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Taking Stock of Startup Stock Options: Addressing Disclosure and Liquidity Concerns of Startup Employees

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NOTES

Taking Stock of Startup Stock Options: Addressing Disclosure and Liquidity Concerns of Startup Employees

U.S. capital markets are becoming increasingly private. Initial public offerings have steadily declined since the 1990s, and private companies are remaining private over twice as long as they have in the past. Furthermore, private company financing has reached unprecedented levels. Private securities offerings now greatly outpace the value of publicly traded securities. Additionally, recent regulatory changes seem to be accelerating this shift from the public to the private markets. One result of this shift is that private company valuations have grown immensely, so much so that private companies with valuations of over $1 billion exist and are known as "unicorns." While the term "unicorn" connotes rarity, these companies are no longer rare—there are now over 1,200 worldwide. Although this investment and growth in private companies benefits the entrepreneurship industry, it raises serious concerns in the U.S. securities law regime, which inherently assumes that private companies need to go public for access to public investors' money, and are willing to provide information to these public investors to receive said money. As it appears, however, private companies are progressively less reliant on money from public investors.

One stakeholder group caught in the middle of this dilemma is large, private company employees. Employees of private companies commonly receive stock ownership in the company as compensation, and many companies base a large portion of an employee's payment in stock. As a result, employees are substantially invested in their employer. But these large private companies are now staying private much longer than in the past, so employees cannot convert their shares to cash by selling them nor can they rely on others to value their shares by relying on mandatory public disclosures. Furthermore, scholarship has demonstrated that the prevailing private-company valuation method leads

to substantial overvaluation. Additionally, the founders of these companies can misrepresent to employees the value of their compensation. If one of these large companies fails or underperforms, its employees leave the firm undercompensated for their work. This Note proposes that implementing modifications to the existing securities laws will provide employees with information that will help them accurately value their stock options and convert these options to cash. Through this solution, employees and employers will have closer bargaining positions without overburdening employers.

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INTRODUCTION

In early 2003, then nineteen-year-old Elizabeth Holmes founded a medical company, Real-Time Cures.[1] Through this company, which she would later rename Theranos, Holmes sought to expand the efficiency of diagnostic testing in healthcare.[2] She certainly had her doubters, even in the beginning.[3] Nonetheless, she persisted, citing the larger-than-life Steve Jobs as inspiration.[4] Holmes was able to convince others to fund her ambitions, and, as time progressed, Theranos gathered money.

"Gathered" is putting it lightly. Theranos amassed over $700 million in investments over the next twelve years, building a board of high-profile investors and gaining national publicity.[5] Holmes became the youngest self-made female billionaire and Theranos reached a valuation of $9 billion;[6] however, her ambition became artifice. Holmes asserted to investors that she had developed revolutionary breakthroughs in blood testing,[7] but the *Wall Street Journal* and Theranos employees demonstrated that these claims were untrue.[8] Furthermore, journalists alleged that Holmes knew her claims were inaccurate and went to great lengths to conceal Theranos's flaws.[9] This

1. Brendan Pierson, *The Rise and Fall of Theranos Founder Elizabeth Holmes*, REUTERS (Jan. 3, 2022, 7:39 PM), https://www.reuters.com/world/us/rise-fall-theranos-founder-elizabeth-holmes-2022-01-04/ [https://perma.cc/QBQ4-K8VJ].

2. Elizabeth Pollman, *Private Company Lies*, 109 GEO. L. J. 353, 354 (2020).

3. *See* Lydia Ramsey Pflanzer, *The Stanford Professor Who Rejected One of Elizabeth Holmes' Early Ideas Explains What It Was Like to Watch the Rise and Fall of Theranos*, BUS. INSIDER (Mar. 18, 2019, 8:50 AM), https://www.businessinsider.com/stanford-professor-phyllis-gardner-on-theranos-and-elizabeth-holmes-2019-3 [https://perma.cc/UZT8-WDW4] (noting that Dr. Gardner, a Stanford Medical School Professor, had tried to explain to Holmes why her testing idea may not work and believed that "she wasn't getting through to Holmes").

4. Yasmin Khorram, *Elizabeth Holmes Wrote Personal Notes to Herself About 'Becoming Steve Jobs' as Theranos Collapse Began*, CNBC (Sept. 29, 2021, 8:12 PM), https://www.cnbc.com/2021/09/29/elizabeth-holmes-wrote-personal-notes-to-herself-about-becoming-steve-jobs.html [https://perma.cc/SL5P-CX3N].

5. Pollman, *supra* note 2, at 354–55.

6. Sara Randazzo, *A Theranos Timeline: The Downfall of Elizabeth Holmes, a Silicon Valley Superstar*, WALL ST. J. (Sept. 13, 2021, 7:35 PM), https://www.wsj.com/articles/a-theranos-timeline-the-downfall-of-elizabeth-holmes-a-silicon-valley-superstar-11631576110 [https://perma.cc/ES5M-F6BZ].

7. John Carreyrou, *Hot Startup Theranos Has Struggled with Its Blood-Test Technology*, WALL ST. J. (Oct. 16, 2015, 3:20 PM), https://www.wsj.com/articles/theranos-has-struggled-with-blood-tests-1444881901 [https://perma.cc/2VKA-NLUC]. For example, Holmes claimed to be able to run over 240 medical tests with just a few drops of a patient's blood. *Id.*

8. *See id.*

9. *See id.*

later led to a criminal investigation of Theranos.[10] In 2018, the SEC charged Theranos and Holmes with defrauding investors, and the matter was subsequently settled.[11] Later that same year, the DOJ brought wire fraud and conspiracy to commit wire fraud charges against Holmes.[12] Holmes was then found guilty and sentenced to over eleven years in prison for defrauding Theranos investors.[13]

While the Theranos story illustrates the self-destruction of a CEO, Holmes was not the only person damaged. High-profile investors,[14] employees,[15] private companies,[16] and a state municipality[17] invested substantial resources into Theranos.

10. *See Theranos and Elizabeth Holmes: History of the WSJ Investigation*, WALL ST. J. (Aug. 14, 2021, 10:25 AM), https://www.wsj.com/articles/theranos-and-elizabeth-holmes-history-of-the-wsj-investigation-11629815129 [https://perma.cc/66R6-CT7D].

11. Press Release, U.S. Sec. & Exch. Comm'n, Theranos, CEO Holmes, and Former President Balwani Charged with Massive Fraud (Mar. 14, 2018), https://www.sec.gov/news/press-release/2018-41 [https://perma.cc/5UK2-H2TR] [hereinafter SEC Press Release].

12. Press Release, U.S. Dep't of Just., Theranos Founder and Former Chief Operating Officer Charged in Alleged Wire Fraud Schemes (June 15, 2018), https://www.justice.gov/usao-ndca/pr/theranos-founder-and-former-chief-operating-officer-charged-alleged-wire-fraud-schemes [https://perma.cc/CDT3-3GUM].

13. Erin Griffith & Erin Woo, *Elizabeth Holmes Is Found Guilty of Four Counts of Fraud*, N.Y. TIMES (Jan. 3, 2022), https://www.nytimes.com/2022/01/03/technology/elizabeth-holmes-guilty.html [https://perma.cc/S6NM-BXXF]; Erin Griffith, *Elizabeth Holmes Is Sentenced to More than 11 Years for Fraud*, N.Y. TIMES (Nov. 18, 2022), https://www.nytimes.com/2022/11/18/technology/elizabeth-holmes-sentence-theranos.html [https://perma.cc/RKJ4-AU5M].

14. Some of these investors included media tycoon Rupert Murdoch, Venture Capitalist Tim Draper, Oracle Founder Larry Ellison, and VC-firm Fortress Investment Group. Sophia Kunthara, *A Closer Look at Theranos' Big Name Investors, Partners and Board as Elizabeth Holmes' Criminal Trial Begins*, CRUNCHBASE NEWS (Sept. 14, 2021), https://news.crunchbase.com/health-wellness-biotech/theranos-elizabeth-holmes-trial-investors-board/ [https://perma.cc/JHM7-QZXY]. Theranos's board of directors included Henry Kissinger (former Secretary of State), Jim Mattis (former Secretary of Defense), Richard Kovacevich (former CEO of Wells Fargo), and William Foege (former director of the CDC). *Id.*

15. *See* Heather Somerville, *In Elizabeth Holmes Trial, Ex-Theranos Employees Cite Culture of Fear and Isolation*, WALL ST. J. (Nov. 13, 2021, 9:00 AM), https://www.wsj.com/articles/in-elizabeth-holmes-trial-ex-theranos-employees-cite-culture-of-fear-and-isolation-11636812000 [https://perma.cc/XYJ9-6UVJ] ("At Theranos's height, Ms. Holmes employed about 800 people.").

16. Walgreens invested $140 million in a partnership with Theranos. Christopher Weaver, *Theranos, Walgreens Reach Deal to Settle Lawsuit*, WALL ST. J., https://www.wsj.com/articles/theranos-walgreens-reach-deal-to-settle-lawsuit-1498037580 (last updated June 21, 2017, 1:03 PM) [https://perma.cc/F7XM-V8ST]. Walgreens later filed suit against Theranos for breach of contract. *Id.* The companies settled for less than $30 million, representing an over $100 million loss for the pharmacy chain. *Id.* Theranos had extensive partnerships with other companies as well. *See* Kunthara, *supra* note 14 (mentioning Theranos's relationships with the Cleveland Clinic, AmeriHealth Caritas, and Capital BlueCross); *see also* Biz Carson, *Safeway Thought It Was Getting Theranos Tech. Instead It Got a Mess*, PROTOCOL (Oct. 6, 2021), https://www.protocol.com/theranos-safeway-steve-burd [https://perma.cc/8ZR2-8VWL] (discussing how grocery store chain Safeway allegedly sank $350 million into a failed deal with Theranos for installation of blood-testing devices into Safeway stores).

17. *See* Sarah Buhr, *Arizona Residents Are Getting Refunds on Theranos Tests*, TECHCRUNCH (Dec. 18, 2017, 2:33 PM), https://techcrunch.com/2017/12/18/arizona-residents-are-getting-refunds-on-theranos-tests/ [https://perma.cc/BLM6-8S2U].

