# *ARTICLES*

# AGENCY COSTS OF VENTURE CAPITALIST CONTROL IN STARTUPS

JESSE M. FRIED* & MIRA GANOR**

*Venture capitalists investing in U.S. startups typically receive preferred stock and extensive control rights. Various explanations for each of these arrangements have been offered. However, scholars have failed to notice that these arrangements, when combined, often lead to a highly unusual corporate governance structure: one where preferred shareholders, rather than common shareholders, control the board and therefore the firm itself. The purpose of this Article is threefold: (1) to highlight the unusual governance structure of these VC-backed startups; (2) to show that preferred shareholder control can give rise to potentially large agency costs; and (3) to suggest legal reforms that may help VCs and entrepreneurs reduce these agency costs and improve corporate governance in startups.*



* Professor of Law, University of California, Berkeley; Co-Director, Berkeley Center for Law, Business and the Economy.

** J.S.D. Candidate, University of California, Berkeley. For comments, we would like to thank Raj Aggarwal, Lucian Bebchuk, Brian Broughman, Albert Choi, Mel Eisenberg, Allen Ferrell, Victor Fleischer, Naomi Fried, Zohar Goshen, Mitu Gulati, Sharon Hannes, Reinier Kraakman, Kim Krawiec, Amir Licht, Anup Malani, Steve Marks, Vahagn Movsesyan, Mark Ramseyer, Mark Roe, Bob Scott, Gordon Smith, Zenichi Shishido, Reed Shuldiner, Paul Stephan, Leo Strine, Guhan Subramanian, Fred Tung, Manuel Utset, Noam Wasserman, Craig Zaim, and workshop participants at Boalt Hall, Boston University, the University of Michigan, and the University of Virginia. Monami Chakrabarti, Elizabeth Jin, Thomas King, Tien Wei Lee, Kim Madigan, and the editors of the *New York University Law Review* provided valuable editorial assistance. We would also like to thank many Silicon Valley angel investors, venture capitalists, entrepreneurs, and lawyers for useful discussions, especially Steve Bochner, Ephraim Heller, Aamer Latif, Rony Sagy, and Lisa Suennen. We gratefully acknowledge support from the Boalt Hall Fund and the Berkeley Committee on Research. Comments are welcome and can be sent to us at friedj@law.berkeley.edu or mganor@boalthall.berkeley.edu. 

## INTRODUCTION

Venture capitalists (VCs) play a significant role in the financing of high-risk, technology-based startup companies, investing billions of dollars annually in these businesses.[1] VCs also provide valuable man-

[1] *See, e.g.*, News Release, Ernst & Young, Increased U.S. Venture-Capital Investing in Fourth Quarter Drives Annual Total to Highest Level in Four Year [sic] (Jan. 23, 2006), http://www.ey.com/global/content.nsf/US/Media_-_Release_-_01-23-06DC (reporting $22.13 billion of VC investment in United States during 2005).

agement and strategic advice to these startups, many of which are founded by entrepreneurs with little business experience.[2] As a result, venture capital is an important contributor to economic growth in the United States and elsewhere.[3]

Given venture capital's importance to the economy, it is not surprising that the subject has attracted considerable interest from economists and legal scholars.[4] The academic literature on venture capital has examined various stages of the venture funding process, including the raising of capital from a venture capital fund's limited partners;[5] the VCs' selection of, and investment in, the fund's portfolio compa-

---

[2] *See* David J. Denis, *Entrepreneurial Finance: An Overview of the Issues and Evidence*, 10 J. CORP. FIN. 301, 305–07 (2004) (surveying financial economics literature on active role taken by VCs in relationship with portfolio companies); Josh Lerner, *Venture Capitalists and the Oversight of Private Firms*, 50 J. FIN. 301 (1995) (studying VC monitoring of portfolio companies).

