only where there is extreme homogeneity of interest among the workers involved.”). Hansmann also observed that worker-owned firms often “give members the right of exit at will on reasonable terms.” *Id.* at 598. Startups notably differ in this respect as well, constrained by private company status.

Startup employees often bring special skills to the venture and make nonseparable contributions such as by collectively developing technology.²¹⁰ The market for talent can be competitive and employees are often strongly associated with the startup itself—reflected in the fact that sometimes large corporations buy startups in “acqui-hire” deals in order to access teams of startup employees.²¹¹ Moreover, it is difficult for employees to protect their contributions through contract alone in light of the uncertainty that characterizes startups, particularly in their early stages, and in light of the contributions employees make that can affect firm value. Startups therefore usually grant employees stock options that vest over time and which, once exercised, are common stock.²¹² This provides employees with the possibility of sharing in the upside of the startup, and in the aggregate can represent a significant stake of the corporate equity. For example, when Facebook went public it had employee equity grants covering more than 961.5 million shares, worth \$36.5 billion at the IPO price.²¹³

Employee participation in startup governance is often indirect—the board seats negotiated for the common shareholders are generally dominated by founders and executives, and option holders’ voting rights do not ripen until the options are vested and exercised.²¹⁴ Nonetheless, employees are important participants in the ownership and control of the startup and their interests can conflict with other common shareholders.

Divergence among the common shareholders can arise when the company has an acquisition offer or is being sold, in secondary sales in which some

²¹⁰ See Yifat Aran, Note, *Beyond Covenants Not to Compete: Equilibrium in High-Tech Startup Labor Markets*, 70 STAN. L. REV. 1235, 1261-63, 1273-76 (2018) (discussing how the origins of Silicon Valley employee stock option practices recognized the value and talent of startup employees as knowledge workers and how options facilitate investment in human capital and innovation); see also MARGARET M. BLAIR, *WEALTH CREATION AND WEALTH SHARING* 9-16, 45 (1996) (discussing the asset-specific investment of human capital); Oliver E. Williamson, Michael L. Wachter & Jeffrey E. Harris, *Understanding the Employment Relation: The Analysis of Idiosyncratic Exchange*, 6 BELL J. ECON. 250, 250 (1975) (discussing “jobs for which nontrivial job-specific skills and task-specific knowledge evolve”).

²¹¹ See John F. Coyle & Gregg D. Polsky, *Acqui-Hiring*, 63 DUKE L.J. 281, 287-302 (2013) (describing the prevalence of acqui-hiring by large technology companies such as Google and Facebook).

²¹² MAYNARD ET AL., *supra* note 69, at 337-44. Stock options may also motivate employees to serve as monitors of other employees. Sharon Hannes, *Reverse Monitoring: On the Hidden Role of Employee Stock-Based Compensation*, 105 MICH. L. REV. 1421, 1422 (2007).

²¹³ Facebook, Inc., Amendment No. 8 to Registration Statement (Form S-1), at 8 (May 16, 2012), <https://www.sec.gov/Archives/edgar/data/1326801/000119312512235588/d287954ds1a.htm> [<https://perma.cc/WC9M-V3AB>]; see also Cable, *supra* note 18, at 621 (summarizing Facebook’s registration filing).

²¹⁴ Employees are also in a precarious position, as illustrated by the Zynga “clawback,” in which the company demanded that certain employees give back some of their options to the company before going public, or else be fired and forfeit all unvested options. Thomas A. Smith, *The Zynga Clawback: Shoring Up the Central Pillar of Innovation*, 53 SANTA CLARA L. REV. 577, 578 (2013).

shareholders have an opportunity to sell their shares, and even in everyday corporate decisionmaking such as regarding whether to extend the exercise period for certain optionholders. These circumstances can pit employees and angel investors against founders and executives, different types of employees such as engineers against non-engineers, and current or early-stage employees against former or late-stage employees.

For example, because equity arrangements for employees can vary with regard to the form of grant, exercise price, vesting schedule, and other terms such as the triggers to accelerate vesting on a change in control, employees can end up on opposite sides of a vote on whether the company should take an exit deal. Web technology firm Feedburner ended up in exactly this situation because it had made inconsistent equity arrangements with its early employees.²¹⁵ When the company received an acquisition offer, employees with one equity structure wanted the company to sell while others did not.²¹⁶

In many circumstances, the issue arises because founders and executives possess information and an opportunity to extract rents that other common shareholders do not have. In a study of trade sales of venture-backed startups, Brian Broughman and Jesse Fried found that in forty-five percent of the deals in their data set, the VCs had given on average nine percent of the deal value to the entrepreneurial team to induce agreement.²¹⁷ Their findings show that sometimes the deal sweetener was a carve-out for all common shareholders to participate in pro rata, but other times the deal sweetener was a management bonus to founders and executives that excluded other common shareholders.²¹⁸ The majority of liquidity events for startups are trade sales,²¹⁹ suggesting that this conflict occurs relatively frequently.

Another example arises when startups have difficulty raising financing. In this situation, startups often look for an opportunity for an “acqui-hire” rather than liquidate the company.²²⁰ But acquirers typically want engineers and may not hire the other employees.²²¹ This can align the buyer and the engineers against the investors and other employees regarding how to distribute the aggregate deal consideration.²²²

Finally, the phenomenon of startups staying private longer has presented new conflicts among common shareholders. When startups raise late-stage rounds of financings, they often also facilitate secondary sales to give partial

²¹⁵ WASSERMAN, *supra* note 43, at 240.

²¹⁶ *Id.*

²¹⁷ Broughman & Fried, *supra* note 132, at 1325.

²¹⁸ *Id.* at 1335-39.

²¹⁹ *VC Director Guide*, *supra* note 59, at 3.

²²⁰ Coyle & Polsky, *supra* note 211, at 295.

²²¹ *Id.* at 299.

²²² *Id.* at 299-300.

liquidity to certain shareholders—this means deciding between early, late, and former employees.²²³

In addition, startups have been faced with deciding whether to extend the typical ninety-day exercise period for departing employees who might otherwise forfeit their vested options because they lack the cash necessary to pay the exercise price and taxes.²²⁴ Yet doing so effectively transfers wealth from employees who choose to stay at the company, because the options would otherwise return to the pool and be available for new hires or refresh grants, and increasing the pool dilutes the ownership of all existing shareholders.²²⁵ Providing an extended exercise period can also misalign the employee and company interests as it can incentivize employees to quit and join a new company to diversify their risk once they have vested some of their options.²²⁶ Despite these concerns, Pinterest and Quora extended their exercise periods to seven and ten years post-departure respectively, allowing former employees to potentially enjoy the liquidity of a later IPO or sale of the company.²²⁷ These issues pose difficult tradeoffs and potentially magnify tensions between the holders of common stock and options.

B. Increasing Governance Issues Over Time

As the above framework has demonstrated, startups include a variety of different participants with different interests. Shareholders are heterogeneous. Further, these participants face conflicts between and among themselves—that is, startups involve inter-group conflicts such as between shareholders and the board, and intra-group conflicts such as between common shareholders. The vertical and horizontal conflicts are interrelated, with the same participants appearing in different configurations and serving in overlapping roles. But these governance issues do not arise all at once. They develop over time in an increasing pattern.

At the founding stage, ownership and control are fully aligned in the founder. Governance is not an issue because there are no relationships or

²²³ See *A Guide to Employee Liquidity Programs: Why and How Companies Align the Interests of All Parties*, FOUNDERS CIRCLE, <http://www.founderscircle.com/secondary-employee-aligned-liquidity-guide/> [https://perma.cc/PVN7-LKAT].

²²⁴ Scott Kupor, *The Lack of Options for (Startup Employees') Options*, ANDREESSEN HOROWITZ (June 23, 2016), <http://a16z.com/2016/06/23/options-timing/> [https://perma.cc/HNY8-SHDX].

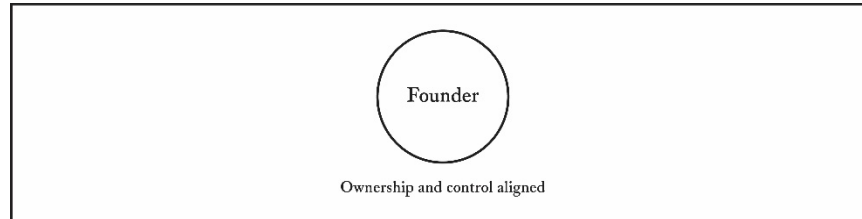
²²⁵ *Id.*

²²⁶ Scott Kupor, *Recommendations for Startup Employee Option Plans*, ANDREESSEN HOROWITZ (July 26, 2016), <https://a16z.com/2016/07/26/options-plan/> [https://perma.cc/W5JU-4WH5].

²²⁷ Ed Zimmerman & Jim Gregory, *Stock Options: VC-Backed Startups Extend Post-Termination Exercise Period*, FORBES (Aug. 27, 2017), <https://www.forbes.com/sites/edwardzimmerman/2017/08/27/stock-options-vc-backed-startups-extend-post-termination-exercise-period-ptept/#63ed345d5568> [https://perma.cc/R7ET-WMKV].

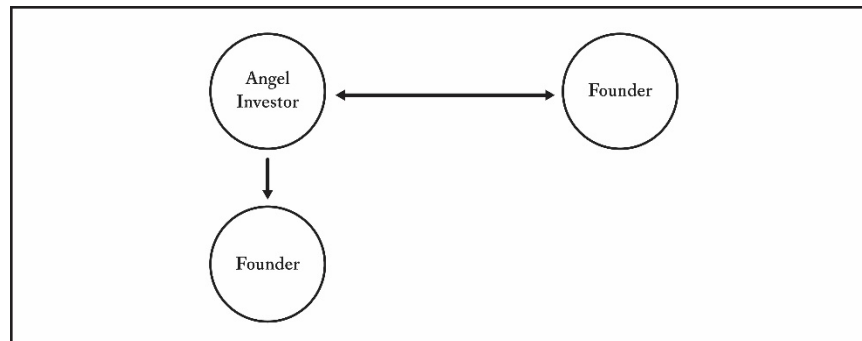
conflicts to manage within the corporation, as Figure 1 depicts. The amoeba-like simplicity of governance is readily apparent.