Theranos's employees, in particular, were wronged.[18] As this Note will discuss, startups[19] like Theranos increasingly rely on paying their employees through employee stock options ("ESOs").[20] While these options offer flexibility for companies, their employees are investing far more in the company than if they were simply paid a typical salary since their livelihood is now tethered to company performance. Combine this phenomenon with the lack of disclosure for private companies, the internal growth of private companies, and illiquidity[21] from private companies now staying private much longer, and a clear problem emerges. Startup employees are deeply invested in their employer and are at the whim of the company if it goes belly up.

This Note proposes that large startups issuing ESOs for compensation should be required to provide significantly more business information to employees so they can make adequately informed financial and income decisions. Simply expanding the available information to employees, however, is not enough. If the employees still cannot liquidate their stock options when they need income, then disclosure is ineffectual. To remedy liquidity issues, this Note also proposes increasing secondary market activity. With the SEC consistently emphasizing attentiveness to amend both the rule allowing private companies to issue equity compensation to employees as well as access to the private markets, this Note hopes to shed light on a possible approach to the above-mentioned problem.[22]

18. Besides losing their jobs, Theranos employees had to negotiate with Holmes and the company for various concessions. *See* Christopher Weaver & John Carreyrou, *Theranos Offers Shares for Promise Not to Sue*, WALL ST. J. (March 23, 2017, 4:44 PM), https://www.wsj.com/articles/theranos-offers-shares-for-promise-not-to-sue-1490301856 [https://perma.cc/FL2Q-LSK4]. This Note will focus on one aspect of their employment: stock-option compensation.

19. For purposes of this Note, a "startup" is a privately traded company seeking financing from outside investors.

20. *See infra* Part II.B. Under a typical compensation plan, an employee receives cash for time worked. Here, an employee receives stock in the company that the employee works for as payment instead of cash. The employee must then sell this stock to obtain cash. *See also infra* Part I.B.

21. "Illiquidity" is the opposite of the term "liquidity". In the financial world, "liquidity" broadly refers to how easily an asset can be converted to cash. *See* U.S. SEC. & EXCH. COMM'N, *Liquidity (or Marketability)*, INVESTOR.GOV, https://www.investor.gov/introduction-investing/investing-basics/glossary/liquidity-or-marketability (last visited Oct. 25, 2022) [https://perma.cc/27EU-CV5T]. Assets are typically illiquid when there are costs surrounding selling or a lack of an existing market for the asset. *Id.* This Note will later expand upon the illiquidity surrounding ESOs. *See infra* Section II.A.3.

22. *See* Tom Zanki, *SEC Could Tighten Eligibility for Private Market Investors*, LAW360 (Feb. 11, 2022, 8:55 PM), https://www.law360.com/articles/1463940/sec-could-tighten-eligibility-for-private-market-investors [https://perma.cc/TXZ4-8U8M]; *SEC Proposes Changes to Form Rule 701 and Form S-8*, COOLEY (Dec. 1, 2020), https://www.cooley.com/news/insight/2020/2020-12-01-sec-

First, Part I provides helpful background on the phenomenon of massive private companies, explains their financing, expands on how private companies become overvalued, and outlines the current disclosure laws for private companies. Part II analyzes how these components fail startup employees and then discusses two approaches to fixing this problem: increasing disclosure and increasing liquidity.

Lastly, Part III proposes a multifaceted solution. First, this Part discusses expanding Rule 701 to require disclosure of a 409A valuation and waterfall analysis to employees periodically and upon issuance of ESOs. Second, this Part proposes increasing liquidity of ESOs by reinterpreting who qualifies as a "shareholder of record." Finally, this Part proposes narrowing the scope of the new disclosure requirements to apply only to private companies that pass a post-money valuation of $1 billion, because at this size, private companies are subject to significant overvaluation issues and have the cash required to handle larger regulatory burdens.

I. BACKGROUND

A. The New Private Market

Traditionally, private companies viewed going public as a necessity for corporate growth.[23] Companies needed access to the public markets to gain valuable capital[24] from public investors, and the largest companies were predominantly public.[25] After all, the disclosure regime

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proposes-changes-rule-701-form-s8#:~:text=Rule%20701%20under%20the%20Securities,employees%2C%20consultants%20and%20directors [https://perma.cc/3WVN-3NH8]; Concept Release on Compensatory Securities Offerings and Sales, Securities Act Release No. 10521, 83 Fed. Reg. 34,958 (proposed July 24, 2018) (asking for public comment on how to update rules behind nonreporting companies issuing securities to their employees).

23. "Going public" to grow a business refers to the process of private companies becoming reporting issuers under the federal securities laws through the initial public offering ("IPO") process. DOUGLAS CUMMING & SOFIA JOHAN, THE OXFORD HANDBOOK OF IPOS 1 (2018). IPOs provide large opportunities to private companies to raise capital. *Id.* For example, U.S. companies have raised over $800 billion in capital from IPOs over the last thirty years. *Id.* Companies can also become reporting issuers through section 12(g) of the Exchange Act, which this Note will later discuss. Securities Exchange Act of 1934, § 12(g)(1), 15 U.S.C. § 78*l*(g)(1); *see infra* note 45 and accompanying text.

24. For purposes of this Note, "capital" will be used interchangeably with "money" and "cash."

25. Jay Clayton, U.S. Sec. & Exch. Comm'n, Remarks to the Economic Club of New York (Sept. 9, 2019), https://www.sec.gov/news/speech/speech-clayton-2019-09-09 [https://perma.cc/Z5PA-84PN] ("Twenty five years ago, the public markets dominated the private markets in virtually every measure. Today, in many measures, the private markets outpace the public markets, including in aggregate size.").

was based on a classic tradeoff: money for information.[26] Today, however, a much different picture exists. Initial public offerings ("IPOs") have been steadily declining since the 1990s.[27] The average time a company remains private before going public has more than doubled,[28] and private companies are now reaching valuations higher than their public competitors.[29] This Section puts forth two main reasons for this new private market—financing and deregulation. Additionally, this Section discusses the phenomenon of exceedingly large private companies, which has resulted from the new private market.

1. Private Company Financing

To understand the new private market, one must first understand how private companies are financed. There are many different types of investors looking to provide money to private companies. To keep things simple, this Note will primarily focus on venture capital financing; however, this model of investing is very similar to other types of private-company financing, which may occur in earlier or later stages of a private company's life.

Venture capital ("VC") is a type of financing where an investment firm provides capital to a startup company that the firm believes will be successful.[30] VC firms are typically operated by a slew of experienced business experts with strong management skills and extensive networks.[31] As a result, the VC firm may also provide advice and expertise on how to properly run the startup post-investment.[32] The firm takes on many risks once it invests in the company—mainly, losing

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26. Verity Winship, *Private Company Fraud*, 54 U.C. DAVIS L. REV. 663, 670 (2020) ("The trade was clear: mandatory disclosure was the price for access to large amounts of capital.").

27. *See* Anat Alon-Beck, *Unicorn Stock Options—Golden Goose or Trojan Horse?*, 2019 COLUM. BUS. L. REV. 107, 144–46; STEPHEN CHOI & A.C. PRITCHARD, SECURITIES REGULATION 490 (5th ed. 2019) ("The relative lack of IPOs in recent years . . . corresponds with a drop in the number of listed domestic companies in the United States. In 1999, the number of listed domestic companies was 7,299. By 2017, that number had fallen to 4,336, a drop of 40%.").

28. Alon-Beck, *supra* note 27, at 111, 147–48.

29. *See* Jennifer S. Fan, *Regulating Unicorns: Disclosure and the New Private Economy*, 57 B.C. L. REV. 583, 601 (2016) (discussing how formerly private Airbnb had a higher valuation while private than its competitor, Hyatt).

30. Adam Hayes, *Venture Capital: What Is VC and How Does It Work*, INVESTOPEDIA, https://www.investopedia.com/terms/v/venturecapital.asp (last updated May 15, 2021) [https://perma.cc/G4S8-FKG2].

31. *See* Alon-Beck, *supra* note 27, at 156 ("VC managers provide services such as mentoring to budding startups and networks of additional investors, potential acquirers, new partners and customers.").

32. *See* Hayes, *supra* note 30.

out on its investment if the company fails. Therefore, the firm is unlikely to volunteer its guidance; rather, it will contract for direct control in company decisions and other protections on its investment.[33] After a certain period, the firm will exit the startup and, if the startup is successful, will do so at a profit. Larger private companies will often receive financing multiple times before going public.[34] Theranos, for example, had ten rounds of financing.[35]

For private companies seeking growth, financing is a lifeline. Many of these private companies do not have access to capital like their larger and more stable public counterparts.[36] Due to this necessity and the ability for lucrative payoffs to early investors, private company financing has become a massive industry.[37] In 2017, SEC research indicated that private securities offerings surpassed $3 trillion, doubling the value of publicly traded stocks and bonds.[38] Additionally, for the past three years, VC firms invested over $100 billion annually in U.S. companies alone and invested approximately $130 billion in 2020, despite the COVID-19 pandemic.[39] This money is also invested broadly throughout the private market—around 43% of current U.S. public companies founded between 1979 and 2013 were VC-backed.[40]

2. Deregulation

Along with a growth in private market financing, several regulatory changes have facilitated private market expansion. These changes include: (1) raising the "shareholders of record" provision, (2) removing employees from the "shareholders of record" category, and (3)

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33. *See infra* Section I.C.1.

34. *See* Yifat Aran, *Making Disclosure Work for Start-Up Employees*, 2019 COLUM. BUS. L. REV. 867, 905.

35. *Organization: Theranos*, CRUNCHBASE, https://www.crunchbase.com/organization/theranos/company_financials (last visited Nov. 22, 2022) [https://perma.cc/56RT-TKYA].

36. *See* TOM NICHOLAS, VC: AN AMERICAN HISTORY 78 (2019).

37. *See* Eliot Brown, *Venture Firms Bask in a Surge of Blockbuster Profits*, WALL ST. J. (Apr. 28, 2021, 7:22 AM), https://www.wsj.com/articles/venture-firms-bask-in-a-surge-of-blockbuster-profits-11619608939 [https://perma.cc/V2QQ-3F3M] (discussing several examples of venture-capital firms making multibillion-dollar returns on million-dollar investments).