[3] *See* Duke K. Bristow et al., *Venture Capital Formation and Access: Lingering Impediments of the Investment Company Act of 1940*, 2004 COLUM. BUS. L. REV. 77, 80 ("[VCs] perform a vital function for the economy and for society."); Josh Lerner, *Boom and Bust in the Venture Capital Industry and the Impact on Innovation*, FED. RES. BANK OF ATLANTA ECON. REV., Fourth Quarter 2002, at 25, 25 ("[Venture capital is] an important contributor to technological innovation and economic prosperity . . . .").

[4] *See, e.g.*, Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 901 (2003) (arguing that VCs' use of convertible preferred stock is driven by tax considerations); Thomas Hellmann & Manju Puri, *The Interaction Between Product Market and Financing Strategy: The Role of Venture Capital*, 13 REV. FIN. STUD. 959, 960 (2000) (noting that VCs provide added value to their portfolio companies by helping to professionalize management); Leslie A. Jeng & Philippe C. Wells, *The Determinants of Venture Capital Funding: Evidence Across Countries*, 6 J. CORP. FIN. 241 (2000) (analyzing factors affecting venture capital financing in 21 countries); George G. Triantis, *Financial Contract Design in the World of Venture Capital*, 68 U. CHI. L. REV. 305, 311–16 (2001) (comparing VC financing to bank financing); Douglas Cumming, *Adverse Selection and Capital Structure: Evidence from Venture Capital* 1–3 (Univ. of N.S.W., Working Paper, 2005), *available at* http://ssrn.com/abstract=261693 (examining capital structure of Canadian startups).

[5] *See, e.g.*, Paul Gompers & Josh Lerner, *The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 39 J.L. & ECON. 463, 493, 496 (1996) (finding that VC partnership agreements differ with respect to inclusion of covenants, and that use of covenants is related to extent of potential agency problems and supply and demand in venture capital industry). *See generally* Michael Klausner & Kate Litvak, *What Economists Have Taught Us About Venture Capital Contracting*, *in* BRIDGING THE ENTREPRENEURIAL FINANCING GAP: LINKING GOVERNANCE WITH REGULATORY POLICY 54 (Michael J. Whincop ed., 2001) (summarizing scholarship on contracts between venture capitalists and investors); Kate Litvak, *Governance Through Exit: Default Penalties and Walkaway Options in Venture Capital Partnership Agreements*, 40 WILLAMETTE L. REV. 771, 771–72 (2004) (analyzing stage financing in VC partnership agreements); William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473 (1990) (describing and analyzing relationship between investors and VCs).

nies;[6] the monitoring of these companies;[7] and exit (through an IPO, a sale, or dissolution of the portfolio firm).[8]

Much of this literature has focused on the structure of VCs' cash flow and control rights in their portfolio companies. In the United States, VCs' cash flow rights differ significantly from those of other shareholders. Founders, early "angel" investors, and employees hold common stock. In contrast, VCs investing in U.S. startups almost always receive convertible preferred stock with substantial liquidation preferences.[9]

VCs also typically receive extensive control rights in venture-backed startups. Like preferred shareholders in other companies, VCs obtain substantial protective rights in their preferred stock contracts, such as the right to veto changes in the certificate of incorporation. More importantly, and unlike public company preferred shareholders, VCs also often obtain board control. As a result, pre-

---

[6] *See, e.g.*, Paul A. Gompers, *Optimal Investment, Monitoring, and the Staging of Venture Capital*, 50 J. FIN. 1461, 1461–62 (1995) (analyzing structure of VC investments and attributing staged financing to information asymmetries and agency costs); George W. Fenn et al., *The Economics of the Private Equity Market* 29 (Bd. of Governors of the Fed. Reserve Sys., Staff Studies Series No. 168, 1995), *available at* http://www.federalreserve.gov/pubs/staffstudies/1990-99/ss168.pdf (studying private equity markets and describing VCs' investing activities, including selecting, structuring, monitoring, and exiting). For further empirical work analyzing VC investment contracts, see, for example, Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281 (2003).