Figure 1: Founding Stage



But what kind of company can one person build alone? As one former entrepreneur observed, "It's very hard to go from 0 to 1 without a team."²²⁸ And, as subsection I.B.1 elaborates, the early stage is typically a key period of bringing an innovation to market, which presents technological challenges and financing needs. Some startups involve two or more cofounders, which creates the potential for disagreement about ownership stakes and management roles and decisions.²²⁹ Early-stage startups usually hire employees and grant them an incentive-based equity stake such as restricted stock or stock options that will vest. They seek a seed round of financing, as described in subsection I.B.2, which often adds angel investors. These additions of outside investors and employees creates governance challenges that can be understood as horizontal between equity holders (or debt and equity), and simultaneously vertical with the founder acting as a managerial agent, per Figure 2.

Figure 2: Seed Stage

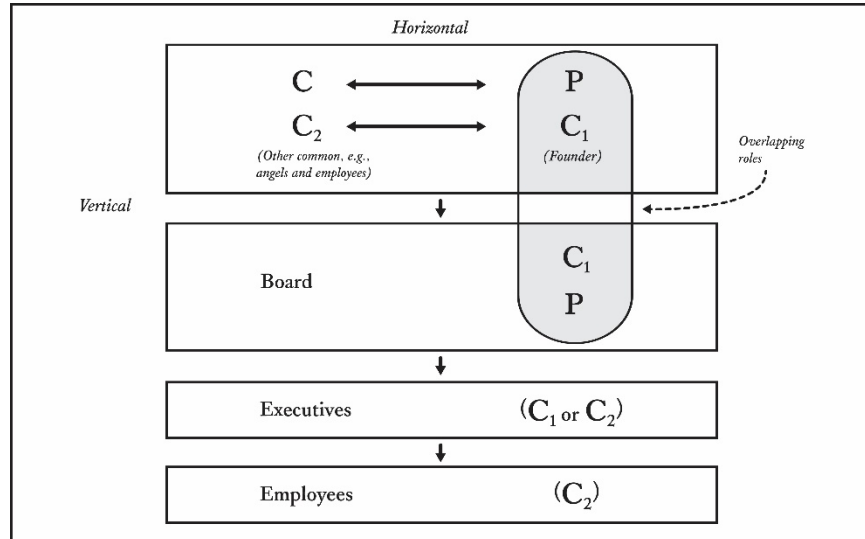


²²⁸ THIEL, *supra* note 48, at 109.

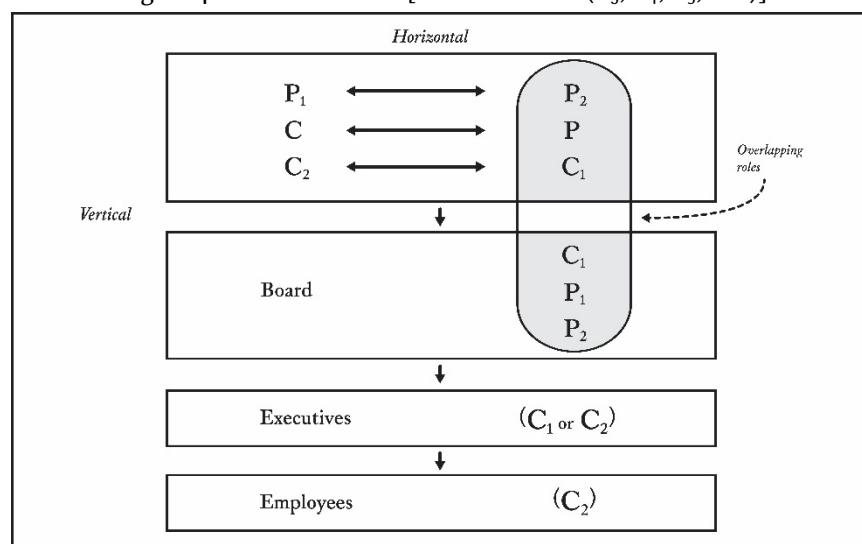
²²⁹ See Kupor, *supra* note 130.

Startups that take venture capital financing again increase potential governance issues—but as subsection I.B.1 explains, the nature of the startup business often necessitates this tradeoff in order to bring an innovation to market or fuel growth. Because VCs typically finance startups through convertible preferred stock, the first round of VC financing adds another layer of horizontal governance issues between the common and preferred shareholders (C and P), as subsection II.A.2 describes. At or before this time, a startup also typically establishes a formal board structure, which adds to layers of potential vertical dilemmas, as discussed in subsection II.A.1. In addition, employees vest stock options for common stock over time and thus potentially play a more significant role in governance conflicts as the company matures. Figure 3 illustrates this dynamic.

Figure 3: Venture-Backed [Series A]



When the startup raises a second round of venture financing, it yet again increases potential governance issues. Unless the second round is exactly pro rata with precisely the same investors, the potential for conflicts between the preferred shareholders arises (P_1 and P_2), as represented in Figure 4 with an additional layer of horizontal conflict among shareholders and additional diversity of interests represented on the board. With each additional round, the pattern continues (P_3 , P_4 , P_5 , etc.).

Figure 4: Venture-Backed [Series B & On (P₃, P₄, P₅, etc.)]

Further, the startup may hire additional executives and employees with varied types of incentive-based equity and associated terms, adding to potential divergences between the interests of common shareholders (C₁ and C₂), also represented in Figure 4. Additional complexity may arise from other capital sources such as corporate venture capital or debt.²³⁰

In sum, startup governance typically evolves from relatively simple to very complex sets of tensions between and among participants—it is not static and yet on the whole it changes in predictable ways. Venture-backed startups share this feature because of the way that VC financing adds to the different types of participants and equity in sequential rounds. Even an individual participant's interest may shift as liquidity needs ripen and other affiliations with the corporation change.²³¹ The emergence of a greater diversity of investors in startups and the trend of startups staying private longer on average might aggravate these issues. Investors represent a larger universe of interests, not all investors have board representation, and the separation of ownership and control grows.

Although scholars usually discuss the corporate framework and governance challenges in fixed terms, this Part has shown these are actually fluid issues. Startups face interrelated horizontal and vertical governance

²³⁰ See *supra* notes 73, 80 & 194.

²³¹ See William J. Carney, *The Theory of the Firm: Investor Coordination Costs, Control Premiums and Capital Structure*, 65 WASH. U. L.Q. 1, 7 (1987) (“Complex capital structures and other costly contracts arise because the preferences of the investor group can change over time.”).

issues and involve heterogeneous shareholders, overlapping governance roles, and dynamic change.

III. IMPLICATIONS AND FUTURE PATHS

This final Part explores new insights that the framework of startup governance can offer on issues of current debate. The implications are numerous, ranging from offering greater explanatory power for the challenges that startups face to bolstering arguments for applying corporate law principles flexibly in the startup context.

A. Understanding Challenges

The increasing nature of governance conflicts and overlapping roles in startups help illuminate two current controversies: monitoring failures and companies navigating the complexities of staying private longer.

1. Monitoring Failures

Scholars have generally assumed that VCs have strong incentives to monitor startups in their portfolios based on their substantial investments and the prevalence of VCs negotiating for designated board seats.²³² This traditional framing reflects the standard agency-cost model, which applied in the startup context has narrowly focused on the vertical relationship between VCs and entrepreneurs.²³³ Recent scandals have put a spotlight on monitoring failures by startup boards, however, that raise a puzzle not explained by the existing literature.

If VCs are strong monitors, why are examples of oversight failures in startups so plentiful and varied? A series of scandals emerged at Uber in the years before it went public involving regulatory evasion, sexual harassment,

²³² See, e.g., Gilson, *supra* note 50, at 901 (“Very powerful incentives for all participants—investors in venture capital funds, general partners of the funds, and entrepreneurs—are coupled with very intense monitoring of entrepreneurs by venture capitalists, and monitoring of venture capitalists by the capital market.” (emphasis omitted)); Ibrahim, *Venture Debt*, *supra* note 73, at 1194 (“In the start-up context, VCs are strong monitors, thereby reducing the need for lender monitoring to curtail managerial slack.”).

²³³ See Bartlett, *False Dichotomy*, *supra* note 11, at 48 (“VC scholarship has been concerned with primarily one question: How do VC investors respond to the extreme uncertainty, information asymmetry, and agency problems inherent in VC investment?”). Studies of VC oversight include Shai Bernstein et al., *The Impact of Venture Capital Monitoring*, 71 J. FIN. 1591, 1591 (2016), which finds that VCs’ “on-site involvement with their portfolio companies leads to an increase in both innovation and the likelihood of a successful exit”, and Josh Lerner, *Venture Capitalists and the Oversight of Private Firms*, 50 J. FIN. 301, 309-15 (1995), which finds that VC representation on the board increases around the time of a CEO replacement and that geographic distance is an important determinant of the board membership of VCs.

and alleged theft of a competitor's trade secrets.²³⁴ Investigative reporting revealed that the blood-testing device developed by Theranos did not match the founder's hype but rather was unreliable and flawed—the company raised \$900 million and reached a \$9 billion dollar valuation before its undoing.²³⁵ At SoFi, a consumer finance startup valued at over \$4 billion, it took several years before the board stepped in and fired the CEO-founder despite reports of rampant misconduct and misrepresentations to customers.²³⁶ Human-resources startup Zenefits paid millions in fines to regulators after it came to light that the company created software to enable its employees to cheat on state-required licensing courses.²³⁷ WeWork's failed IPO revealed questionable financial dealings between the company and its CEO-founder, among other governance concerns.²³⁸ And the list of examples goes on.²³⁹

This Article's framework sheds light on why monitoring failures may occur.²⁴⁰ Two main explanations emerge once we take into account that the VC-entrepreneur relationship is not simply a vertical principal-agent relationship, but instead part of a system of startup governance that puts heterogeneous participants in overlapping roles that creates both vertical and horizontal tensions that tend to increase over time.

²³⁴ See *supra* note 178.

²³⁵ JOHN CARREYROU, *BAD BLOOD: SECRETS AND LIES IN A SILICON VALLEY STARTUP* 294–96 (2018); Christopher Weaver, *Theranos Settles Investor Suit as Funds Run Low*, WALL ST. J. (July 22, 2018), <https://www.wsj.com/articles/theranos-settles-investor-suit-as-funds-run-low-1532275276> [<https://perma.cc/FAW2-32PP>]; Matt Levine, *The Blood Unicorn Theranos Was Just a Fairy Tale*, BLOOMBERG (Mar. 14, 2018), <https://www.bloomberg.com/view/articles/2018-03-14/theranos-misled-investors-and-consumers-who-used-its-blood-test> [<https://perma.cc/ENN7-US2T>].