38. SCOTT BAUGUESS, RACHITA GULLAPALLI & VLADIMIR IVANOV, SEC, CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF THE MARKET FOR UNREGISTERED SECURITIES OFFERINGS, 2009-2017, at 7 (2018), https://www.sec.gov/files/DERA%20white%20paper_Regulation%20D_082018.pdf?mod=article_inline [perma.cc/R3Z7-DMVP].

39. PRICEWATERHOUSECOOPERS & CB INSIGHTS, MONEYTREE REPORT: Q4 2020, at 5 (2020), https://www.pwc.com/us/en/moneytree-report/assets/pwc-moneytree-2020-q4.pdf [https://perma.cc/Q95P-T5ZX].

40. Ilya A. Strebulaev & Will Gornall, *How Much Does Venture Capital Drive the U.S. Economy?*, STAN. BUS. (Oct. 21, 2015), https://www.gsb.stanford.edu/insights/how-much-does-venture-capital-drive-us-economy [https://perma.cc/3GSY-VLE3].

lowering the minimum-required holding period of stock in a private company.[41]

First, Congress raised the Securities Exchange Act of 1934's ("Exchange Act")[42] "shareholders of record" trigger for public reporting to 2,000 shareholders (with no more than 500 of such shareholders being accredited investors)[43] through the Jumpstart Our Business Startups Act ("JOBS Act").[44] Before this change, a company was required under section 12(g)(1)(A) of the Exchange Act to register with the SEC a class of securities if the class contained 500 or more shareholders.[45] Before the JOBS Act, large private companies had gone public due to the 500 shareholder limit, and the limit had become essentially a roadblock for companies attempting to stay private.[46] The results of this change were significant. At the time of its passing, over two-thirds of public companies did not reach the new threshold.[47] With this amendment, private companies had *substantially* more wiggle room with how they managed shareholders. Besides to provide more freedom to private companies, the documented rationale behind this amendment, or any discussion on its downsides, are limited.[48] There is clear history on why Congress passed the JOBS Act,[49] but the legislative history as to why Congress increased the "shareholders of

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41. While this Note will mainly discuss the three changes mentioned, other regulatory changes have occurred that have facilitated staying private, such as an expansion of who is able to buy shares in private companies and a reduction in barriers to marketing private company shares. *See* Amy Deen Westbrook, *We('re) Working on Corporate Governance: Stakeholder Vulnerability in Unicorn Companies*, 23 U. PA. J. BUS. L. 505, 543–47 (2021).

42. Securities Exchange Act of 1934, 15 U.S.C. § 78a.

43. On a basic level, an "accredited investor" is one who meets one of several requirements on net income, net worth, professional experience, total assets, total investments, or is an entity in which all of the owners are accredited investors. *Accredited Investors - Updated Investor Bulletin*, INVESTOR.GOV (Apr. 14, 2021), https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins/updated-3 [https://perma.cc/CKA5-435A]. These tests indicate that the investor is financially savvy enough to protect themselves. *Id.* Thus, these investors have more freedom to participate in private company disclosures, and private companies are not required to disclose as much information to them. *Id.*

44. Jumpstart Our Business Startups (JOBS) Act of 2012, Pub. L. No. 112-106, sec. 501, § 12(g)(1)(A), 126 Stat. 306, 325.

45. Westbrook, *supra* note 41, at 549–50.

46. *See id.* at 549 (noting how the threshold is what apparently caused Google and Facebook to start IPOs); Michael D. Guttentag, *Patching a Hole in the JOBS Act: How and Why to Rewrite the Rules that Require Firms to Make Periodic Disclosures*, 88 IND. L.J. 151, 171 (2013) (discussing how the threshold had "increasingly become the binding constraint" and had partially caused Facebook, Google, and Microsoft to go public).

47. Robert C. Pozen & John Choates, *Bill to Help Businesses Raise Capital Goes Too Far*, BROOKINGS (Mar. 15, 2012), https://www.brookings.edu/opinions/bill-to-help-businesses-raise-capital-goes-too-far/ [https://perma.cc/HM39-4VQT].

48. Guttentag, *supra* note 46, at 174–75.

49. *See id.* at 173 n.118.

record" limit is, as one scholar would note, "virtually nonexistent."[50] Recently, however, the SEC has considered making changes to its implementation of the "shareholders of record" limit in order to compel more private companies to disclose information.[51]

Second, and also under the JOBS Act, Congress removed employees who receive stock through an employee compensation plan from the consideration of whether a company has reached the 2,000 "shareholders of record" limit.[52] As a result, private companies no longer have to worry whether paying employees in stock will trigger public reporting under the Exchange Act, since employees are not included under section 12(g)(1)(A) of the Exchange Act.[53] Like the "shareholders of record" limit increase, this decision included few, if any, documents explaining the legislators' reasoning.[54] Notably, many large venture-backed technology companies and their stakeholders lobbied for these changes.[55] This change has likely led to increased hiring within companies relying on employee equity stock options. Private companies can now acquire higher and higher numbers of employee shareholders and avoid providing employees information that would otherwise be required by disclosure laws.[56]

Lastly, the SEC reduced the required holding period for holders of private company stock to one year with no conditions.[57] Under Rule 144 of the Securities Act of 1933 ("Securities Act"), holders of private

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50. As explained by Michael D. Guttentag, the only explanation for this aspect of the JOBS Act appears in a House report on the Private Company Flexibility and Growth Act. *Id.* at 174. This report notes that by changing the trigger, Congress eliminated a barrier to "capital formation for small companies." *Id.* Testimony is also cited in the report that the previous trigger of five hundred shareholders disincentivized companies to hire new employees, make acquisitions through stock, and provide stock-based compensation to employees. *Id.* Besides this, there is testimony concerning other proposed regulatory changes that were later included in the JOBS Act. *Id.* at 175.

51. Tom Zanki, *SEC Could Pull More 'Unicorns' into Public Reporting Regime*, LAW360 (Jan. 28, 2022, 9:14 PM), https://www.law360.com/articles/1459446/sec-could-pull-more-unicorns-into-public-reporting-regime [https://perma.cc/77E2-ANML] ("The SEC is powerless to revise statutory thresholds enacted by Congress. But the agency can revisit its rules determining how shareholders of record are determined, which has become a sticking point.").

52. Jumpstart Our Business Startups (JOBS) Act of 2012, Pub. L. No. 112-106, § 502, 126 Stat. 306, 326.

53. CHOI & PRITCHARD, *supra* note 27, at 201.

54. Guttentag, *supra* note 46, at 174.

55. Michael Rapoport, *Tallying the Lobbying Behind the JOBS Act*, WALL ST. J. (May 25, 2012, 9:31 AM), https://www.wsj.com/articles/BL-WB-34693 [https://perma.cc/4Y6C-K9WY] (noting proponents such as the National Venture Capital Association and Biotechnology Industry Organization, a technology group).

56. *See infra* Part I.B.

57. Revisions to Rules 144 and 145, Securities Act Release No. 33-8869, 72 Fed. Reg. 71,456 (Dec. 17, 2007). Originally, holders of private company stock were allowed to resell after two years subject to SEC-required conditions and after three years without conditions. *See* Release of Restricted and Other Securities, Securities Act Release No. 33-6099, 17 SEC Docket 1422, 1428, 1429, 1434 (Aug. 2, 1979).

company stock can engage in secondary market transactions after a year holding period.[58] On top of this, under Rule 144A of the Securities Act, the SEC allows secondary sales to qualified institutional buyers, or QIBs, to occur immediately with no holding period.[59] These changes instantly simplified private company stock transfers and increased the liquidity of private company shares. Unsurprisingly, in the years following the deregulation, platforms emerged that acted as intermediaries for private company stockholders.[60] Startups, which heavily rely on equity compensation for employees, were then required to act quickly to manage their shareholder base.[61] These companies, however, still benefitted since they now had access to a more liquid secondary market without going public.[62]

3. The "Unicorn"

As previously demonstrated, private companies today (1) have access to a massive financing market through venture capital firms and other financers, and (2) have been subject to progressively less regulation. As a result, private companies are simply staying private longer.[63]

These two principals have led to a new kind of private company—the "unicorn." "Unicorns" are startups with a valuation of over $1 billion.[64] This term gained traction around 2013, when an internet article used the term to refer to the thirty-nine VC-backed companies with valuations of over $1 billion.[65] In 2013, only a small fraction of VC-backed companies reached this milestone—hence the name, "unicorn."[66] Over time, however, this number has grown dramatically, and unicorns are no longer as rare as their name

58. 17 C.F.R. § 230.144(b)(1)(i) (2020).

59. 17 C.F.R. § 230.144A (2013); QIBs are buyers that fall under a long list of entities under § 144A(a)(1)(i) and "own[ ] and invest[ ] on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the entity." 17 C.F.R. § 230.144A(a)(1)(i).

60. Pollman, *supra* note 2, at 375.

61. Startups were likely concerned with hitting the 2,000 "shareholders of record" threshold of section 12(g). *See id.; supra* text accompanying notes 41–46.

62. *See id.* at 376 (discussion on intermediaries working with companies to begin "liquidity programs").

63. *See* Westbrook, *supra* note 41, at 520.

64. Aileen Lee, *Welcome to the Unicorn Club: Learning from Billion-Dollar Startups*, TECHCRUNCH (Nov. 2, 2013, 1:00 PM), https://techcrunch.com/2013/11/02/welcome-to-the-unicorn-club/ [https://perma.cc/RZ9W-XEM6].