[7] *See, e.g.*, Malcolm Baker & Paul A. Gompers, *The Determinants of Board Structure at the Initial Public Offering*, 46 J.L. & ECON. 569, 570–71 (2003) (finding that VC-backed IPO firms have more independent outside directors); Gompers, *supra* note 6, at 1461, 1465, 1485 (arguing that staged financing is used to facilitate monitoring); Thomas Hellmann & Manju Puri, *Venture Capital and the Professionalization of Startup Firms: Empirical Evidence*, 57 J. FIN. 169 (2002) (finding that VCs help professionalize startup companies); Lerner, *supra* note 2 (studying changes in VCs' involvement in their portfolios as reactions to changes in need for oversight).

[8] *See generally, e.g.*, Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243 (1998) (analyzing VCs' exit through IPO and relation between stock market and VC market); Douglas J. Cumming & Jeffrey G. MacIntosh, *A Cross-Country Comparison of Full and Partial Venture Capital Exits*, 27 J. BANKING & FIN. 511 (2003) (studying different types of exit and arguing that partial rather than full exit is used to signal quality in cases of information asymmetry); D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315 (2005) (studying exit provisions in VC contracting and finding increase in VCs' control over exit with stage of investment).

[9] As Part II.B.1, *infra*, describes in more detail, preferred stock offers investors more senior rights than does common stock. Most importantly, preferred stockholders have a "liquidation preference": a claim to the proceeds from the sale of the business that ranks ahead of claims by common shareholders. Preferred stock is said to be "convertible" if the holder has the right to convert to a designated number of common shares. Most preferred stock issued to VCs is convertible.

ferred-owning VCs frequently acquire substantial power over other participants in the startup.

The literature on VC investment arrangements suggests that VCs' cash flow and control rights reflect the parties' efforts to minimize agency costs. In particular, VCs' enhanced cash flow and control rights may reduce the moral hazard problems associated with financing entrepreneurs. For example, VCs' use of preferred stock may provide founders with stronger incentives to generate value, and board control may enable VCs to more easily monitor and replace poorly performing entrepreneur-managers.

VCs' use of preferred stock may also result, in part, from an implicit tax penalty associated with their use of common stock.[10] Under the current tax regime, VCs' use of common stock could effectively subject the firm's employee compensation to a higher tax rate.[11] This, in turn, might require the firm to pay employees more, which would reduce the founder's and investors' returns.[12] Thus, when negotiating over the terms of VC investment, both the founder and the VCs have a tax incentive to structure the deal using preferred rather than common stock. There is evidence that VCs' use of preferred stock may be driven by these tax considerations in many cases. For example, outside the United States, where tax rules are different, VCs frequently use common stock when investing in startups.

Surprisingly, little attention has been given to the fact that the combination of VCs' cash flow and control rights, whatever their origin, often leads to a highly unusual corporate governance structure: one in which preferred—rather than common—shareholders control the board and the corporation. The purpose of this Article is threefold: (1) to highlight the unusual governance arrangements of these venture-backed startups; (2) to show that preferred shareholder control can give rise to its own set of agency costs by leaving common shareholders vulnerable to preferred shareholder opportunism;[13] and (3) to suggest possible legal reforms aimed at helping entrepreneurs and VCs reduce these agency costs and improve corporate governance in startups.

Our first objective is to highlight an important point that has been overlooked in the literature: VCs' investment in startups frequently creates a corporate governance structure that is, as far as we know,

---

[10] *See* Gilson & Schizer, *supra* note 4, at 901 (arguing that VCs' use of convertible preferred stock is driven by tax considerations).

[11] *See infra* Part II.A.3.

[12] *See infra* Part II.A.3.

[13] We use the term "opportunism" to mean self-serving behavior that reduces total value—the value available to all parties affected by the behavior.

unique. In a typical corporation, the board is controlled by common shareholders and is expected to serve their interests. Under the courts' long-standing approach to corporate fiduciary duties, a board controlled by common shareholders owes no fiduciary duty to the preferred; it is free to take steps that benefit the common even if doing so imposes much larger costs on the preferred. To reduce the risks associated with common-shareholder opportunism, preferred shareholders usually negotiate elaborate agreements with the corporation designed to contractually protect their interests. This standard arrangement—common in control, with no fiduciary duty owed to the preferred—is considered desirable because, among other reasons, common shareholders generally have the greatest incentive to increase corporate value.