²³⁶ Nathaniel Popper & Katie Benner, *'It Was a Frat House': Inside the Sex Scandal That Topped SoFi's C.E.O.*, N.Y. TIMES (Sept. 12, 2017), <https://www.nytimes.com/2017/09/12/technology/sofi-chief-executive-toxic-workplace.html> [<https://perma.cc/Z2K5-7JC5>].

²³⁷ Marisa Kendall, *Zenefits Hit With \$3.4 Million Bill for Failing to Pay Overtime*, MERCURY NEWS (June 20, 2017), <https://www.mercurynews.com/2017/06/20/zenefits-fined-3-4-million-for-failing-pay-overtime/> [<https://perma.cc/W8JQ-EVTB>]; Farhad Manjoo, *Zenefits Scandal Highlights Perils of Hypergrowth at Start-Ups*, N.Y. TIMES (Feb. 17, 2016), <https://www.nytimes.com/2016/02/18/technology/zenefits-scandal-highlights-perils-of-hypergrowth-at-start-ups.html> [<https://perma.cc/WTG2-PZ6P>].

²³⁸ Matt Phillips et al., *Wall Street Deflates America's Favorite Start-Ups*, N.Y. TIMES (Sept. 30, 2019), <https://www.nytimes.com/2019/09/26/business/tech-ipo-market.html> [<https://perma.cc/NH7D-6UP6>]; Jean Eaglesham & Eliot Brown, *WeWork Investors Turned Off by 'Sloppy' IPO Filings*, WALL ST. J. (Oct. 7, 2019), <https://www.wsj.com/articles/wework-investors-turned-off-by-sloppy-ipo-filings-11570440674> [<https://perma.cc/W5MH-4FFF>].

²³⁹ See, e.g., Steve Blank, *When Founders Go Too Far*, HARV. BUS. REV., Nov.-Dec. 2017, at 94, 96 (listing additional examples of startups that have faced “scandal and founder misbehavior”).

²⁴⁰ This discussion is not intended to suggest that VCs or other investors routinely fail to monitor startups, but rather to posit explanations of how monitoring weaknesses might arise. It is difficult to know the full extent of startup board monitoring failures and whether it is a widespread phenomenon given that the public usually only learns of these issues through leaks or when there is publicly disclosed legal or regulatory action.

First, early-stage startups need a managerial board to add resources and guidance—this value-add is what VCs are known for and aim to provide.²⁴¹ In light of the great uncertainty at this stage regarding whether any value will be created, the board typically invests little in compliance and internal controls.²⁴² This makes sense because, as Section I.B explains, the company is usually still figuring out if it can even make an innovative product or service that people want and develop a strategy to bring it to market.²⁴³

But the key point is what comes next—as a startup moves beyond its early stages, board members have incentives to prioritize growth and profits. As the framework in Part II demonstrates, the potential for governance conflicts typically increase across time.²⁴⁴ Board members—whether investors or founders—need the company’s valuation to keep going up in order to raise another round of financing and not get significantly diluted, and eventually to reach an exit that generates returns.²⁴⁵ An upward valuation trajectory also avoids problems associated with “underwater” stock options, which provide little retention or incentive value to employees because the exercise price is greater than the current value.²⁴⁶ Startups must grow fast

²⁴¹ To the extent VCs have exit control rights or redemption protections, this may also weaken incentives to monitor. See Smith, *Exit Structure*, *supra* note 12, at 344 (“The primary benefit of exit options is the venture capitalist’s interest in liquidity, while the primary cost of exit options is the venture capitalist’s reduced incentive to monitor.”).

²⁴² See Jeff Jordan, *16 Things CEOs Should Do Before an IPO*, ANDREESSEN HOROWITZ (Aug. 23, 2017), <https://a16z.com/2017/08/23/ipo-process-prep/> [<https://perma.cc/NWN5-GWQ8>] (“Early-stage companies allocate scarce product resources to the projects that will move the needle on revenue and profits. As a result, much-needed improvements in administrative systems are almost always deferred . . . and deferred . . . and deferred . . . sometimes until right before they IPO.”); David F. Larcker & Brian Tayan, *Scaling Up: The Implementation of Corporate Governance in Pre-IPO Companies* 1, 7 (Stan. Closer Look Series No. CGRP75, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3293883 [<https://perma.cc/Z3XE-BUXX>] (finding that “corporate leaders make vastly different choices about when and how to implement . . . standards” and that, on average, pre-IPO companies did not become “serious about developing a corporate governance system” until six years after formation).

²⁴³ See *supra* subsection I.B.1 (discussing early-stage focus on innovation, high failure rate, and VC business model focused on achieving returns with a small number of high-potential companies).

²⁴⁴ See *supra* Section II.B.

²⁴⁵ On this point, one prominent venture capitalist remarked, “I’m a bit sick and tired of the [fact that the] objective of every operating plan I see is to get the business to a point where it can raise money at a much higher price . . . I’d prefer to see an operating plan that has the objective of getting to sustainable profitability.” Wilson, *supra* note 55; see also Erin Griffith, *Silicon Valley Is Trying Out a New Mantra: Make a Profit*, N.Y. TIMES (Oct. 8, 2019), <http://nytimes.com/2019/10/08/technology/silicon-valley-startup-profit.html> [<https://perma.cc/U2LM-39KY>] (discussing venture capital investors’ focus on growth and profits).

²⁴⁶ See Jeffrey P. Crandall et al., *Davis Polk Discusses Down-Round Financings of Private Companies: Considerations for Outstanding Equity Compensation Awards*, CLS BLUE SKY BLOG (Mar. 1, 2016), <http://clsbluesky.law.columbia.edu/2016/03/01/davis-polk-discusses-down-round-financings-of-private-companies-considerations-for-outstanding-equity-compensation-awards/> [<https://perma.cc/B4R9-FA4W>] (discussing strategies for dealing with underwater stock options);

to achieve an exit that benefits all participants without putting them at odds with each other. To the extent that company culture or lack of compliance imperils the company's ability to achieve a successful exit, board members have an incentive to monitor and invest in controls; otherwise, they will likely prioritize growth and profits.²⁴⁷

Second, whereas the VC literature often adopts the standard framing of the VC as principal and the entrepreneur as agent, in fact these key participants frequently serve in overlapping roles. Startup directors are both the monitor and the subject—a dual status which may engender conflicts of interest and weaken oversight.

As explored in the analysis above, startup boards are the result of sequential multi-party negotiations.²⁴⁸ Directors typically hold designated seats, for example allocated to a founder or a particular series of preferred stock. Constituency directors may identify with their representative role. For example, VCs serving on boards may see themselves more as investors than as agents or fiduciaries of the corporation and all shareholders.²⁴⁹ Staged financing contributes to this view by putting VCs in a position of being asked to invest again in future rounds of preferred stock at the same time as wearing a governance hat. In addition, VCs invest in a portfolio of startups and often sit on multiple boards, which may reinforce their perspective as an investor and result in “overboarding,” or a decrease in the amount of attention and resources they can invest in monitoring each company.²⁵⁰

Mark Poerio & Sean Honeywill, *What To Do With Underwater Stock Options*, PAUL HASTINGS (Nov. 2008), <https://www.paulhastings.com/docs/default-source/PDFs/1080.pdf> [<https://perma.cc/TK2S-FM2P>] (noting that underwater stock options in executive compensation packages have “little retention or incentive value”).

²⁴⁷ In some of the startups in which oversight failures have recently come to light, it was employees rather than the board that prompted the investigations: an engineer's public blog post catalyzed the sexual harassment investigation at Uber, and an employee at Theranos exposed the misconduct by alerting regulators and the *Wall Street Journal*. Maureen Dowd, *She's 26, and Brought Down Uber's C.E.O. What's Next?*, N.Y. TIMES (Oct. 21, 2017), <https://www.nytimes.com/2017/10/21/style/susan-fowler-uber.html> [<https://perma.cc/VVW6-LG4J>]; John Carreyrou, *Theranos Whistleblower Shook the Company—and His Family*, WALL ST. J. (Nov. 18, 2016), <https://www.wsj.com/articles/theranos-whistleblower-shook-the-companyand-his-family-1479335963> [<https://perma.cc/UZL5-9AR6>].

²⁴⁸ See *supra* subsection II.A.1.

²⁴⁹ See, e.g., FELD & RAMSINGHANI, *supra* note 52, at 70 (“Recognize that a VC is taking a board seat as a fiduciary responsibility to his own investors (his LPs). While he also has a legal duty to the company as a board member, his duty as a fiduciary to his investors will often take precedence.”); cf. Bochner & Simmerman, *supra* note 127, at 4 (“[F]iduciary duties tend to run primarily to the common stockholders, as the relevant case law views preferred stockholder rights as a function of, and protected primarily by, contract law.”).

²⁵⁰ See Zider, *supra* note 57 (observing that the “popular image of venture capitalists as sage advisors is at odds with the reality of their schedules. The financial incentive for partners in the VC firm is to manage as much money as possible. The more money they manage, the less time they have to nurture and advise entrepreneurs.”); Alfred Lee, *How Many Board Seats Is Too Many?*, THE INFO.

The litigation between VC firm Benchmark Capital and Uber cofounder and former CEO Travis Kalanick, discussed in Section II.A, demonstrates this dynamic that arises from participants holding overlapping roles. Benchmark was one of Uber's early VC investors and held a large equity stake in the company and a designated board seat.²⁵¹ The firm sued Kalanick, claiming that he "intentionally concealed and failed to disclose his gross mismanagement and other misconduct at Uber."²⁵² The complaint notably takes the perspective of Benchmark as an investor—but the firm also held a board seat. It was that director's duty to take an active role in monitoring the corporation's management and putting in place information reporting systems and controls that would bring to light misconduct occurring at the company.²⁵³ The complaint highlighted the concealment of information from investors rather than the monitoring role of directors.²⁵⁴

The other aspect of overlapping roles that might affect board monitoring arises from the relational nature of startup governance. VCs and other startup investors are repeat institutional players in a reputation-based market for investments.²⁵⁵ As investors they could be characterized as principals in the startup, but in a very real sense they get hired or chosen by founders—the agents in traditional models.²⁵⁶ Recent work has traced the changing market

(Jan. 17, 2018), <https://www.theinformation.com/articles/how-many-board-seats-is-too-many> [<https://perma.cc/Z6CV-XKEU>] (identifying twenty-four VCs who hold nine or more directorships at tech startups, including one VC who sits on eighteen boards).