65. *Id.*

66. *Id.* (discussing, in the context of software startups, how "about .07 percent of venture-backed [companies]" were unicorns).

otherwise indicates.[67] As of February 2023, there are now more than twelve hundred unicorns worldwide with a cumulative valuation of well over $3.8 trillion dollars.[68] Other terms have been adopted to describe these private companies, such as "decacorn" (valuation of over $10 billion) and "hectocorn" (valuation of over $100 billion).[69] As this Note has shown, unicorns have no need to go public to obtain capital as they can obtain all the money they need as a private company.[70]

As private companies, unicorns are subject to limited legally mandated disclosures of information. In fact, they are essentially required to file only two public documents. First, unicorns are required to file a Form D with the SEC when issuing shares to nonemployee investors.[71] Once filed, this form becomes available on the SEC's website. Form D requires information on the issuer's identity, principal place of business and contact information, persons of interest, industry identification, issuer size, applicable federal exemption and exclusions, type of filing, duration of offering, type of securities offered, and minimum investment allowed.[72] Second, unicorns are required to file certificates of incorporation under state corporate laws.[73] A certificate of incorporation is filed with the state that the unicorn is incorporated in, and it sets forth the characteristics of each class and series of stock in the company.[74] Certificates of incorporation are publicly accessible; however, some states, such as Delaware, charge fees for access.[75]

Additionally, unicorns are industry agnostic; however, a large percentage of unicorns are technology companies.[76] As of September 2022, over half of all unicorns could be classified as technology companies.[77] Overall, the technology industry receives most of the

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67. Fan, *supra* note 29, at 587.

68. *The Complete List of Unicorn Companies*, CB INSIGHTS, https://www.cbinsights.com/research-unicorn-companies (last visited Feb. 7, 2023) [https://perma.cc/8CRJ-N86J].

69. *Id.*

70. *See supra* Section I.A.1.

71. *Filing a Form D Notice*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/smallbusiness/exemptofferings/formd (last updated Aug. 30, 2022) [https://perma.cc/U698-F2D5].

72. Fan, *supra* note 29, at 593.

73. *Id.* at 598.

74. *Id.* at 594.

75. *Id.* at 611.

76. *See $1B+ Market Map: The World's 1,170 Unicorn Companies in One Infographic*, CB INSIGHTS (July 6, 2022), https://www.cbinsights.com/research/unicorn-startup-market-map/#:~:text=Unicorn%20company%20trends%20by%20category,and%20artificial%20intelligence%20(7.8%25) [https://perma.cc/2F6Q-MVZB].

77. This conclusion was reached by downloading the list of unicorn companies developed by CB Insights and filtering for unicorns that were classified as operating in one of the following industries: artificial intelligence, cybersecurity, data management & analytics, education technology, financial technology, and internet software and services. *See* CB Insights, Global

available venture funding in the United States.[78] And, the majority of this funding increasingly occurs at later stages of the company's life—put differently, when the technology company reaches or has already reached unicorn status.[79]

B. Employee Equity Compensation in Startups

Unicorns are in a "war for talent."[80] A qualified candidate or employee for a tech company typically has many lucrative employment options available.[81] As a result, these companies experience high employee turnover.[82] Employee stock options came into use in the startup industry in the 1970s and '80s to address this issue.[83] By paying employees in equity ownership, ESOs gave employees the opportunity to invest in the future of their employer and stay long enough to see their employer grow. When a company was ready to go public or merge with another company, employees could cash in on their shares, ideally for a large payoff. Besides incentivizing employees to stay and work hard, these compensation plans also retained cash, which was often in rare supply due to the inconsistent cash flows of most startups.[84] This style of compensation was efficient, but startups offering equity options would still quickly trigger reporting requirements, limiting the efficacy

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Unicorn Club: Private Companies Valued at $1B (Sept. 13, 2022) (on file with author). The result was 690 of the 1,178 existing unicorns, or about 59%. *See id.*

78. Michael Schallehn & Chris Johnson, *Why Venture Capitalists Are Doubling Down on Technology*, BAIN & CO. (Sept. 20, 2021), https://www.bain.com/insights/why-venture-capitalists-are-doubling-down-on-technology-tech-report-2021/ [https://perma.cc/E2HH-GZHK] ("From 2010 through 2020, tech start-ups made up a majority of venture funding across all deals by independent venture capital (VC) firms and corporate venture capitalists.").

79. *Id.*

80. Alon-Beck, *supra* note 27, at 138.

81. The tech sector has the largest turnover rate out of any business sector, according to a 2018 report from LinkedIn. *See* Tim Johnson, *The Real Problem with Tech Professionals: High Turnover*, FORBES (June 29, 2018, 7:00 AM), https://www.forbes.com/sites/forbesbusinessdevelopmentcouncil/2018/06/29/the-real-problem-with-tech-professionals-high-turnover/?sh=3b0f59d84201 [https://perma.cc/SL46-CJ8G]. High turnover has been an ongoing problem, and companies pursue expensive measures to acquire talent, such as acquisitions of entire companies just for their workforce. *See* Thanh Pham, *Analyzing the Software Engineer Shortage*, FORBES (Apr. 13, 2021, 7:00 AM), https://www.forbes.com/sites/forbestechcouncil/2021/04/13/analyzing-the-software-engineer-shortage/?sh=4a16ffa6321c [https://perma.cc/U65N-C58E]; Angus Loten, *Tech Talent Shortage Is Helping Drive M&A Deals*, WALL ST. J., https://www.wsj.com/articles/tech-talent-shortage-is-helping-drive-m-a-deals-11644235210 (last updated Feb. 7, 2022, 12:23 PM) [https://perma.cc/6L8E-JVQP].

82. Alon-Beck, *supra* note 27, at 113–19.

83. Aran, *supra* note 34, at 888.

84. Alon-Beck, *supra* note 27, at 122.

of ESOs.[85] The Supreme Court established disclosure exemptions for indirect equity compensation to employees and for employees who were financially sophisticated.[86] Startups paying equity options to employees that did not meet these exemptions, however, were left out.

To remedy this issue, the SEC promulgated Rule 701.[87] Rule 701 exempts employees' share-based compensation from the Securities Act's public reporting requirements.[88] Specifically, if the aggregate amount of share-based compensation sold does not exceed $10 million[89] within a twelve-month period, then the company is only required to provide employees with a copy of the compensatory plan.[90] Rule 701 has been immensely helpful for startups relying heavily on equity compensation. This rule, however, still applies the same to unicorns, which clearly do not suffer from the cost issues that affect smaller businesses.[91] Furthermore, these large private companies are staying private longer, so employees are along for a substantially longer ride.[92] Thus, employees are taking ownership stakes in larger companies with no effective information to value their investments. As the next Section will discuss, startup employees may only have access to information that misleads them on the value of their investments.

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85. Specifically, startups would run into trouble with the "shareholders of record" trigger discussed above, which, until the JOBS Act, was still a threshold of 500 shareholders, including employees. Aran, *supra* note 34, at 891.

86. *See* Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 560 (1979) (holding that the "equity" the plaintiff employee received through a pension plan was not a security and not subject to reporting requirements because the equity the employee received was too attenuated to the employee's purpose of working); SEC v. Ralston Purina Co., 346 U.S. 119, 125–26 (1953) (creating exemption for employees who have access to the same kind of information available in a disclosure statement, or as more widely known, who can "fend for themselves").

87. *See* 17 C.F.R. § 230.701 (2018).

88. *Id.* § 230.701(a). To clear up any confusion, Rule 701 simply creates an exemption to the general rule that offerings of securities must be registered. *Id.* Companies issuing securities under Rule 701 are still subject to the "shareholders of record" trigger for reporting status, but Section 502 of the JOBS Act established that employees paid in equity compensation are not counted towards the "shareholders of record" trigger. *See supra* Section I.A.2.

89. Companies going over the $10 million limit are required to provide additional disclosures to investors. 17 C.F.R. § 230.701(e). These disclosures include the risks associated with the investment and financial statements. *Id.* This Note will later discuss the flaw of this provision. *See infra* Section II.A.2.

90. *See* 17 C.F.R. § 230.701(e). The provision in the original rule was $5 million, however, this limit has been expanded to $10 million. *See* Exempt Offerings Pursuant to Compensatory Arrangements, Securities Act Release No. 10521, 83 Fed. Reg. 34,940, 34,941 (July 24, 2018).

91. Alon-Beck, *supra* note 27, at 183, 186.

92. *See* Westbrook, *supra* note 41, at 520.

C. Overvaluation of Unicorns

Since its creation in 1934, the SEC has established an extensive disclosure regime for public companies to provide information to investors.[93] Through EDGAR, the SEC's search tool, interested persons can access disclosure forms of public companies, which provide a substantial amount of information on the company's financial health.[94]

Unicorns are private companies and are not subject to the totality of these requirements; rather, they are only required to file Form Ds and a certificate of incorporation.[95] For employees paid under ESOs, unicorns are required to provide only a copy of the compensation plan.[96] As a result, employees may face some confusion with regards to determining the value of their stock options in the company. As this Section will show, the typical sources of information available to startup employees cannot solve this gap and can mislead employees on the value of their stock.

1. Reported Valuations and the Post-Money Formula

As mentioned earlier, VCs take on significant risks when investing in a startup.[97] Accordingly, VCs will protect their investment by contracting for certain rights as stockholders. As a result, VC transactions occur almost entirely through the transfer of preferred stock with special privileges rather than through common stock allocations.[98] Most VC transactions involve preferred stock with conversion rights, allowing the preferred owners the option to convert their shares to common stock at any time pursuant to a conversion ratio.[99] This provision grants VCs the ability to greatly increase their returns during a liquidation opportunity if the investment exceeds expectations. VCs are not limited to contracting for conversion rights and can, and likely will, negotiate for other preferred rights.

In *Squaring Venture Capital Valuations with Reality*, Will Gornall and Ilya A. Strebulaev explain how the use of convertible

93. *See* U.S. SEC. & EXCH. COMM'N, ". . . GOOD PEOPLE, IMPORTANT PROBLEMS AND WORKABLE LAWS": 50 YEARS OF THE U.S. SECURITIES AND EXCHANGE COMMISSION 9–10 (1984).

94. *About EDGAR*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/edgar/about (last visited Oct. 7, 2022) [https://perma.cc/Y58W-QY9T].

95. *See* Fan, *supra* note 29, at 598.

96. *See* discussion *supra* Part I.B. *But see supra* note 89.

97. *See supra* Section I.A.1.