In contrast, in a VC-backed startup, preferred shareholders often receive *both* protective provisions *and* board control. And, under what we call the courts' "control-contingent" approach to fiduciary duties, giving control to the preferred effectively alters the board's fiduciary obligations. A preferred-controlled board, unlike a common-controlled board, is not required to serve the interests of common shareholders. Rather, it may take steps that reduce the value of the common shares, as long as those steps can be justified as in the "best interests of the corporation." Thus, unlike the standard corporate arrangement in which the common shareholders control the board and directors owe no fiduciary duty to the preferred shareholders, in many VC-backed startups the preferred shareholders control the board and have leeway to advance their own interests at the expense of common shareholders.

The second purpose of this Article is to show that common shareholders may be vulnerable to preferred shareholder opportunism when preferred shareholders control the board. In particular, we show that preferred-owning VCs may sometimes have an incentive to pursue lower-value, lower-risk investment and exit strategies over higher-value, higher-risk strategies that would benefit shareholders as a group. For example, VC-controlled boards may prematurely push for liquidation events, such as dissolutions or mergers, that hurt common shareholders more than they benefit the preferred, thereby reducing total shareholder value.[14] We show that potential legal and

[14] Of course, VC control of the board facilitates other forms of VC opportunism that would arise regardless of the form of their investment (whether it is through preferred or common stock). *See, e.g.*, Manuel A. Utset, *Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital-Financed Firms*, 2002 WIS. L. REV. 45, 110–12 (describing potential for VC opportunistic behavior at exit stage). VCs might push for quick IPOs for grandstanding purposes, i.e., in order to attract attention that will help them

non-legal mechanisms for preventing such value-reducing behavior—such as fiduciary duties, shareholder voting, appraisal rights, and VCs' reputational considerations—are unlikely to be effective in many cases. Thus, while VCs' cash flow and control rights may reduce the parties' tax burden and certain agency costs, they likely give rise to another set of agency costs.

We also explain that the mere expectation of preferred opportunism may adversely affect the behavior of current and potential common stockholders even before VCs invest. First, the prospect of preferred opportunism makes it more expensive for entrepreneurs to raise equity capital from investors who typically invest through common stock, such as angel investors. Second, the possibility of preferred opportunism could reduce the incentive effects and financial value of the common stock widely used to compensate employees of such companies.

We also consider the incidence of the agency costs of preferred control and the parties' ability, under current legal rules, to reduce them. If capital and labor markets are perfectly competitive, the costs and benefits of VCs' investment arrangements—including the agency costs of preferred control—are borne solely by entrepreneurs. Thus, everything else being equal, entrepreneurs would benefit from eliminating or reducing the agency costs of preferred shareholder control.

As we explain, however, existing tax rules and the courts' current control-contingent approach to fiduciary duties make it costly (or impossible) for entrepreneurs to take certain steps that would reduce preferred opportunism. For example, VCs could be given common stock rather than preferred. Such an arrangement would completely eliminate the agency costs of preferred control. However, it would also penalize the parties by increasing the tax cost of employee compensation. Alternatively, VCs could be given preferred stock but denied control of the board. This arrangement would eliminate the

raise subsequent funds (at the expense of even their own limited investors). *See* Paul A. Gompers, *Grandstanding in the Venture Capital Industry*, 42 J. FIN. ECON. 133, 133 (1996) (showing that younger VCs may take companies public early in order to market themselves); Peggy M. Lee & Sunil Wahal, *Grandstanding, Certification and the Underpricing of Venture Capital Backed IPOs*, 73 J. FIN. ECON. 375, 405 (2004) (describing loss of wealth to investors in VC funds from grandstanding). VCs might take corporate opportunities from one portfolio company and give them to other portfolio companies in which they have larger stakes. Finally, VCs might engage in self-dealing transactions, such as selling themselves cheap stock. *See, e.g.*, Kalashian v. Advent VI L.P., No. CV-739278, 1996 WL 33399950, at *1–2 (Cal. App. Dep't Super. Ct. Oct. 4, 1996) (VCs alleged to have engaged in self-dealing by selling stock below fair market value and diluting equity of common shareholders). In this Article, however, our focus is on the problems that arise solely because (1) VC investment takes the form of preferred stock; and (2) VCs control the board.