²⁵¹ See Complaint, *supra* note 177, at ¶¶ 19-20 (noting that at the time of the lawsuit Benchmark held "approximately 13% of Uber's stock, including approximately 20% of Uber's voting power, approximately 36% of the preferred stock voting power and approximately 0.5% of Uber's Class B common stock" and Uber's voting agreement provided for a board seat "designated by Benchmark").

²⁵² *Id.* at ¶ 4. According to the complaint, this failure induced Benchmark to execute a stockholder consent and amended voting agreement that created three new board seats to be designated by Kalanick. *Id.* at ¶¶ 4-5.

²⁵³ For a discussion of directors' oversight responsibility, see *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 968-70 (Del. Ch. 1996) (identifying failure to monitor as a potential basis for director liability). See also *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 369-70 (Del. 2006) (establishing the standard for a *Caremark* oversight claim); Hillary A. Sale, *Fiduciary Law, Good Faith, and Publicness*, in *THE OXFORD HANDBOOK OF FIDUCIARY LAW* 763, 779 (Evan J. Criddle et al. eds., 2019) (explaining that "good faith requires establishing risk oversight, internal controls, and monitoring systems, as well as evaluating the effectiveness of the systems over time").

²⁵⁴ See, e.g., Complaint, *supra* note 177, at ¶¶ 2, 5, 6, 30, 65, 77.

²⁵⁵ See Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 254-55 (1998) (arguing that VC opportunism is constrained by reputational concerns).

²⁵⁶ See KUPOR, *supra* note 36, at 20-22 (noting that in the post-2005 era of VC, the amount of capital required to start a company has declined, available capital has increased, and information about building a startup has become widely available, prompting VCs "to compete for the right to fund entrepreneurs"); Pollman, *Private Company Boards*, *supra* note 122, at 635-39 (describing how entrepreneurs are advised to be selective in the board members they "hire"); Anu Hariharan, *How to Manage a Board*, Y COMBINATOR (July 15, 2019), <https://blog.ycombinator.com/how-to-manage->

pressures that began in the early 2000s, explaining that “[w]hereas once too many start-ups chased limited amounts of capital from a relatively small number of VC firms, today, some would argue, too much capital is chasing too few quality start-ups.”²⁵⁷

This dynamic can put investors in a position in which they hold a board seat, but it is not in their individual interest to exercise their power as a strict monitor. Early investors get board seats that they might not be willing to give up even when their ability to add value has passed.²⁵⁸ They may be subject to competitive and reputational constraints that encourage them to adopt founder-friendly stances, both in order to remain in a founder’s good graces to participate in subsequent rounds and to maintain reputations that will give them access to other companies’ deals.²⁵⁹ Among the highest echelon of startups, the “fire-the-founder” era of the twentieth century evolved into a “founder-friendly” era of the twenty-first.²⁶⁰ And, if founders maintain control past the early part of a startup’s lifecycle, they may be unlikely to give it up even as needs and expectations change for the board from managerial to monitoring. Some of the hottest startups have their choice of investors and bargaining leverage to demand favorable terms.²⁶¹

Entrepreneurs and VCs alike have noted the weak oversight that can arise from the overlapping roles in the governance structure. For example, the CEO of online real-estate brokerage Redfin, which went public in 2017, remarked, “There is a new world of VCs who really can’t perform their governance functions on boards because they want to preserve their relationship with

a-board [<https://perma.cc/PSR7-GFBS>] (suggesting founders conduct reference checks on potential board members); *supra* note 137 and accompanying text.

²⁵⁷ Blank, *supra* note 239, at 99-100.

²⁵⁸ See, e.g., Adam Epstein, Comment to Jessica E. Lessin, *The Private Tech Board Crisis and What to Do About It*, THE INFO. (Dec. 1, 2017), <https://www.theinformation.com/articles/the-private-tech-board-crisis-and-what-to-do-about-it> [<https://perma.cc/NDP7-6ZGZ>] (describing frequent experience with “pre-IPO boardrooms where the Series A & B investors are: (1) no longer remotely expert in a business that has pivoted numerous times . . . ; (2) are on 7-10 other boards in addition to being full time investors . . . ; and (3) have no formal governance training whatsoever and/or loathe board service.”); Thomas Lee, *Stretched Thin: Venture Capitalists Serve On Too Many Boards*, S.F. CHRON. (Aug. 26, 2017), <https://www.sfchronicle.com/business/article/Stretched-thin-Venture-capitalists-serve-on-too-11966545.php> [<https://perma.cc/8MTJ-9Ezt>] (quoting a VC noting that sitting on unicorn boards can make a VC look good and “open doors”).

²⁵⁹ See, e.g., Blank, *supra* note 239, at 99 (discussing the emergence of “founder friendly” VCs with competitive advantage in marketing). VCs may also recognize that an exit through a sale of the company is far likelier than an IPO, and having a founder retain a leadership role can make a deal more attractive to acquirers. *Id.*

²⁶⁰ *Id.* at 96-97, 99.

²⁶¹ See *supra* notes 147-150 and accompanying text; see also Jessica E. Lessin, *The Private Tech Board Crisis and What to Do About It*, THE INFO. (Dec. 1, 2017), <https://www.theinformation.com/articles/the-private-tech-board-crisis-and-what-to-do-about-it> [<https://perma.cc/NDP7-6ZGZ>] (“As long as demand for great companies outstrips supply, some investors will back any company with growth potential, regardless of its governance standards.”).

you.”²⁶² Similarly, Benchmark general partner Bill Gurley stated, “There’s a systematic problem in Silicon Valley[:] the venture capitalist board members are finding [it] harder and harder to speak up and hold entrepreneurs responsible for financial performance.”²⁶³ He explained, “Our business has gotten super competitive. What the venture capitalist is afraid of is losing the next big one [Y]ears ago [some of the best venture capitalists] were known for storming into board rooms [to demand fiduciary responsibility]—if you get a reputation like that you won’t win the next deal.”²⁶⁴ He lamented that Silicon Valley board rooms have mostly become applauding audiences of clapping hands.²⁶⁵

Although some observers may have little sympathy for VCs who lose money due to oversight failure, it is not only VCs who bear the cost of weak startup boards and compliance failures.²⁶⁶ Particularly egregious examples such as the blood-testing scandal at Theranos, which harmed not only investors and employees but also innocent third-party patients, put the concern into sharp relief.²⁶⁷

Yet the potential for oversight weakness stems from the underlying governance structure and is not easily resolved. Founder-friendly terms exacerbate the issue, and unicorn size raises the stakes, but the structure and dynamics that contribute to the oversight weakness are commonplace in venture-backed startups.²⁶⁸

²⁶² Winkler & Farrell, *supra* note 149.

²⁶³ Matthew Lynley, *Very Famous VC Bill Gurley Says Startup Boardrooms Are Now Just Filled With *Clapping Hand Noise**, TECHCRUNCH (Feb. 14, 2018), <https://techcrunch.com/2018/02/14/very-famous-vc-bill-gurley-says-startup-boardrooms-are-now-just-filled-with-clapping-hand-noise/> [<https://perma.cc/3YH7-8VGM>].

²⁶⁴ *Id.* (second and third alterations in original).

²⁶⁵ *Id.*

²⁶⁶ See Martin Kenney & John Zysman, *Unicorns, Cheshire Cats, and the New Dilemmas of Entrepreneurial Finance*, 21 VENTURE CAP. 35, 39 (2019) (observing that with large amounts of private capital available, “money-losing firms can continue operating and undercutting incumbents for far longer than previously—effectively creating disruption without generating profit” and that “in some cases, they may be destroying social value”).

²⁶⁷ Another issue is that companies and regulators may not fully appreciate the social risks and costs of new technology until some time after deployment. John Armour et al., *Putting Technology to Good Use for Society: The Role of Corporate, Competition and Tax Law*, 6 J. BRIT. ACAD. 285, 294-95 (2018).

²⁶⁸ This point reflects that while worthy of attention, the governance issues that unicorns manifest do not spring into existence only when these companies cross the line of a billion-dollar valuation, and notably the valuations may be unreliable markers. See Robert P. Bartlett III, *A Founder’s Guide to Unicorn Creation: How Liquidation Preferences in M&A Transactions Affect Start-Up Valuation*, in RESEARCH HANDBOOK ON MERGERS AND ACQUISITIONS 123, 123-24 (Claire A. Hill & Steven Davidoff Solomon eds., 2016) (explaining that the stated valuations of unicorns may be unreliable measures of firm value because they reflect preferred stock terms); Gornall & Strebulaev, *supra* note 78, at 1 (modeling the valuation of unicorns and finding that after adjusting for valuation-inflating terms, almost half of unicorns lose their status).

Independent directors who do not hold overlapping roles have the potential to improve the monitoring function of startup boards.²⁶⁹ Recent reports and advice from former SEC chair Mary Jo White and former attorney general Eric Holder indeed call on mature startups to enhance board oversight by adding independent directors and installing an independent board chair.²⁷⁰ In previous periods when startups went public earlier on average, much of the company's growth phase could have been funded by public capital markets and overseen by a public company board with greater independence. Proposals concerning independence, particularly for late-stage startups, can thus be understood as efforts to move startup boards to a model closer to that of public company boards and previous expectations about the publicness of companies with a sizeable footprint.²⁷¹

But, as the description of startup boards in subsection II.A.1 explains, not all startups have independent directors and those that do typically use them as a means of providing for shared control of the board between VCs and founders.²⁷² One study of independent directors found that rather than monitoring management, independent directors in startups "arbitrate disputes between entrepreneurs and investors" and act as a commitment mechanism forcing compromise between directors and limiting threats of opportunism.²⁷³

Further, not only may the independent director be envisioned more as a tie-breaker than a monitor, the meaning of independence in the startup context is in many ways narrower than public company norms—it often refers simply to an individual who is not an inside manager such as a founder or executive and not a major outside investor such as a VC. Independent

²⁶⁹ Empirical studies have not, however, definitively established a link between board independence and corporate profitability or stock price performance. Fisch, *Boards*, *supra* note 53, at 276 (stating that "evidence demonstrating a relationship between independence and profitability is in short supply"); Langevoort, *supra* note 162, at 798 (describing how "a growing body of economics research has been unable to find any such connection," while conceding that "measurement problems plague empirical work in this area").