98. Alon-Beck, *supra* note 27, at 134–35.

99. Will Gornall & Ilya A. Strebulaev, *Squaring Venture Capital Valuations with Reality*, 135 J. FIN. ECON. 120, 124–25 (2020).

preferred stock can lead to unrealistically high valuations of VC-backed companies, specifically unicorns.[100] They note this difficulty arises from two characteristics: (1) the shares issued to VCs (convertible preferred shares) often contain several difficult-to-value rights, and (2) VC-backed companies often consist of many classes of shares, with each class having different control rights and cashflow preferences.[101]

To determine the value of a VC-backed company, those inside and outside the VC industry use the post-money valuation formula. The formula consists of multiplying the price per share of the most recent round of financing by the fully diluted number of shares.[102] "Fully diluted" means that the preferred shares exercise their right to convert to common stock and are added to the already existing pool of common shares, along with any employee stock options.[103]

To illustrate the issues arising from applying the post-money valuation formula to VC-backed companies, consider this hypothetical:[104] VC-backed StartUp, Inc. is a technology company out of Silicon Valley that sells software to companies across the United States. StartUp just obtained its first round of financing ("Series A") where it issued five million preferred shares for $10 per share to a VC fund. The Series A shares were promised a one-to-one conversion to common stock and a 1X liquidation preference with participation rights. The 1X liquidation preference allows the VC fund to obtain the full value of its investment before other classes of investors are paid. The participation rights allow the VC fund to receive additional compensation from the remaining proceeds in proportion to its ownership (here, one-third of the total number of shares). Without this participation right, the VC fund must choose whether it receives its liquidation preference or converts to common stock instead. StartUp's ownership structure, accounting for common and Series A, looks like this:

100. *Id.*

101. *Id.*

102. *Id.*

103. *Id.*

104. Special thanks to Professor Brian Broughman for inspiration and guidance on this example.

TABLE 1: STARTUP SHARES

Share Class	**Number of Shares**	**Price Per Share**
Common	10,000,000	$8
Series A	5,000,000	$10

If the post-money valuation formula is applied to StartUp after its most recent round of financing, the result is a valuation of $150 million.[105] StartUp is eventually sold to another company for $125 million. Due to the liquidation preference, the Series A investors are entitled to their initial investment of $50 million before anyone else is paid. And due to the participation rights, the VC fund can still receive other proceeds, so the remaining $75 million is then split between the common and Series A shareholders at $50 million and $25 million, respectively. This sale results in a total payout to Series A shareholders of $75 million and a total payout to common shareholders of $50 million. While the amount paid to each class becomes more balanced at higher prices and common shareholders will eventually make more money,[106] Series A shareholders are making more money per share than common shareholders. Thus, the preferred shares are worth more than the common shares that do not have special rights. This difference in value of share classes, however, is ignored by the post-money valuation formula that treats every class of shares as the same value as the most recent class.[107] When the formula is then used as a substitute for fair value, it overstates the value of common shares and, as a result, misleads the company's employees.[108]

This formula is publicly accepted when discussing VC-backed companies despite its clear issues.[109] A quick Google search will return

105. Obtained by multiplying 15 million shares (fully diluted number of shares) by $10 per share (per share price of most recent round of financing).

106. As the price of the sale increases, the percentage payout for common stock gradually begins to reach the value that common shareholders would be entitled to if Series A shares had no special rights. The sale price must greatly increase before common shareholders get close to receiving two-thirds of the total value of the sale.

107. Gornall & Strebulaev, *supra* note 99, at 122.

108. *Id.*

109. *See id.* at 121 & n.5 ("Many finance professionals, both inside and outside of the VC industry, think of the post-money valuation as a fair valuation of the company. . . . [For example, the post-money valuation of] Square was reported as its fair valuation by the financial media, from the *Wall Street Journal* to *Fortune* to *Forbes* to *Bloomberg* to the *Economist*.").

pages of results of companies that are reaching valuation milestones after receiving their most recent rounds of financing.[110] Each subsequent round of financing a startup receives contains many different provisions for the investor, and the post-money valuation formula does not take these provisions into account. Attempting to measure actual value versus post-money value of unicorns, Gornall and Strebulaev developed an alternative formula to consider the distinctive qualities of each share class and applied it to several unicorns.[111] Under Gornall and Strebulaev's formula, the average unicorn was overvalued by approximately 50%, and sixty-five of the 135 unicorns in their study dipped below a valuation of $1 billion.[112] Gornall and Strebulaev also found that common shares were even further overvalued, with an average overvaluation of 56%.[113]

The post-money valuation formula is seriously flawed, and employees may rely on the reported results of this formula when considering the value of their stock options that are not subject to the benefits of VC preferred stock. Unfortunately, this formula misleads employees on the worth of their investments.

2. Internal Misrepresentation: From High Expectations to Fraud

Unicorns can also become overvalued due to founder misrepresentation. Founders have a variety of incentives to misrepresent: to receive subsequent rounds of financing, higher amounts of financing in each round, or an overvalued price at an IPO. This misrepresentation can range from founders having high expectations to founders covering up substantial flaws in the company's

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110. *See, e.g.*, Maria Armental, *Education-Technology Startup Multiverse Raises $130 Million*, WALL ST. J. (Sept. 28, 2021, 7:00 AM), https://www.wsj.com/articles/education-technology-startup-multiverse-raises-130-million-11632826801 [https://perma.cc/EJ98-TERH] (company valued at around $875 million after VC-financing round); Sean O'Neill, *TripActions Bags $275 Million to Grow Expense Management: Travel Startup Funding This Week*, SKIFT (Oct. 15, 2021, 1:00 AM), https://skift.com/2021/10/15/tripactions-bags-275-million-to-grow-expense-management-travel-startup-funding-this-week/ [https://perma.cc/58DZ-JL99] (company obtaining post-money valuation of $7.25 billion after receiving Series F financing).

111. *See* Gornall & Strebulaev, *supra* note 99.

112. *Id.* at 135.

113. *Id.* Gornall & Strebulaev addressed a shortcoming of their alternative valuation formula–that it ignores future financing rounds–in a later paper. *See* Will Gornall & Ilya A. Strebulaev, *A Valuation Model of Venture Capital-Backed Companies with Multiple Financing Rounds* 2 (June 1, 2021) (unpublished working paper). After modifying their previous formula, they reached the same conclusion as their first valuation article: the post-money valuation formula should not be used as a proxy for stock-option value because it overstates the true value of VC-backed companies. *See id.* at 8, 33.

operations. Unicorns WeWork and Theranos are recent examples of founder misrepresentation.

WeWork's CEO, the eccentric Adam Neumann,[114] had an ambitious vision for a company that owned office space and rented offices to customers on short-term leases.[115] As the investments in the company grew,[116] so too did Neumann's ego and his claims about the company's present and future condition. For example, Neuman claimed to one investor that WeWork would reach revenue of $101 billion by 2023 and be worth $10 trillion by 2028.[117] Obviously, many were skeptical of claims like these and had serious doubts about WeWork.[118] Yet WeWork raised multiple rounds of financing and obtained an enormous post-money valuation of $47 billion.[119] It was not until WeWork began to file for an IPO and investors peered into the company's registration statements that reality set in.[120] Neumann's representations to investors were illogical given WeWork's business model, and WeWork management had made many concerning business decisions.[121] As this information became publicly known, WeWork was forced to postpone its IPO plans after a substantial drop in valuation, and it was two more years before the company was able to go public.[122] As a result, employees relying on the reported valuation of WeWork and internal confidence of the company's growth were effectively misled on the value of their equity.

While WeWork's overvaluation concerned a founder's high expectations about his company, the Theranos scandal highlights how

114. For more information on Neumann's oddities, see Donald C. Langevoort & Hillary A. Sale, *Corporate Adolescence: Why Did "We" Not Work?*, 99 TEX. L. REV. 1347, 1350–58, 1367–74 (2021).

115. *Id.* at 1351.

116. WeWork raised eight rounds of financing, raising $6.85 million in its first round and raising a total of $5.4 billion in its last two rounds. *Id.* at 1352, 1374.

117. Eliot Brown & Maureen Farrell, *The We That Didn't Work at WeWork*, WALL ST. J. (July 17, 2021, 12:00 AM), https://www.wsj.com/articles/wework-adam-neumann-masa-son-cult-of-we-11626474657 [https://perma.cc/2A8J-5BWK].

118. Westbrook, *supra* note 41, at 512–13.

119. Langevoort & Sale, *supra* note 114, at 1350.

120. *See* Brown & Farrell, *supra* note 117 ("Nine months later, the attempted IPO would roil the financial world as investors balked at WeWork.").

121. WeWork's business model—long-term leasing or ownership of office space by the company for rental to its customers on short-term leases—exposed WeWork to substantial liability and did not create the predictable revenue necessary to sustain Neumann's grandiose vision of WeWork. *See* Langevoort & Sale, *supra* note 114, at 1354–55. Additionally, WeWork (driven by Neumann) had made many bizarre business decisions, such as using company funds to establish unrelated businesses and allowing WeWork to be controlled by Neumann for his entire life and, afterwards, his children. *See* Westbrook, *supra* note 41, at 508–10.

122. *See* Sissi Cao, *WeWork Finally Goes Public–Does Anyone Still Want a Piece of It?*, OBSERVER (Oct. 22, 2021, 10:12 AM), https://observer.com/2021/10/wework-go-public-spac-nyse-stock-analysis/ [https://perma.cc/LA8U-MUK4].

a company can become overvalued due to a founder acting fraudulently. As discussed above, Theranos's main product was a portable blood analyzer that could conduct hundreds of medical tests with only one drop of the user's blood and without a needle.[123] Over a dozen years, Theranos amassed a $9 billion valuation.[124] What was held out to be a medical breakthrough was revealed to be a sham, however, when employees released information that the company falsified lab records, and that Holmes misled investors and employees on the efficacy of Theranos's blood tests.[125] The SEC later brought suit against Holmes, which was settled.[126] The DOJ followed soon after, and Holmes was convicted of multiple charges of wire fraud.[127] Like WeWork, the Theranos valuation bubble eventually popped, yet the damage was already done. Hundreds of Theranos employees had lost their jobs, and their equity became worthless as the company shut down, forcing them to rely on payouts from the unreliable Theranos board.[128]

II. ANALYSIS

To recap the discussion so far, the new private market, through a proliferation of financing and relaxed regulation, has led to more startups becoming unicorns. These companies thus avoid the capital-raising need to go public, dodging the public disclosure regime. In turn, employees for these companies, who are paid in equity, are now making a much longer investment in the company than before, since the company no longer has a pressing need to go public. Furthermore, the common sources of information available to employees—reported "valuations" of unicorns and internal information—have serious flaws. The next Section will expand upon the problems employees face and discuss the pros and cons of viable solutions to these problems.