agency costs of preferred control and avoid the tax penalty associated with a common-only capital structure. But it would expose VCs to the risk of common-shareholder opportunism, a risk exacerbated by the courts' insistence that a common-controlled board owes no fiduciary duty to preferred shareholders.

The third and final purpose of the Article is to examine the possibility of altering the mandatory legal framework within which entrepreneurs and VCs must currently contract to help them reduce the agency costs of preferred opportunism and increase the size of the startup pie. The problems we identify all arise from (1) the existence of a capital structure that includes both common and preferred stock; (2) board control by the preferred shareholders; and (3) the vulnerability of the non-controlling common to opportunism by the controlling preferred. Thus, to the extent that changing tax and corporate fiduciary laws can reduce the use of dual-class structures and, in dual-class corporations, reduce controlling-class opportunism, altering these rules may well be socially beneficial.

We first consider how the tax treatment of stock compensation in startups might be modified to eliminate the penalty for VCs' use of common stock. To the extent that VCs' use of preferred is caused by tax considerations, leveling the tax playing field would lead VCs to invest through common, as they often do when investing outside the United States, thereby eliminating the agency costs of preferred control. We first explain why reducing the penalty for VCs' use of common stock through tougher enforcement of the tax laws against preferred-issuing firms might impose too high a cost on startups to be socially desirable. We then put forward for discussion a proposed change to the substantive tax rules that would completely level the tax playing field without imposing additional costs on startups.

However, VCs' use of preferred stock is unlikely to be tax-driven in every case. Thus, some dual-class structures are likely to persist even if the tax playing field is leveled. Accordingly, we consider whether the courts' current control-contingent approach to fiduciary duty rules could be modified to improve corporate governance in startups. We propose that firms be permitted to use corporate charter provisions to "opt into" more restrictive fiduciary duty rules when the parties believe such rules would improve corporate governance. For example, firms should be allowed to opt into what we call a "balancing approach" to fiduciary duties. Under the proposed approach, a board would violate its duty of loyalty to the corporation and its shareholders whenever it acts to benefit one group of shareholders and in doing so imposes a greater cost on another group of shareholders. We

explain how such a rule may improve the governance of not only preferred-controlled startups but common-controlled startups as well.

Before proceeding, we wish to make clear our assumptions about the bargaining that occurs when VCs invest in an entrepreneur's startup. Although we doubt that many entrepreneurs are well advised and fully informed when contracting with VCs,[15] for purposes of this Article we assume that entrepreneurs, VCs, and other parties enter into arrangements that, taking current tax and corporate law rules as given, serve each of their interests. Our claim is that these rules distort the parties' arrangements and board decisionmaking, thereby limiting the size of the pie that the parties can create. Modifying this mandatory legal framework, we argue, would enable the parties to produce and share a larger pie.

The remainder of the Article proceeds as follows. Part I describes the standard corporate governance arrangement, in which common shareholders control the board and directors do not owe a fiduciary duty to preferred shareholders (or to any other investors). Part II highlights the unusual corporate governance arrangement of venture-backed startups: one where those usually controlling the board—the VCs—own preferred stock rather than common, and directors do not owe a fiduciary duty to the common. It also explains the possible agency cost and tax benefits of these arrangements. Part III shows that this unusual arrangement leaves common shareholders vulnerable to opportunistic behavior by preferred-controlled boards, thereby giving rise to a different set of agency costs. Part IV puts forward and discusses our legal reform proposals that are designed to help entrepreneurs and VCs reduce the agency costs associated with their arrangements.