²⁷⁰ See *Uber Report: Eric Holder's Recommendations for Change*, N.Y. TIMES (June 13, 2017), <https://www.nytimes.com/2017/06/13/technology/uber-report-eric-holders-recommendations-for-change.html> [<https://perma.cc/JP94-DBP5>] (recommending the addition of independent board members, an independent chair of the board, and an oversight committee); White, *supra* note 42 (calling on entrepreneurs and venture capitalists to ask whether mature startups are including on their boards "outsiders with larger, and ideally public, company experience").

²⁷¹ For discussions of the concept of "publicness," see Langevoort & Thompson, *supra* note 29, at 383; Hillary A. Sale, *The New "Public" Corporation*, 74 LAW & CONTEMP. PROBS. 137, 138-39 (2011).

²⁷² See Broughman, *supra* note 142, at 461-64 (considering the role of independent directors in venture-backed startups); *supra* subsection II.A.1; see also Lessin, *supra* note 25861 (criticizing notable unicorns for failing to appoint independent directors).

²⁷³ Broughman, *supra* note 142, at 461, 464 (internal quotation marks omitted); see also Fried & Ganor, *supra* note 13, at 989 (noting that VCs often have considerable influence over independent directors).

directors in the startup context may still have significant social and professional ties with the VCs, founders, or executives. These connections can add enormous value to the startup and establish the trust necessary to have a voice on the board,²⁷⁴ but could at the same time influence their ability to provide oversight. In addition, not only does independence have a narrower meaning in the startup context, the information generally available to these directors in carrying out their board service is also limited by the lack of public reporting and stock exchange price.

And, finally, unless a startup reaches maturity without being acquired and begins to prepare for an IPO exit, there may be little incentive for participants to cede control and build an independent, public-company-style board. Founders value the ability to pursue their vision for the company; VCs appreciate founders' ability to create an innovative culture and also want their own seat on the board.²⁷⁵ Control, and the many ways to divide, balance, and share it through board governance and contract, are a central and ongoing concern for startup participants. One examination of the practices of thirty prominent venture-backed private tech companies found that only about half of these companies had any independent directors—companies such as Stripe, Instacart, Reddit, SpaceX, and 23andMe had none despite valuations over one billion dollars.²⁷⁶ Without having to comply with stock exchange rules or federal regulations pertaining to public companies, there is little impetus apart from the preferences of founders and VCs. New entrants to late-stage investing, such as mutual funds, could have a voice to push for governance improvements, but this force remains to be seen in the startup context.

In sum, this Article's analysis highlights that VCs may not always be the strong monitors they are assumed to be, and that adding some measure of

²⁷⁴ See, e.g., Emilio J. Castilla et al., *Social Networks in Silicon Valley*, in *THE SILICON VALLEY EDGE: A HABITAT FOR INNOVATION AND ENTREPRENEURSHIP* 218, 245 (Chong-Moon Lee et al. eds., 2000) (describing the "crucial importance of social networks" to the "flow of people, resources, and information" in Silicon Valley startups); Scott Shane & Daniel Cable, *Network Ties, Reputation, and the Financing of New Ventures*, 48 *MGMT. SCI.* 364, 377 (2002) (finding that social ties influence venture financing). See generally Mark S. Granovetter, *The Strength of Weak Ties*, 78 *AM. J. SOC.* 1360 (1973) (examining the importance of weak social ties in diffusion of influence, information, and talent).

²⁷⁵ See SCHUMPETER, *supra* note 48, at 128-38 (describing the role of entrepreneur as innovator); Blank, *supra* note 239, at 96 ("The decline of IPOs and less focus on management credentials have reduced the need for 'adult supervision,' and VCs have come to respect founders' ability to maintain a fast-moving, innovative culture."); Goshen & Hamdani, *supra* note 117, at 565-66, 577-79 (describing the entrepreneur's "idiosyncratic vision" and the value of controlling management decisions to pursue such vision under conditions of information asymmetry or differences of opinion).

²⁷⁶ *Private Tech Governance: Best and Worst*, *THE INFO.* (Nov. 20, 2017), <https://www.theinformation.com/corporate-governance> [<https://perma.cc/78KW-6VD2>].

greater independence may improve the oversight function of startup boards. This proposal is unlikely to be a panacea, however, because the system of startup governance is not oriented around such a goal; rather, insiders' vision, shared control, and social ties provide value for growing, innovative companies. Accountability mechanisms other than board oversight may take on greater importance as the social costs of startups are increasingly felt in communities around the world.

2. Extreme Late-Stage Governance and Liquidity Pressure

While startup scandals and monitoring failures have captured headlines, another issue has attracted considerable academic attention. In just two decades, the number of publicly listed U.S. companies has plummeted by nearly half and the number of companies going public through an IPO has decreased to roughly one-third.²⁷⁷ Scholars and commentators have debated the role that regulatory costs, securities law changes, technology, and public market dynamics may have played in these developments, and whether companies still have incentives to go public.²⁷⁸

Drawing on the framework of startup governance set out in Part II, this Section contributes a novel, supplementary explanation of why some companies might choose to go public even when they do not need to raise money: increasing governance costs and liquidity pressure from heterogeneous shareholders. Staying private for long periods while growing and adding participants with diverging interests involves significant governance complexity. Going public offers a chance to unwind a complicated and largely contractual governance structure in favor of a more traditional

²⁷⁷ See Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 HASTINGS L.J. 445, 454 (2017) ("From 2001 through 2012, there were an average of only 99 IPOs per year, compared to 310 IPOs per year between 1980 and 2000."); Andrew Ross Sorkin, *C.E.O.s Meet in Secrecy Over the Sorry State of Public Companies*, N.Y. TIMES (July 21, 2016), <https://www.nytimes.com/2016/07/21/business/dealbook/ceos-meet-in-secret-over-sorry-state-of-public-companies.html> [<https://perma.cc/98EY-QSPX>] ("In 1996, there were 8,025 public listed companies in the United States; by 2012, the number of companies was about half: 4,101, according to the National Bureau of Economic Research."); Kathleen M. Kahle & René M. Stulz, *Is the U.S. Public Corporation in Trouble?* 2 (Eur. Corp. Governance Inst., Finance Working Paper No. 495/2017, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2869301 [<https://perma.cc/A9L3-TFQW>] ("The steady decrease in the number of listed firms since 1997 has resulted from both low numbers of newly listed firms and high numbers of delists [T]he average yearly number of IPOs after 2000 is roughly one-third of the average from 1980 to 2000.").

²⁷⁸ See, e.g., De Fontenay, *supra* note 277, at 447, 453-58; Kahle & Stulz, *supra* note 277, at 1; see also Brian R. Cheffins, *Rumours of the Death of the American Public Company Are Greatly Exaggerated* 22-23 (Eur. Corp. Governance Inst., Law Working Paper No. 444/2019, 2019) (arguing that based on the "ratio of aggregate market capitalization of publicly traded stocks to gross domestic product," the public company is "currently as important relative to the U.S. economy as it ever has been, if not more so").

allocation of rights and responsibilities. Even dual-class stock can represent a considerable simplification over the complex multi-class structures and contracts of late-stage startup companies.²⁷⁹

Historically, the key reason for companies to go public was for broader access to capital.²⁸⁰ For some companies this may still be a significant motivation, but many unicorns have demonstrated that they can raise large amounts of capital without accessing public markets.²⁸¹

Liquidity is also commonly listed as a reason to go public, but its importance is usually explained as increasing the value of equity and lowering the cost of capital for companies to make acquisitions and hire and retain managers and employees.²⁸² Some scholars have additionally recognized that going public is an important form of exit for venture-backed companies, serving as a “mechanism for founders, employees, and early investors to cash out their relatively illiquid stakes in the firm.”²⁸³ What remains underappreciated, however, are the governance dynamics occurring in these late-stage companies that can be difficult to navigate and make liquidity pressure particularly problematic, especially for employees.²⁸⁴

²⁷⁹ See *supra* note 109 and accompanying text (finding that unicorns have an average of eight share classes and layered contracts between a wide mix of equity holders including founders, employees, VC funds, mutual funds, sovereign wealth funds, corporate investors, and others).

²⁸⁰ De Fontenay, *supra* note 277, at 461; see John Koeplin et al., *The Private Company Discount*, 12 J. APPLIED CORP. FIN. 94, 99 n.10 (2000) (noting “relatively less access to capital for private firms”); Gary C. Sanger & John J. McConnell, *Stock Exchange Listings, Firm Value, and Security Market Efficiency: The Impact of NASDAQ*, 21 J. FIN. & QUANTITATIVE ANALYSIS 1, 1-2 (1986) (repeating the “frequently encountered hypothesis regarding the value of a major stock exchange listing . . . that improved liquidity provided by exchange trading stimulates demand for a firm’s stock, which, in turn, gives rise to a permanent increase in stock price”).

²⁸¹ De Fontenay, *supra* note 277, at 447.

²⁸² Jeff Schwartz, *The Twilight of Equity Liquidity*, 34 CARDOZO L. REV. 531, 536-37 (2012).

²⁸³ De Fontenay, *supra* note 277, at 461; see also Black & Gilson, *supra* note 255, at 245 (arguing that “a well developed stock market that permits venture capitalists to exit through an [IPO] is critical to the existence of a vibrant venture capital market”); Josh Lerner, *Venture Capitalists and the Decision to Go Public*, 35 J. FIN. ECON. 293, 293 (1994) (“Venture capitalists, who specialize in providing funds to privately held firms, generate the bulk of their profits from firms that go public.”); Armin Schwienbacher, *Innovation and Venture Capital Exits*, 118 ECON. J. 1888, 1888 (2008) (recognizing that “[s]ince most high-tech start-ups initially do not generate profits to pay dividends or buy back shares, the exit route is the primary way the venture capitalist can realise a positive return on the investment”). Researchers have also examined reputational motivations and the benefit of allowing founders to diversify their private holdings and regain control over firms. Jay B. Kesten, *The Law and Economics of the Going-Public Decision*, in THE OXFORD HANDBOOK OF IPOs 27, 28-29 (Douglas Cumming ed., 2018) (summarizing literature on the potential benefits of going public).