A. Why the New Private Market Fails Startup Employees

1. Lack of Information

The compensation plan required by Rule 701, the reported post-money valuations of unicorns, and the problems associated with

123. *See supra* Introduction.

124. Pollman, *supra* note 2, at 354–55.

125. *Id.* at 355.

126. SEC Press Release, *supra* note 11.

127. United States v. Holmes, No. 5:18-cr-00258-EJD, 2020 WL 666563 (N.D. Cal. Feb. 11, 2020); *see supra* notes 12–13 and accompanying text.

128. *See* Weaver & Carreyrou, *supra* note 18.

internal information related to these companies paints a bleak picture for employees attempting to value their compensation. The disclosure required by Rule 701 is problematic because only providing a copy of the compensatory plan to the employee tells her nothing about the future value of her shares at possible exit points.[129] As discussed earlier, if a company issues share-based compensation to employees that is below $10 million within a twelve-month period, it is only required to disclose a copy of the compensation plan as required by Rule 701.[130] That is all. This plan does not include any discussion of the liquidation preferences, conversion ratios, participation rights, or other benefits of preferred stock present in the structure of unicorns that lead to drastic overvaluation of these companies in public reporting.[131] Furthermore, the SEC has not provided much insight on the information necessary for employees under this plan.[132] Nor has the SEC brought any enforcement actions against equity issuers regarding the terms required in a compensation plan.[133]

Additionally, the information the employee receives while working at the company may be limited. While it might be true that employees are more informed than most since they are on the ground level working *in* the company, savvy founders can limit the information available to their employees by segmenting operations, limiting interactions with other employees, and, in general, creating an environment of secrecy. Founders often have legitimate reasons to limit

129. The next Section will highlight another flaw with Rule 701 and the information available to employees when companies issue over $10 million in securities to employees—the law assumes the employee is financially sophisticated. *See infra* Section II.A.2.

130. Under Rule 701(c)(2), the SEC defines a "compensatory benefit plan" as "any purchase, savings, option, bonus, stock appreciation, profit-sharing, thrift, incentive, pension or similar plan." Robert B. Robbins, *Securities Offerings to Employees, Consultants and Advisors Under Rule 701*, PILLSBURY WINTHROP SHAW PITTMAN LLP 5 (2013), https://www.pillsburylaw.com/images/content/4/8/v2/483/RobbinsRule7012013.pdf [https://perma.cc/P554-VS7T].

131. Aran, *supra* note 34, at 938–39.

132. The SEC has instead emphasized that Rule 701 is to be used for compensatory purposes and not capital-raising purposes, without any mention of employees or their need for information. *Id.*

133. Enforcement actions under Rule 701 are very rare. One action concerned a company issuing over $10 million in shares to employees over a twelve-month period. Michael S. Dicke & Vincent Barredo, *SEC Fines Private Company in First Enforcement Action Resulting from Rule 701 Option Grants Investigation*, FENWICK (Mar. 15, 2018), https://www.fenwick.com/insights/publications/sec-fines-private-company-in-first-enforcement-action-resulting-from-rule-701-option-grants-investigation [https://perma.cc/4NYX-SREH]. The issue in that action was the lack of financial statements and risks disclosures as required for companies issuing over $10 million in shares. *Id.* The action did not involve a lack of disclosure on the benefit plan. *See id.* The only other action that has been reported occurred in 2005 and, like the action in 2018, also involved failure to provide financial information to its employees. Google, Inc., Securities Act Release No. 8523, 2005 WL 82435 (Jan. 13, 2005).

information—such as protecting trade secrets and upkeeping employee morale.[134] Limited access to information, however, creates problems for employees evaluating the worth of their ESOs.

Consider the Theranos scandal.[135] There, Elizabeth Holmes and the Theranos executives created an environment of secrecy.[136] The company set up extensive barriers to communication between employee teams, punished voices raising suspicion by threatening them with dismissal and ridicule, and made extensive use of nondisclosure agreements when employees were hired and left.[137] As a result, it took employees several years to gather the information necessary to expose Theranos's fraud. By then, Theranos had obtained millions of dollars in investments and entered fraudulent business deals.[138] Besides showing how founders can limit exposure of fraud through controlling information, this scandal also illustrates how difficult it can be for the employees to value their ESOs. In cases where founders are being deceptive or, more likely, have a legitimate need for a strong grip on the company's development, expecting the employee to rely on internal information from the company will not always make up for the gap in information that employees need to value their ESOs.

To summarize, due to limited disclosure under Rule 701, employees may instead attempt to rely on information they receive as company insiders, but this information can be limited by founders. If so, employees may then put more reliance on founders' reassurances since they do not have access to the information themselves. This can be troubling if the founder is acting fraudulently or is simply naive. Alternately, these employees may turn to more public sources of information to value their investments, exposing them to the problematic post-money valuation formula.

2. Assumed Sophistication

Another reason why the current disclosure regime fails ESO-granted employees is because it *inherently* assumes that employees are sophisticated investors.[139] Generally, employees are not financially

134. *See* Aran, *supra* note 34, at 917–918, 918 n.171.

135. *See supra* Introduction.

136. *See supra* Introduction.

137. Lauren Rogal, *Secrets, Lies, and Lessons from the Theranos Scandal*, 72 HASTINGS L.J. 1663, 1667–68 (2021).

138. *See id.*

139. This Note uses the term "sophisticated" not in the sense of whether the employee is accredited. Rather, this Note treats sophisticated investors as those, in the words of the *Ralston* court, that can "fend for themselves" through their expertise or ability to analyze disclosures and

sophisticated.[140] Despite the many intelligent and very talented workers at startups and unicorns, these workers are usually not skilled in analyzing financial disclosures.[141] Yet, the law provides them with information that only an employee with financial sophistication can take full advantage of.[142]

Under Rule 701, once an employer provides over $10 million in equity grants to its employees within a twelve-month period, it is additionally required to provide recipients disclosures of financial statements and risk factors.[143] While this is information that can help value investments,[144] it is not information that a financially unsophisticated startup employee is equipped to analyze. These employees need information that clearly explains the value of their equity in dollar values, not disclosures that simply provide them with the means of determining valuation after applying a complicated valuation formula.[145] Furthermore, startups do not like the idea of disclosing such detailed financial information to their employees and are very hesitant to give up this information due to confidentiality concerns.[146]

Relying on employees to interpret information from state certificates of incorporation results in the same negatives. Certificates of incorporation are required by state corporate law and provide

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are not simply "members of the investing 'public.' " *See* SEC v. Ralston Purina Co., 346 U.S. 119, 125–26 (1953).

140. Aran, *supra* note 34, at 902.

141. *Id.*

142. *Id.* at 902–03 (discussing interviews with startup employees and lawyers that indicated the employees interviewed "did not know what to make of [financial statements]" nor did they "find value in the opportunity to access these documents").

143. 17 C.F.R. § 230.701(e) (2018); 17 C.F.R § 230.252(a) (2015).

144. Rule 701 requires quite a large disclosure of information for companies exceeding the $10 million mark. *See supra* note 89. Employee investors are entitled to income statements, cash flows, and statements of stockholders' equity for the previous two years plus any period of the current fiscal year that has been accounted for. Robbins, *supra* note 130, at 19. The issuer is not initially required to provide audited statements. *Id.* If it does have any audited statements, however, these must be provided. *Id.* Lastly, a balance sheet is also required. *Id.* With this information, a knowledgeable investor can get a meaningful understanding of the health of a company and its recent performance.

145. Even if we assume that startup employees are financially sophisticated enough to gain value from these statements, disclosures mandated by Rule 701 do not list the rights of preferred share classes. Aran, *supra* note 34, at 938.

146. The disdain that large private issuers have for enhanced disclosure under Rule 701 is well documented, ranging from interviews with lawyers representing such unhappy firms to the American Bar Association's message to the SEC raising concerns. *See id.* at 932. These complaints are understandable, since the disclosure required by Rule 701, once the $10 million mark is surpassed, may expose information that startups really want to keep private. *See id.* at 931. As discussed earlier, the only two reported enforcement actions regarding Rule 701 involve companies failing to disclose said financial statements required by Rule 701. *See supra* note 133.

information on firm share structure and rights of each class of shareholders,[147] which can be used to reach a valuation number.[148] Employees, however, cannot be reasonably expected to use this information to calculate a proper valuation of the company and their own equity. Any employee attempting to do so would need to understand the substantial impact that preferred rights have on private company valuation, applying a complex formula like Gornall and Strebulaev's to obtain a proper value.[149] This also assumes that employees know their firm's certificate of incorporation exists and can access it.[150]

Overall, employees do have access to *some* information that can help them value their investments; however, the information provided by these sources—namely, expanded disclosures of financial statements under Rule 701 and certificates of incorporation—is only valuable if the reader is savvy enough to understand it. Unfortunately, startup employees are, on balance, not this sophisticated of investors.[151]

3. Illiquidity

Even if there was more information available or financial sophistication among employees, the secondary market for ESO liquidation is not dynamic enough to provide employees an exit when needed.

The current legal regime results in private companies locking up large amounts of ESOs and employees holding illiquid ESOs. In fact, employees of these startups are potentially incredibly wealthy on paper. It is likely that employees hold close to $400 billion in stock globally in unicorns alone.[152] Until these employees can sell their shares, however,

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147. *Certificate of Incorporation*, COOLEYGO, https://www.cooleygo.com/glossary/certificate-of-incorporation/#:~:text=Also%20known%20as%20the%20Articles,US%20state%20such%20as%20 Delaware (last visited May 10, 2021) [https://perma.cc/Z4H2-2HYW] (also referred to as a "charter" or the "Articles of Incorporation").

148. *See* Gornall & Strebulaev, *supra* note 99, at 122.

149. *See id.* at 124–29.

150. Certificates of incorporation are not always free. Delaware, for example, charges a fee for access. *See* Fan, *supra* note 29, at 611.