## I
## ORDINARY CORPORATE GOVERNANCE: COMMON SHAREHOLDERS IN CONTROL

This Part briefly discusses the corporate governance arrangements that are found in almost all private and public corporations. In the typical corporation, the entire board of directors is elected by

[15] *See generally* Mark C. Suchman et al., *The Legal Environment of Entrepreneurship: Observation on the Legitimation of Venture Finance in Silicon Valley*, *in* THE ENTREPRENEURSHIP DYNAMIC: ORIGINS OF ENTREPRENEURSHIP AND THE EVOLUTION OF INDUSTRIES 349 (Claudia Bird Schoonhoven & Elaine Romanelli eds., 2001) (reporting that financing terms are standard across investments, which suggests that they may not be bargained over but rather presented to entrepreneurs on take-it-or-leave-it basis). *Cf.* Utset, *supra* note 14, at 100–01 (arguing that entrepreneurs are overly optimistic, inexperienced, and likely to over-rely on VCs' representations of contractual content).

common shareholders; preferred shareholders do not have the right to vote for directors. And under what we call the "control-contingent" approach to corporate fiduciary law, these common-elected directors owe a fiduciary duty only to common shareholders. As long as the firm respects the contractual rights of the preferred shareholders, directors are free to pursue the interests of the common at the expense of the preferred. Thus, a common-elected board may take steps that benefit common shareholders even when those steps reduce total shareholder value. Commentators justify this approach on two grounds. First, common shareholders' interests are generally aligned with corporate value maximization. Second, common shareholders are uniquely vulnerable to insider opportunism because, unlike preferred shareholders, they lack contractual protection.

### *A. The Board: Controlled by Common*

A corporation is run by its board of directors. The board manages the business and affairs of the company[16] and initiates fundamental transactions, such as mergers, IPOs, or liquidations.[17] All major "organic" decisions, such as whether to reincorporate in another state or merge with another company, must be approved by the board. The board hires, monitors, and may replace the CEO. It also makes a wide variety of other important decisions, such as how to respond to acquisition offers and whether to seek additional financing or distribute cash to shareholders.

The board, in turn, is elected—and can be replaced—by those shareholders entitled to vote for directors.[18] In most firms—even those that issue preferred stock—the right to elect the board is vested solely in one or more classes of common stock.[19] Thus, ultimate con-

---

[16] DEL. CODE ANN. tit. 8, § 141(a) (2001); CAL. CORP. CODE § 300(a) (West 1990); REVISED MODEL BUS. CORP. ACT § 8.01 (1984).

[17] Shareholders, on the other hand, usually cannot initiate fundamental transactions even when their approval is required to effectuate the transaction. *See, e.g.*, Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261, 301–03 (2001) (noting reactive nature of shareholder voting to actions by board in takeover context).

[18] DEL. CODE ANN. tit. 8, § 141(k) (2001).

[19] *Cf.* Marcel Kahan & Edward B. Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions as Precommitment*, 152 U. PA. L. REV. 473, 493 n.57 (2003) ("Preferred stockholders commonly have contingent rights to appoint directors that mature only if the firm fails to pay certain dividends to the preferred stockholders."). Certain situations, such as a prolonged delay in the distribution of dividends to the preferred shareholders, may trigger a preferred shareholder right to participate in the election of directors. *See, e.g.*, *id.* Even in such an unusual event, however, the preferred shareholders are unlikely to obtain complete control of the board. Of course, preferred shareholders whose stock is convertible into common stock can vote after they convert their preferred stock to common stock. But they generally cannot vote for directors as preferred shareholders.

trol of the corporation generally resides in the hands of common shareholders.

### *B. Directors' Fiduciary Duty to Favor Common*

While all corporations issue common stock, some also issue one or more classes of preferred stock—shares with different cash flow rights than the common stock.[20] Among other rights, preferred shareholders are usually entitled to receive, upon dissolution of the corporation, a "liquidation preference" after creditors' claims are satisfied and before common shareholders receive any payment. This liquidation preference gives preferred stock debt-like cash flow rights.