²⁸⁴ When Facebook went public in 2012, it listed employee liquidity as one of the principal purposes of its IPO. Facebook, Inc., Registration Statement (Form S-1), at 7 (Feb. 1, 2012), <https://www.sec.gov/Archives/edgar/data/1326801/000119312512034517/d287954ds1.htm> [<https://perma.cc/9KLS-MMWD>] (“The principal purposes of our initial public offering are to create a public market for our Class A common stock and thereby enable future access to the public

Recall from Part I the late-stage mature startup's financial and governance structure that is characterized by extreme complexity—these companies are increasingly raising financing rounds of previously unheard-of size, bringing new public-style investors into the capital structure.²⁸⁵ Part II observes that these startups can be plagued by tensions between and among all participants and in a pattern that increases. This raises the question of what is the ultimate endpoint. Most startups fail or reach an exit through a sale of the company.²⁸⁶ But what happens to the companies that have not taken this path?

We are currently witnessing the answer to this question play out. To date, the structure of venture-backed companies has been premised on the notion that there must ultimately be an exit.²⁸⁷ Key participants rely on the assumption that exit is an essential goal. VC funds have a fixed life, usually ten years and sometimes with an option for a short extension.²⁸⁸ Incentive-based equity compensation for employees usually vests over four years and typically has a term of ten years from the date of grant.²⁸⁹

Extended periods of staying private have strained these timelines and prompted new mechanisms to give partial liquidity: secondary markets for private company stock, third-party tender offers, and company-sponsored share buybacks.²⁹⁰ These are important developments that provide a release valve for participants' liquidity needs and governance conflicts. For example, Benchmark's lawsuit against Uber's cofounder and former CEO ultimately settled as part of a deal that also brought in a new institutional investor, gave partial liquidity to Benchmark, and restructured the board.²⁹¹ Palantir, a data analytics startup, conducted a \$225 million buyback, offering to repurchase up to 12.5 percent of certain employees' shares.²⁹² But these transactions also create new risks and challenges that must be managed and it is an open

equity markets by us and our employees, obtain additional capital, and facilitate an orderly distribution of shares for the selling stockholders.”).

²⁸⁵ See *supra* subsections I.B.2 & II.B.

²⁸⁶ See *VC Director Guide*, *supra* note 59, at 3 (“Historically, the majority of . . . liquidity events occur through mergers and acquisitions.”).

²⁸⁷ See Zider, *supra* note 57, at 132 (“Venture money is not long-term money. The idea is to invest in a company's balance sheet and infrastructure until it reaches a sufficient size and credibility so that it can be sold to a corporation or so that the institutional public-equity markets can step in and provide liquidity.”); Smith, *Exit Structure*, *supra* note 12, at 345 (“Exit is not merely optional for venture capitalists.”).

²⁸⁸ Smith, *Exit Structure*, *supra* note 12, at 345.

²⁸⁹ MAYNARD ET AL., *supra* note 69, at 340-41. Another type of stock-based compensation, restricted stock units, usually expire after five to seven years. Lee, *supra* note 5.

²⁹⁰ See *supra* note 110.

²⁹¹ See *supra* notes 176–179 and accompanying text.

²⁹² Steven Davidoff Solomon, *Palantir Buyback Plan Shows Need for New Silicon Valley Pay System*, N.Y. TIMES (June 28, 2016), <https://www.nytimes.com/2016/06/29/business/dealbook/palantir-buyback-plan-shows-need-for-new-silicon-valley-pay-system.html> [<https://perma.cc/DN6H-FFEA>].

question whether it will be sustainable for startups to remain private forever—whether, for example, companies can find new investors large enough to satisfy all liquidity needs on a continual basis and that do not demand assurances of a timeline to go public.

Staying private in the extreme late stage involves significant governance difficulty and cost. Raising new rounds of financing requires complex renegotiations among an increasingly diverse group of shareholders. It often raises the bar for a potential exit down the road, for example, by giving protective terms to the newest investors regarding the price and timing of an IPO that guarantees them a return, potentially at the expense of founders, employees, and earlier investors.²⁹³ Taking on additional capital can also reduce the number of potential acquirers that would have the means and interest to buy the company in a trade sale.

Further, companies are limited in the types of workers they can grant “compensatory” equity under federal securities laws exemptions.²⁹⁴ While private, Uber and Airbnb, for example, asked the SEC to change the rules to allow drivers, hosts, and other gig economy workers to receive equity from startups.²⁹⁵ The issue only arises for private companies—once public, they can simply register the shares.

Managing information within the private governance structure also becomes increasingly challenging. State corporate law provides shareholders with the right to inspect the corporate books and records.²⁹⁶ This right provides startup employees and other shareholders with an important protection and means of seeking information to value their stock, but it is potentially costly and time-consuming for companies to respond to these

²⁹³ See *supra* note 108 and accompanying text; see also KOPP & GANZ, *supra* note 66, at 25 (quoting venture capitalist John Doerr of Kleiner Perkins: “Having a \$1 billion valuation can be a real problem . . . [.] Being a unicorn is really an albatross.”).

²⁹⁴ See 17 C.F.R. § 230.701(c) (2018).

²⁹⁵ Comment Letter from Danielle Burr, Head of Federal Affairs, Uber Technologies, Inc., to U.S. Securities & Exchange Commission (Oct. 11, 2018), <https://www.sec.gov/comments/s7-18-18/s71818-4510185-175992.pdf> [<https://perma.cc/CK6N-GDKG>] (“Uber believes that individuals who get work through the entrepreneurial economy should be able to receive securities pursuant to an exempt offering under Rule 701 [17 CFR § 230.701] and also through a registered offering on Form S-8 from the companies with whom they partner.”); Comment Letter from Rob Chesnut, General Counsel, Airbnb, Inc., to U.S. Securities & Exchange Commission (Sept. 21, 2018), <https://www.sec.gov/comments/s7-18-18/s71818-4403356-175575.pdf> [<https://perma.cc/AVU2-P7F4>] (“We believe that an update to 17 CFR 230.701 (“Rule 701”) is necessary to reflect the evolving nature of how individuals earn income.”).

²⁹⁶ See, e.g., Cal. Corp. Code § 1601(a) (2019) (“The accounting books, records, and minutes of proceedings of the shareholders and the board . . . shall be open to inspection . . . upon the written demand on the corporation of any shareholder . . . for a purpose reasonably related to the holder’s interests as a shareholder.”); Del. Code Ann. tit. 8, § 220 (2019) (“Any stockholder, in person or by attorney or other agent, shall . . . have the right . . . to inspect for any proper purpose . . . [t]he corporation’s stock ledger, a list of its stockholders, and its other books and records.”).

requests.²⁹⁷ In addition, federal securities law requires companies that grant more than \$10 million of options or other employee equity awards in a twelve-month period to provide detailed financial statements and risk disclosures to their employees.²⁹⁸ The SEC levied a civil penalty on Credit Karma, a personal finance startup, for failing to comply—the company had the information available, but did not want to provide it to employees due to confidentiality concerns.²⁹⁹ Companies are in a bind: employees are making investment decisions and are entitled to the information, but a company may suffer when sensitive financial information is leaked. As companies get bigger and stay private longer, avoiding leaks becomes harder.

Partial liquidity events are often problematic. Secondary trading can be time-consuming and distracting for managers and employees—whose time and attention are key resources for company performance and value.³⁰⁰ Because unrestricted secondary trading poses problems for startups in managing their shareholder base and valuation,³⁰¹ startup lawyers added trading restrictions that prevent employees and other shareholders from selling without company consent.³⁰² Although this alleviates certain concerns,

²⁹⁷ See Jeremy Quittner, *A Little-Known Rule Could Force Startups to Divulge Financial Info*, FORTUNE (May 26, 2016), <http://fortune.com/2016/05/26/startups-financial-info> [<https://perma.cc/L467-7JMQ>] (noting that “[a]nswering the queries is potentially costly and time-consuming for the company, which could be subject to multiple such letters”); Rolfe Winkler, *Former Employee Wins Legal Feud to Open Up Startup’s Books*, WALL ST. J. (Jan. 26, 2017) (discussing litigation in which a former startup employee succeeded in obtaining corporate financial records to value his shares), <https://www.wsj.com/articles/former-employee-wins-legal-feud-to-open-up-startups-books-1485435602> [<https://perma.cc/234B-BZW6>].

²⁹⁸ Exempt Offerings Pursuant to Compensatory Arrangements, 83 Fed. Reg. 34,940, 34,940 (July 24, 2018) (to be codified at 17 C.F.R. pt. 230). The threshold was raised from five million dollars in a twelve-month period. See 17 C.F.R. § 230.701(e) (2018).

²⁹⁹ Michael S. Dicke & Vincent Barredo, *SEC Fines Private Company in First Enforcement Action Resulting from Rule 701 Option Grants Investigation*, FENWICK & WEST LLP (Mar. 15, 2018), <https://www.fenwick.com/publications/Pages/SEC-Fines-Private-Company-in-First-Enforcement-Action-Resulting-from-Rule-701-Option-Grants-Investigation.aspx> [<https://perma.cc/KL3C-FWEF>].

³⁰⁰ See, e.g., *A Legal Guide To Secondaries: What Startups Need to Know About Employee Tender Offers*, FOUNDERS CIRCLE, <http://www.finderscircle.com/legal-guide-to-secondaries> [<https://perma.cc/2YND-ANFU>] (“What if all of your employees start keeping daily tabs on the current price per share of their stock? What if they start asking for company information that it doesn’t want to provide and potentially feed to prospective buyers? What if they sell to competitors?”).

³⁰¹ See *id.* (noting that secondary transactions can “create some unwanted chaos” by affecting the company’s option pricing and shareholder base); see also Pollman, *Information Issues*, *supra* note 37, at 213-14 (discussing concerns about managing shareholders and pricing issues).