151. Furthermore, since private company shares do not exist in an efficient market, employees cannot simply rely on the market to incorporate information from certificates of incorporation or financial statements provided due to Rule 701. For a summary of efficient market hypothesis, see Lucas Downey, *Efficient Market Hypothesis (EMH)*, INVESTOPEDIA, https://www.investopedia.com/terms/e/efficientmarkethypothesis.asp (last updated Dec. 31, 2021) [https://perma.cc/8WZT-7367].

152. This number is calculated by taking the current number of unicorns and multiplying it by a low-end prediction for the average percentage of startups' stock dedicated to option pools. *See* CB INSIGHTS, *supra* note 68; Brad Gersich, *The Option Pool: Wading or Olympic Sized*, DLA PIPER, https://www.dlapiperaccelerate.com/knowledge/2017/the-option-pool-wading-or-olympic-sized.html (last visited Oct. 7, 2022) [https://perma.cc/5E9Z-97P6].

this value remains unrealized. As a result, unicorn employees may put substantial pressure on their employers to go public or create liquidity events.[153]

Liquidity events, however, can be monetarily expensive and resource intensive.[154] Many startups, therefore, have guided employees to the secondary markets as a liquidity option.[155] As discussed earlier, the private secondary market has increased significantly as the SEC has removed restrictions to trading.[156] The feasibility of this solution still has some limitations. Mainly, companies allowing employees to sell their shares on the secondary market can still quickly reach reporting status by surpassing the 2,000 "shareholders of record" limit.[157] Additionally, employees may also struggle with finding a buyer for their shares.[158] Investors on the secondary market may be understandably hesitant about buying shares from employees, considering the overvaluation issues discussed in this Note.[159] Furthermore, investors may be dissuaded by the limited public disclosure: certificates of incorporation and Form Ds.

B. Where Do We Go from Here?

1. Increasing Disclosure

Two approaches have been put forth that increase disclosure to ESO-paid employees, but to varying degrees. The first involves multiple financial disclosures on top of disclosing the firm's compensation plan.[160] Specifically, this approach would require a schedule of the

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153. Jan-Erik Asplund, *The Privately-Traded Company: The $225 Billion Market for Pre-IPO Liquidity*, SACRA (Sept. 9, 2020), https://sacra.com/research/the-privately-traded-company-secondary-market-liquidity/ [https://perma.cc/L243-RX9T] (discussing how illiquidity from being private can become an "existential threat" to private companies and that "companies must go public . . . to keep their talent happy"); *id.* (quoting Wayfair CFO Michael Fleisher, "[I]f you can continue to raise money privately, and there is sufficient liquidity for . . . investors, don't go public . . . .").

154. Brianne Lynch, *Why Do Employees Need Pre-IPO Liquidity?*, EQUITYZEN (May 20, 2021), https://equityzen.com/knowledge-center/blog/why-employees-need-liquidity/ [https://perma.cc/4MNJ-BZ8H].

155. *Id.*

156. *See supra* notes 52–59 and accompanying text.

157. *See* Guttentag, *supra* note 46 and accompanying text; *see also* CHOI & PRITCHARD, *supra* note 27, at 204 (discussing how, while secondary market activity is growing with the creation of platforms like Nasdaq Private Market, the private companies typically still retain a right of first refusal on ESO sales likely to avoid the 2,000 "shareholders of record" reporting threshold).

158. Alon-Beck, *supra* note 27, at 173.

159. *See supra* Part I.C; *see also id.*

160. *See* Alon-Beck, *supra* note 27, at 183–85.

amount of capital raised by the company to date, including investors with preferred rights; a disclosure of the firm's accumulated debt; and, whether the firm restricts secondary trading and, if so, how.[161] Further, this proposal would also require disclosure of current and future stock and debt issuances, management team information, a list of substantial investors, and a quarterly estimated fair market value of the stock.[162]

While this approach gives employees significantly more information, it fosters two main problems: (1) it still results in employees obtaining information they do not need, and (2) it requires that unicorns provide sensitive information. Under this "maximalist approach,"[163] employees have access to a plethora of sensitive information. Some of this information is certainly not necessary and is likely to be ignored by employees due to its complexity.[164] In response to this argument, the first approach, however, requires companies to hire an independent purchaser representative for their employees.[165] Companies, though, will still be very concerned with releasing confidential information en masse to employees and subsequent leaks.[166] Additionally, hiring independent purchaser representatives and complying with the disclosure of additional financial information will cost companies—particularly newer startups—money that could be otherwise contributed to the company's early development.[167] While unicorns are likely fit to shoulder these costs, they are not nominal, and companies would still have real concerns about releasing proprietary information.

A second, and less disclosure-heavy, approach exists that gives startup employees access to valuation information and estimated values at exit points.[168] Under this approach, prospective employees upon receival of their offer letter (and assuming the company triggers a

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161. *Id.* at 184–85.

162. *Id.* at 185.

163. Aran, *supra* note 34, at 945.

164. *See supra* notes 142–143 and accompanying text.

165. *See* Alon-Beck, *supra* note 27, at 185 ("[The companies] should also provide employees with the assistance of an experienced and independent purchaser representative.").

166. *See* Aran, *supra* note 34, at 946.

167. Under this proposal, the company would also be required to be independently audited if issuing equity to unsophisticated investors above a certain monetary threshold. *See* Alon-Beck, *supra* note 27, at 185.

168. *See* Aran, *supra* note 34, at 952–63.

two-factor threshold),[169] receive what is known as a 409A valuation[170] and also an exit waterfall analysis.[171] Additionally, Current employees would receive a 409A valuation and waterfall analysis every twelve months and following any material events.[172] A 409A valuation estimates the fair market value of the overall company's common stock, and an exit waterfall analysis illustrates the payout to each class of shares if all of the company's equity is sold. Providing both the 409A valuation and exit waterfall analysis to employees remedies some of the issues mentioned above: it simplifies the information given to employees and somewhat addresses concerns of disclosing proprietary information. By disclosing a 409A valuation and waterfall analysis, the company can explicitly avoid providing the many sensitive disclosures required by the "maximalist approach."[173] Furthermore, the company can provide a final value to employees and a graphical analysis of how it reached that value—it is simple, easy-to-understand information for employees. As the author of this proposal wrote, "The fact that the financial structure of start-ups is often multilayered and complicated . . . does not necessarily dictate that disclosure to employees should be complicated as well."[174]

One important issue arises under this proposal. Given that the disclosure would be provided before the employees begin working, the company could be providing sensitive information to people that it may not ultimately hire.[175] The company could use non-disclosure agreements to protect itself, but this may result in the traditional

169. *Id.* at 956 ("[T]he disclosure should be delivered with the offer letter."); *id.* at 958 (proposing two-part test to trigger advanced disclosure when "(1) the company has issued equity incentives in Rule 701 offerings to 100 employees or more; *and* (2) the aggregate ownership percentage of these employees on a fully diluted basis is more than 10% of a class of the company's equity securities").

170. Under § 409A of the Internal Revenue Code, private companies that issue equity to employees are required by the IRS to obtain a fair market value of the company's stock, so the company can determine the price per share. Andy Przystanski, *What Is a 409A Valuation?*, CARTA (May 26, 2022), https://carta.com/blog/what-is-a-409a-valuation/ [https://perma.cc/F5KH-MU3Z]. Private companies can conduct this appraisal internally or hire an independent auditor to do so. *Id.* Additionally, the company's 409A valuation must be updated yearly and whenever a "material event" occurs. *Id.* For example, a new round of financing would be considered "material." *Id.*

171. The waterfall analysis is used in the process of creating a 409A valuation by the private company. *Waterfall Analysis*, EQVISTA, https://eqvista.com/terminology/waterfall-analysis/ (last visited Oct. 7, 2022) [https://perma.cc/6QQA-GRCT]. In making the 409A report for the IRS, companies use waterfall analyses with their own data to visually determine the payout to every class of shares under any given exit scenario. *Id.* For startups with complex ownership structures, this is very useful. *See id.*

172. Aran, *supra* note 34, at 957.

173. *Id.* at 955.

174. *Id.* at 953.

175. *See id.* at 956.

problems associated with nondisclosure agreements, raise hiring costs, and create litigation costs for enforcement if litigation is necessary.[176]

2. Increasing Liquidity

Less discussed in scholarship is how increasing liquidity could also help employees. Without a way to exit the company, employees are still along for the ride at the whims of the founders—even with greater disclosure. Startups in the past have turned to artificially creating liquidity events, but these are often expensive, take long to execute, and require substantial legal work.[177] Additionally, studies have shown that around 86% of private companies require employees to obtain company approval before selling their shares.[178] Many startups also possess a right of first refusal on employee shares.[179] As discussed, private companies often restrain sale of their shares to avoid reporting requirements.[180] Some argue that companies can avoid the 2,000 "shareholders of record" requirement through grouping shares in special purpose vehicles; however, the success of this approach is questionable.[181] As a result, amending the "shareholders of record" requirement would make it easier for employees to liquidate their ESOs and minimize private companies' worries that free sales of their shares would lead to them being subject to the public disclosure regime. And the SEC is presently considering changing who qualifies as a shareholder "of record."[182]

Even if employees had freedom to trade their shares, it remains uncertain whether other investors would buy them. The secondary private market has grown substantially as the SEC has deregulated

176. *See* Gregory W. McClune, *How Weak Are Employee "Nondisclosure Agreements"? The Answer May Make You Gag*, FOLEY (May 30, 2017), https://www.foley.com/en/insights/publications/2017/05/how-weak-are-employee-nondisclosure-agreements-the [https://perma.cc/VHY5-WFX3] (noting that nondisclosure agreements are problematic because they are governed by nonuniform state laws, are viewed unfavorably by courts, and do not legally replace the need of employers to be protective of confidential information).

177. An IPO or sale of a business are ordinary liquidity events. *See* Lynch, *supra* note 154. Companies can "artificially" create liquidity events through secondary market transactions. *See id.*

178. Matthew Wansley, *Taming Unicorns*, 97 IND. L.J. 1203, 1244 (2022).

179. *Id.*

180. *Id.*; *see supra* note 61 and note 157.