³⁰² Schwartz, *supra* note 282, at 559-60; Katie Benner, *Airbnb and Others Set Terms for Employees to Cash Out*, N.Y. TIMES (Aug. 10, 2016), <https://www.nytimes.com/2016/08/12/technology/airbnb-and-others-set-terms-for-employees-to-cash-out.html> [<https://perma.cc/FU2Q-HUK5>]; see Kupor, *supra* note 226 (discussing transfer restrictions on startup stock); see also *Henry v. Phixios Holdings, Inc.*, C.A. No. 12504-VCMR, 2017 WL 2928034, at *8 (Del. Ch. July 10, 2017) (discussing the enforceability of transfer restrictions).

it puts directors, founders, and executives in further tension with other startup participants as they are deciding which shareholders are allowed to sell, and when they do, it often necessitates information disclosures in addition to company consent.³⁰³

Similar concerns about distractions, fairness, and disclosures arise when a company does a buyback or facilitates a third-party tender offer.³⁰⁴ Palantir's share buyback put the company in the position of picking and choosing among current and former employees to offer partial liquidity at a price above the valuation that one of its institutional shareholders, Morgan Stanley, had determined in a markdown.³⁰⁵ Different pricing and terms for investors and employees are commonplace in private tender offers.³⁰⁶ Company-facilitated transactions expose corporate decisionmakers and the corporation itself to litigation and regulatory risk from potential pricing and information asymmetry issues.³⁰⁷ Further, third-party tender offers may pose problems for the company post-exit. More than one hundred special purpose vehicles had reportedly invested in Uber before its IPO, which may have precipitated a market selloff after the company became publicly traded.³⁰⁸

In addition, a lengthy list of problems for startup employees in particular can arise from the extended pre-liquidity period. The discussion in Section II.A explained problems arising from expiring exercise periods and how it can put common shareholders in tension with each other. Some companies have turned to giving cash bonuses instead of options and loaning employees money to exercise their options,³⁰⁹ but these solutions are costly, complicated,

³⁰³ See Pollman, *Information Issues*, *supra* note 37, at 213-15 (discussing company disclosures in secondary transactions); see also *supra* note 223 and accompanying text.

³⁰⁴ Dawn Belt, Practice Note, *Pre-IPO Liquidity for Late Stage Start-Ups*, LEXIS PRACTICE ADVISOR (2018), <https://www.fenwick.com/FenwickDocuments/Pre-IPO-Liquidity-for-Late-Stage-Start-Up.pdf> [<https://perma.cc/2S22-JR4P>]; *Private Company Secondary Liquidity—Private Tender Offer Disclosures*, NASDAQ PRIVATE MARKET (Sept. 8, 2017), <https://www.nasdaqprivatemarket.com/private-company-secondary-liquidity-private-tender-offer-disclosures> [<https://perma.cc/X797-MKCP>].

³⁰⁵ Davidoff Solomon, *supra* note 292.

³⁰⁶ *Factors to Consider When Structuring Private Tender Offers*, NASDAQ PRIVATE MARKET (Jan. 21, 2018), <https://www.nasdaqprivatemarket.com/factors-to-consider-when-structuring-private-tender-offers> [<https://perma.cc/SSS2-J8WF>].

³⁰⁷ See Pollman, *Information Issues*, *supra* note 37, at 238-39.

³⁰⁸ Alistair Barr, *One Theory Why Lyft, Uber IPOs Flopped: Special Purpose Vehicles*, BLOOMBERG (May 17, 2019), <https://www.bloomberg.com/news/articles/2019-05-17/one-theory-why-lyft-uber-ipo-flopped-special-purpose-vehicles> [<https://perma.cc/ZEA4-TTUZ>].

³⁰⁹ Ted G. Wang, *Playing with Fire: Loans to Exercise Options*, FENWICK & WEST LLP (June 24, 2014), <https://www.fenwick.com/publications/pages/playing-with-fire-loans-to-exercise-options.aspx> [<https://perma.cc/XRD3-R3LH>]; Olivia Zaleski, *Airbnb Calms Employees with Cash Bonuses, Releases New Details on IPO*, BLOOMBERG (June 28, 2018), <https://www.bloomberg.com/news/articles/2018-06-28/airbnb-calms-employees-with-cash-bonuses-releases-new-details-on-ipo> [<https://perma.cc/A5MV-EQ25>]. A new cottage industry is also emerging, of third-party companies and funds making loans to startup employees and relying on their stock as collateral. Alfred Lee,

and only underscore the need for a better system that aligns company and employee interests.

In the meanwhile, employees risk getting hurt in the process. In startups, option exercise requires out-of-pocket money to cover the exercise price and taxes. The more valuable the options, the more expensive it is to exercise them, and coming up with the cash can be difficult for employees—it can sometimes run in the hundreds of thousands of dollars.³¹⁰ Once the options are exercised they become shares of (semi) illiquid common stock and it remains to be seen what they will be worth. Some companies fail or ultimately exit at an unfavorable valuation.

For example, when Good Technology sold to BlackBerry after a cancelled IPO and having turned down a much higher acquisition offer, employees discovered their stock was valued at 44 cents per share, down from \$4.32 a year earlier.³¹¹ Although Good Technology had at one time been labeled a unicorn valued at more than \$1 billion, its final sale price was \$425 million and most of the proceeds went to the preferred shareholders.³¹² Many employees were stuck with large losses and tax bills, and they subsequently sued the directors for breach of fiduciary duty.³¹³ This example reflects the classic principle that equity comes with risk, but it also shows something more particular to startups—the governance cost of exposing large numbers of employees to personal financial harm and, consequently, key managers to litigation.

Nothing in this discussion suggests that there is only one reason to go public or that the impetus will be the same for all companies. Instead, this discussion adds depth to understanding the governance costs and liquidity pressure that develop in the extreme late stage of startups. The framework

Back in Vogue, Tech Lending Funds Cater to Pre-IPO Workers, THE INFO. (Mar. 27, 2018), <https://www.theinformation.com/articles/back-in-vogue-tech-lending-funds-cater-to-pre-ipo-workers> [https://perma.cc/8PW3-QQZ7].

³¹⁰ See Matt Levine, *Work for Uber, Wind Up in Debt*, BLOOMBERG (Dec. 13, 2017), <https://www.bloomberg.com/view/articles/2017-12-13/work-for-uber-wind-up-in-debt> [https://perma.cc/LNV8-SJGW] (describing one former Uber employee's \$100,000 payment to exercise 20,000 stock options).

³¹¹ Katie Benner, *When a Unicorn Start-Up Stumbles, Its Employees Get Hurt*, N.Y. TIMES (Dec. 23, 2015), <https://www.nytimes.com/2015/12/27/technology/when-a-unicorn-start-up-stumbles-its-employees-get-hurt.html> [https://perma.cc/8NUB-C7EA].

³¹² *Id.*

³¹³ *Id.*; Matt Levine, *Good Technology Wasn't So Good For Employees*, BLOOMBERG (Dec. 23, 2015), <http://www.bloombergview.com/articles/2015-12-23/good-technology-wasn-t-so-good-for-employees> [https://perma.cc/RB64-UHT2]; see Helaine Olen, *These Startup Workers Thought Their Company Stock Would Make Them Rich. Instead They Got Worthless Shares and Massive Tax Bills*, SLATE (Dec. 23, 2015), http://www.slate.com/blogs/moneybox/2015/12/23/good_technology_workers_thought_their_stock_would_make_them_rich_nope.html [https://perma.cc/JU8L-2QE7] (noting that “even as corporate honchos were aware that an ‘outside appraisal firm’ had priced the firm’s common stock at 88 cents a share in June, employees were still purchasing company stock at \$3.34 a share in August”).

offered here suggests that we can expect increasing complexity to remaining private and an ownership structure of different types of participants with vesting and investing timelines that can be delayed, but will eventually push toward an exit.³¹⁴

B. *Applying Corporate Law*

In addition to illuminating current issues of debate such as monitoring failures and late-stage startups, this Article's framework also suggests that more attention be paid to how corporate law might adapt in the future to account for startups. Foundational doctrines have been shaped in the context of classic closely held problems of majority–minority disputes and the public corporation context of shareholder–manager agency costs.³¹⁵ High-growth, innovative startups funded by venture capital present different features and issues.

This final section aims to start a conversation about how to apply traditional corporate law doctrine to startups. It takes as a key example *In re Trados*, discussed above in Section II.A, regarding the conflict that can arise between the common and preferred shareholders.³¹⁶

The case involved a startup that faced dim prospects for growth after several years of operation in which it had taken on multiple rounds of preferred stock having an aggregate liquidation preference of approximately \$58 million.³¹⁷ As is typical for a startup by this stage of its life cycle, the board had been renegotiated such that the preferred shareholders and company

³¹⁴ The recent batch of IPOs and direct listings, including companies that reached late-stage maturity such as Uber, Lyft, Zoom, Pinterest, Spotify, and Slack, evidence this possibility of governance complexity and liquidity pressure pushing toward going public. For example, the digital music service company Spotify and the software messaging company Slack both went public without selling a single new share and prioritized giving immediate liquidity to all existing shareholders, without lock-up provisions that normally delay employees in accessing the market. Alexander F. Cohen et al., *Spotify Case Study: Structuring and Executing a Direct Listing*, LATHAM & WATKINS (June 21, 2018), <https://www.lw.com/spotify-case-study> [<https://perma.cc/ZR85-GKXF>]; Maureen Farrell, *Slack Plans to Follow Spotify on Unconventional IPO Route*, WALL ST. J. (Jan. 11, 2019), <https://www.wsj.com/articles/slack-planning-to-pursue-direct-listing-11547202723> [<https://perma.cc/HK2K-X8WE>]; Ellen Huet, *Slack Tops \$19 Billion Value in Trading Debut After Shunning IPO*, BLOOMBERG (June 20, 2019), <https://www.bloomberg.com/news/articles/2019-06-20/slack-ceo-says-no-lockup-no-cash-drew-company-to-direct-listing> [<https://perma.cc/QMK5-GU26>].

³¹⁵ See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182, 185 (Del. 1986) (ruling in the public corporation context that when a sale of the company becomes inevitable, the duty of the board is to maximize the corporation's value by getting the best price available for the shareholders); D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 279 (1998) (tracing to the closely held corporation context the development of the fiduciary duty to act in the best interest of the corporation and its shareholders).

³¹⁶ *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 47 (Del. Ch. 2013).

³¹⁷ *Id.* at 20–25.

executives composed the board, together with one independent industry expert.³¹⁸ The legal dispute concerned the board's decision to sell the company to a strategic buyer for \$60 million—an amount that went to the preferred shareholders in light of their liquidation preference and to management under a management incentive plan that provided select executives with a bonus to find and carry out the deal.³¹⁹ The question was whether, in negotiating and approving a sale that gave the common shareholders nothing, the directors breached their fiduciary duty.³²⁰

The court held that the directors owed a fiduciary duty to the common shareholders as the residual claimants.³²¹ It characterized the preferred shareholders as having rights and preferences that are only contractual in nature like creditors rather than residual claimants—“the ultimate beneficiaries of the firm's value.”³²² As a majority of the directors were VCs and executives whom the court deemed not disinterested and independent, the court applied the entire fairness standard, “Delaware's most onerous standard.”³²³ It found the process lacking because the board members “did not understand that their job was to maximize the value of the corporation for the benefit of the common stockholders” and failed to form an independent committee that would represent the common shareholders.³²⁴ It further found, however, that the common stock had no economic value due to the corporation's weak prospects, and thus the common shareholders had received their fair value.³²⁵ Fortunately for the defendants, they had no liability in the case, but commentators pointed out that the court's application of the entire fairness standard had resulted in years of litigation and posed concerns for future potential litigants.³²⁶

Most critically, *Trados* sets out a vision of fiduciary principles that imagines that all directors have an immutable obligation to maximize value for common shareholders. This does not accord with the reality of most startups, which do not have homogeneous shareholders, even among the common stock class.

³¹⁸ See *id.* at 45-55 (outlining the conflicts of interest faced by six of the seven directors).

³¹⁹ *Id.* at 20, 26-33.

³²⁰ *Id.* at 33-35.

³²¹ *Id.* at 40-41.

³²² *Id.* at 39-41.

³²³ *Id.* at 44-45.

³²⁴ *Id.* at 62, 64-65.

³²⁵ *Id.* at 76.

³²⁶ See KUPOR, *supra* note 36, at 228 (noting the litigants “spent a ton of time and money on legal fees on this case, so there were real costs,” and that “an entrepreneur or a VC [wouldn't] want to hang [their] hat on the fair price part of this analysis” because “the chances are pretty good that any given court on any given day could come to a different conclusion”); Abraham J.B. Cable, *Does Trados Matter?*, J. CORP. L. (forthcoming) (manuscript at 12-16) (on file with author) (discussing the response to *Trados* by legal practitioners, the venture capital community, and academics).

Although there might be special concerns about the potential vulnerability of some common shareholders such as employees, the common shareholders do not represent the firm value or an undifferentiated residual as imagined. Instead, the common shareholders represent only a segment of the equity and they often stand in tension with each other and have other forms of affiliation with the corporation in addition to their shareholding.³²⁷

Furthermore, the preferred shareholders often play a key role in governance and do not fit the typical paradigm of creditors that have negotiated their contractual relationship at arm's length and without the expectation of other involvement, protections, or equity-like investment returns.³²⁸ Because of uncertainty and the non-contractibility of certain types of potential issues in startups, preferred shareholders do not have complete protection from opportunism through their contracts.³²⁹ VCs and entrepreneurs frequently use a governance system of shared control to resolve matters in the boardroom, which allows for decisions to be made as events unfold rather than by advance specification and for boards to function collaboratively on strategy and innovation.³³⁰ Preferred shareholders' ability to use shared control as an alternative to contract is undermined by an immutable legal rule that requires maximization for the common shareholders. *Trados* could discourage venture capital investment through corporations or raise the cost of capital to innovative startups.³³¹

The features of startup governance suggest that courts should be willing to apply fiduciary doctrine more flexibly in this context to recognize the different types of contributions represented in the corporation and that the board is repeatedly renegotiated on the path to an eventual exit. The value of the corporation itself, the site of these investments and bargains, best reflects the sum of the participants' interests and it is to the corporation that the fiduciary duty should be owed.

³²⁷ See *supra* subsection II.A.2.

³²⁸ See Bratton & Wachter, *supra* note 13, at 1815 (arguing that "preferred stock is both corporate and contractual—neither all one nor all the other").

³²⁹ See Bratton, *supra* note 12, at 894 (explaining that preferred shareholders in startups typically have "incomplete protection from issuer opportunism"); *supra* subsections II.A.1.a, II.A.1.c, II.A.2.a–b (describing governance conflicts involving preferred shareholders).

³³⁰ See *supra* subsection II.A.1 (discussing shared control in startups).

³³¹ See Sepe, *Constituency Directors*, *supra* note 27, at 311–12 (arguing that current fiduciary doctrine concerning constituency directors could reduce corporate access to capital); Cable, *supra* note 326, at 1, 22–40 (finding that "Silicon Valley lawyers describe modest effects" of the *Trados* decision on practice to date).

Over time, with increasing numbers of participants with diverging interests,³³² it becomes even harder to engage in bargaining toward an optimal outcome and even more important to allow the board to act as it best understands the interests of the corporation as a whole. To do otherwise limits the utility of the corporate form for a sector that has generated some of the world's most valuable companies. This explanation, grounded in understanding startup governance, bolsters other efficiency-based arguments that *Trados* can lead to suboptimal outcomes that fail to maximize the firm value.³³³

In addition, when disputes end up in litigation, courts should recognize that corporate law's standard approach to conflicts, such as giving judicial deference to decisions made by a disinterested majority or committee of the board, is often not possible in the startup context.³³⁴ Most participants in the startup lack independence by design. Directors will unavoidably be conflicted in many cases.³³⁵ "Independent" directors typically have social ties in the entrepreneurship community.³³⁶ These social ties and networks are a valuable resource for startups to mobilize the talent, information, and investments needed to grow an innovative company.³³⁷ Social and professional connections also often create the trust necessary for VCs and entrepreneurs to invite an independent director to the board, a practice that should be encouraged as discussed in subsection III.A.1 concerning oversight. Further, courts should

³³² See *supra* subsection III.A.2 (discussing late-stage governance complexity and the increasing number of heterogeneous participants, including large institutional investors and employees).

³³³ See Bartlett, *Shareholder Wealth*, *supra* note 13, at 295 (arguing that *Trados* "risk[s] undermining the utility of the corporate form as a vehicle for maximizing firm value"); Bratton, *supra* note 12, at 945 ("When disputes between venture capitalists and entrepreneurs come to court, a rote presumption favoring the common stockholder is not defensible on efficiency grounds."); Bratton & Wachter, *supra* note 13, at 1905 ("Given two classes of equity, the interests of which conflict, enterprise value maximization works better as the default norm.").

³³⁴ Under current doctrine, director defendants in startups typically face the burden of demonstrating entire fairness, which tends to preclude dismissal at the pleadings stage. See, e.g., *Mehta v. Mobile Posse, Inc.*, C.A. No. 2018-0355-KSJM, 2019 WL 2025231, at *12 (Del. Ch. May 8, 2019) (assuming director-defendants will bear the burden of demonstrating entire fairness and denying motion to dismiss). Even when a company has worked with investment bankers over a three-year period, contacted over a hundred potential buyers, and pursued more than one failed bid with third parties, it may not be able to show at the motion to dismiss stage that the common stock had no economic value before a merger in which the common shareholders received no consideration. See *id.* at *3, *13.

³³⁵ See Bochner & Simmerman, *supra* note 127, at 3 ("[C]onflicts of interest are never very far away in a venture-backed company.").

³³⁶ See *Sandys v. Pincus*, 152 A.3d 124, 129-34 (Del. 2016) (ruling in the context of public company Zynga, previously a venture-backed startup, that independence was lacking for one director because of her social tie of co-owning a private airplane with the company's former CEO and controlling shareholder, and for two VC directors with a network of ongoing business relations with the same former officer and another board member).

³³⁷ See *supra* note 274.

recognize that startups often have only one independent director, if any, available to serve on a special committee.³³⁸

Therefore, the potential for bias and self-interest are significant, but the lack of independence or a special committee does not indicate a lack of good faith efforts to act in the best interest of the corporation. Shareholders have bargained for a different style of board governance. Startup boards have other process protections available, such as hiring an investment banker and doing a thorough market check. In some circumstances, disinterested shareholder approval is another possible process check.

As the full range of process tools often will not be available in the startup context, future case law could more clearly shed light on which practices might be emphasized or adapted.³³⁹ Traditional notions of “fair process” and “fair dealing” could adjust to the startup environment, while still maintaining the essential role that fiduciary duties can serve to police bad faith, opportunistic conduct that harms corporate value. In turn, startup directors can also embrace the opportunity to improve corporate governance practices. At a certain point in a startup’s lifecycle, it becomes more realistic to expect a company to invest in financial and accounting systems, compliance controls, to recruit truly independent board members,³⁴⁰ and more generally to be mindful about building systems for accountability that promote long-term value creation and responsible business practices.

CONCLUSION

As large numbers of startups increasingly pursue growth and transformational technology while remaining private, they have come to represent an essential part of the economy and have a significant impact on employees, communities, and other stakeholders. It is time that far greater attention be devoted to understanding their internal dynamics and the recurring problems they face.

This Article has provided a comprehensive, novel account of startup governance. It is a positive, descriptive framework, built from the ground up with an understanding of the evolving nature of the startup business and capital structure, driving the interrelated set of vertical and horizontal governance issues between all participants. Setting out this framework shows

³³⁸ Delaware courts have applied a higher level of scrutiny to one-member special committees. *Gesoff v. IIC Indus., Inc.*, 902 A.2d 1130, 1149 (Del. Ch. 2006).

³³⁹ See *Cable*, *supra* note 326, at 45-48 (arguing that Delaware courts should provide “more clarity in defining the parameters of fairness review” for startups, “rooted in the practicalities of customary practice”).

³⁴⁰ See *Larcker & Tayan*, *supra* note 242 (discussing the process by which pre-IPO companies develop reliable systems of corporate governance).

that startups are characterized by heterogeneous shareholders, overlapping governance roles, and dynamic change.

This understanding offers important distinctions from prevailing models and paradigms and reveals a richer, more complicated set of conflicts and features. It explains the critical current issues of monitoring failures by startup boards and the governance complexity of extreme late-stage startups. Further, it provides the foundation for doctrinal change, showing that courts could adapt their application of longstanding corporate law principles to fit startups and ensure the continued viability of the corporate form for innovative business.

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