181. In 2011, Goldman Sachs attempted to use special purpose vehicles to help investors indirectly invest in Facebook and avoid section 12(g), but ultimately decided against it due to Rule 12g5-1(b)(3), which prohibits any forms of holding securities primarily to circumvent section 12(g) when the issuer (here, Facebook) knows of this purpose. CHOI & PRITCHARD, *supra* note 27, at 203–04. *But see* Pollman, *supra* note 2, at 372 (discussing use of special purpose vehicles for aggregation of holdings).

182. *See* Zanki, *supra* note 22.

startups,[183] but, just like startup employees, investors on these platforms still suffer from a lack of information.[184] Thus, to incentivize purchasers of employee shares on the private market, disclosure to secondary investors could be increased. Some have proposed increasing disclosure to startup investors, besides employees, by expanding Form D.[185]

III. SOLUTION

As this Note has illustrated, helping employees in startups who are compensated by ESOs requires improving both the information available to employees and the liquidity of their ESOs. Focusing on liquidity *or* increased disclosure does not fully solve the problem, as these two factors are dependent on each other. Without liquidity, employees' wealth is tethered to the company. And, if there is no additional disclosure, employees cannot effectively value their ESOs. To remedy these issues, this Note proposes expanding disclosure by requiring unicorns to provide comprehendible information to employees and expanding liquidity by amending the SEC's interpretation of "shareholders of record."

First, this Note proposes expanding disclosures by requiring that unicorns reveal to ESO-compensated employees a copy of the company's most recent 409A valuation and waterfall analysis. Second, and to increase liquidity of ESOs, this Note proposes that the SEC revisit the "shareholders of record" requirement under section 12(g).

Regarding the first step, requiring a disclosure of a 409A valuation and waterfall analysis is the most realistic way to provide expanded and comprehendible disclosure to employees. The SEC can do this by amending Rule 701.[186] Specifically, the two current levels of disclosure under Rule 701—(1) disclosure of a copy of the compensation plan, and (2) disclosure of financial statements and risk factors once an employer surpasses $10 million in employee stock in a twelve-month period—would be altered. Disclosure of a copy of the compensation plan would remain. If the company issued more than $10 million in stock in

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183. *See supra* notes 41–62 and accompanying text.

184. *See supra* Section II.A.1.

185. *See* Fan, *supra* note 29.

186. The SEC would need to engage in its rulemaking process to amend Rule 701. *An Introduction to the U.S. Securities and Exchange Commission – Rulemaking and Laws*, U.S. SEC. & EXCH. COMM'N: INV. BULL. (Aug. 20, 2015), https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_rulemaking [https://perma.cc/E4B6-U3H9]. First, it would publish a detailed rule proposal for public comment. *Id.* After considering the public's comments on the rule proposal, the Commission would adopt a final rule. *Id.*

an annual period, however, it would no longer be required to provide financial statements and risk factors. Instead, the company's value—rather than the value of the securities issued—would be used to expand disclosure beyond just providing the compensation plan. If the company's post-money valuation is greater than $1 billion, it would then be required to disclose its most recent 409A valuation and waterfall analysis when it issues securities to employees.[187] The disclosure of the 409A valuation and waterfall analysis would occur to prospective employees upon receival of their offer letter. For current employees, disclosure would occur annually or when a material event occurs, such as a subsequent financing round.

Because a unicorn must already obtain 409A valuations[188] and will likely create a waterfall analysis during this process, it is not a substantial regulatory or financial burden to ask of the company.[189] Additionally, this approach helps remedy some of the information leakage issues that arise under the "maximalist approach" discussed above by limiting unnecessary, but sensitive, financial information disclosed to employees.[190] This enhanced level of disclosure also addresses how the current regime assumes sophistication by providing employees with information that they actually need and can comprehend.[191] Furthermore, it is likely that the 409A valuations would be created by independent auditors,[192] so this proposal hopes to avoid conflicts of interest arising from unicorns conducting their own 409A valuations for their employees.

For the second step, the SEC should amend the "shareholders of record" provision to facilitate employee stock sales. The JOBS Act exempted employees from the determination of the "shareholders of record" calculation; however, nonemployee investors are included. A potential way to amend this provision would be to exclude "shareholders of record" calculation the first outside investor that

187. Under the Aran approach discussed above, the enhanced disclosure threshold does not hinge on company valuation, but rather the number of employees issued ESOs and the percentage of company stock owned by employees. *See supra* note 169. This Note opts for an enhanced disclosure threshold determined by valuation instead due to the valuation problems prevalent in unicorns discussed previously. *See supra* Part I.C.

188. As discussed earlier, the funding round leading to the company reaching unicorn status would already require a conduction of a 409A valuation anyways, since this would be a "material event." *See* Przystanski, *supra* note 170.

189. *See* Aran, *supra* note 34, at 948–49.

190. *Id.* at 955; *see* discussion *supra* Section II.B.1.

191. Aran, *supra* note 34, at 954–55.

192. If a private company uses an independent auditor to conduct its 409A valuation, the valuation is presumed valid by the IRS, and it is unlikely for any IRS penalties to arise. *See* Przystanski, *supra* note 170. Private companies are thus incentivized to hire independent auditors to conduct their 409A valuations. *See id.*

employee shares are transferred to. For example, if an employee sold their shares to an outside investor that investor would also not be treated as a "shareholder of record." If the outside investor then sold the shares to another outside investor, the purchaser would then be considered a "shareholder of record." Since who qualifies as an "of record" shareholder under 12(g), like Rule 701, is an SEC interpretation, the Agency can redefine who is considered in the calculation.[193] Under this proposal, this new definition would remedy some of the concerns that startups have when allowing employees to sell their shares on secondary markets.[194] Reinterpreting section 12(g)'s threshold would greatly improve the liquidity of ESOs and lower the percentage of startups that possess contractual rights restricting ESO sales.

This proposal addresses unicorns specifically because unicorns have the resources, through their large accumulations of cash during financing rounds, to shoulder the regulatory and financial burdens that these changes may add. Furthermore, 409A valuations are more accurate when companies become larger, increasing the value of their disclosure to ESO-owning employees.[195] Lastly, as startups grow larger, their capital structures concurrently grow more complicated with each additional round of financing.[196] As a result, overvaluation from reported post-money valuations due to complex capital structures becomes more and more likely.[197]

This proposal does have downsides. Mainly, it still requires the use of nondisclosure agreements by companies to preserve proprietary information. This is, however, unavoidable when addressing the

193. Increasing liquidity through section 12(g) could also be accomplished by amending the Exchange Act through legislation and increasing the number of investors that private companies are allowed to have before being subject to reporting requirements. Increasing section 12(g)'s limit is precisely what the JOBS Act did. *See supra* notes 42–51 and accompanying text. This proposal, however, hopes to avoid all the complications of legislation by asking the SEC to amend its own interpretation instead through its rulemaking process. *See supra* note 186 (briefly explaining rulemaking).

194. Startups may still want to restrict the sale of shares to incentivize employees to remain with the company. *See* discussion *supra* Part I.B. The SEC, however, could at least alleviate the concern that the sale of employee shares to outside investors would potentially lead to becoming a reporting company.

195. While 409A valuations have been criticized as inaccurate, the startup's control over the 409A valuation, and ability to artificially lower it for purposes of paying employees lower valued options, decreases as the company grows. Aran, *supra* note 34, at 949–50. As the company starts to look more "public," the startup's cash flows start to resemble those of more stable public companies. *Id.* at 950.

196. *See supra* notes 93–113 and accompanying text.

197. *See supra* notes 93–113 and accompanying text.

liquidity and disclosure surrounding ESOs.[198] Unicorns also have sufficient resources to cover costs arising from nondisclosure agreements.

It can also be argued that even if the definition of "shareholders of record" is amended, startups may still want to preserve control over how employees trade their shares. While this may be true, this proposal should give employees more bargaining power, since the company would have less incentive to rely on rights of first refusal and company approval policies to ensure its compliance with section 12(g).

Lastly, it can be argued that non-employee investors suffer from the same information issues that employees do, and, thus, they will be unlikely to purchase employee shares. But while these shares are issued by private companies that are not required to disclose information to retail investors, nonemployee investors are better equipped to appreciate these information issues than employees. For example, secondary market platforms generally require that purchasers are accredited investors.[199] Furthermore, some investors interested in purchasing employee shares often do have access to financial information. When private companies complete a financing round, the institutional investors of the round have learned financial information about the startup throughout financing negotiations, and these institutional investors will use this information to also purchase employee shares.[200]

CONCLUSION

The new private market has grown through financing and deregulation. This Note illustrates that private companies can become highly overvalued due to misrepresentation and underlying share structures. This Note also illustrates the use of ESOs in the compensation of startup employees. When startups reach massive sizes, their potential to damage employees is greatly increased, and, due to limited information and illiquidity, employees cannot protect themselves. Expanding disclosure to employees *or* increasing ESO liquidity helps but is nonetheless inadequate. To truly help startup employees, both insufficient disclosure *and* ESO illiquidity must be improved.

As a result, this Note proposes a multistep solution to increase liquidity and disclosure. First, the SEC should amend Rule 701 to

198. While this proposal requires multiple rule changes, it avoids the need for any congressional legislation.

199. Wansley, *supra* note 178, at 1252.

200. *See* Pollman, *supra* note 2, at 376–77, 377 n.146.

provide disclosure of a 409A valuation and waterfall analysis to unicorn employees. Second, and to increase liquidity, the SEC should amend the "shareholders of record" definition under section 12(g)—ideally, to not include initial secondary sales of ESOs. By limiting parts of this proposal to unicorns, this Note addresses the unicorn overvaluation issues discussed above and remedies accuracy concerns surrounding 409A valuations.

Through this approach, employees would have access to needed information. That is, metrics that help them easily value their investment without requiring serious financial knowledge. Furthermore, under this approach, employees are less likely to be tethered alongside the company due to illiquidity. If employees want to exit the unicorn and turn their ESOs into well-deserved cash, this solution reduces the barriers for them to do so.

Unicorns are now a substantial aspect of the private markets. Their number grows each day, surpassing 1,200 at the time of writing this Note. They are also growing larger and larger, and these companies are too impactful to be ignored. By updating our laws to address the new issues that surround unicorns in the context of employee compensation, we can give employees a fighting chance for when the next Theranos or WeWork inevitably arises.

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