Because common shareholders and preferred shareholders have different cash flow rights, a particular transaction or business decision may make common shareholders better off but preferred shareholders worse off. In such a case, a common-controlled board will naturally wish to pursue the transaction that makes common shareholders better off, regardless of its effect on the preferred shareholders or on total shareholder value.

Courts have declined to use directors' fiduciary duties to constrain common-controlled boards' ability to hurt the preferred shareholders in these situations. A longstanding doctrine of corporate law holds that directors owe a fiduciary duty of loyalty to the corporation and its shareholders. Directors' corporate duty of loyalty requires them to promote the best interests of the corporation and its shareholders. Among other things, the duty of loyalty prohibits a director from certain conduct—such as engaging in self-dealing transactions—that would benefit himself personally at the expense of the corporation and its shareholders as a group.[21]

In a firm that has issued both common and preferred stock, courts could interpret the duty of loyalty to prohibit common-elected directors from favoring common stockholders in ways that disproportionately burden the preferred shareholders. Put differently, courts could prohibit directors from taking steps to benefit a favored group of shareholders when those steps reduce the value available to all shareholders as a group. Such a rule, if it could be enforced relatively

---

[20] These rights are set out in the preferred stock agreement that accompanies the issuance of the stock. We use the term "preferred stock agreement" to mean both contracts between the preferred and the corporation as well as any provisions in the certificate of incorporation that specify the preferred shareholders' rights.

[21] Such duties are generally enforced through derivative or direct litigation. *See* Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 10–11 (1991) (comparing shareholders' derivative litigation with class action lawsuits).

easily, would maximize the size of the total pie to be shared by the parties and, presumably, be the rule they would agree to ex ante.[22]

However, Delaware law[23] generally allows a board controlled by common shareholders to ignore the effects of its business decisions on preferred shareholders. When determining which strategies the firm should pursue, directors elected by common shareholders owe a duty solely to common shareholders and are not required to take into account the interests of preferred shareholders, as long as the firm does not violate specific provisions of the preferred stock agreement.[24]

Consider the case of *Equity-Linked Investors, L.P. v. Adams*.[25] Genta Corporation, managed by a common-controlled board, faced a choice between liquidating (through a dissolution or sale) and continuing to operate as an independent entity. Liquidation would yield an amount less than the preferred shareholders' $30 million liq-

---

[22] To the extent that the shareholders are the only parties affected by the board's decisionmaking, this rule would promote Kaldor-Hicks efficiency. *See* Jules L. Coleman, *Efficiency, Utility, and Wealth Maximization*, 8 HOFSTRA L. REV. 509, 513–15 (1980) (arrangement, activity, or rule is efficient to extent that it maximizes total social welfare even if it reduces the welfare of some parties). In Part IV.B, *infra*, we suggest that parties be allowed to contractually opt into such a fiduciary rule through a corporate charter provision.

[23] Our analysis focuses on the case law of Delaware, the state in which the plurality (if not the majority) of VC-backed startups are incorporated. *Cf.* Brian Broughman & Jesse Fried, Deviations from Contractual Priority in the Sale of VC-Backed Startups pt. 4.1–.2, tbl.1 (unpublished manuscript, on file with the *New York University Law Review*) (reporting that in sample of 51 Silicon Valley startups sold in 2003 or 2004, 36 were incorporated in Delaware at time of acquisition).

[24] *See, e.g.*, D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1471 (2002) (noting generally nonfiduciary nature of preferred stock relationship). Delaware courts have departed from this approach in situations involving an obvious zero-sum transaction (such as an allocation of merger proceeds or a repurchase of one class of stock), holding that in such situations a common-controlled board has a fiduciary duty to treat all classes fairly. *See In re* FLS Holdings, Inc. S'holders Litig., No. Civ. A. 12623, 1993 WL 104562, at *4 (Del. Ch. Apr. 2, 1993, revised Apr. 21, 1993) (requiring common-controlled board to treat preferred shareholders fairly when allocating merger proceeds); *cf. In re* Tele-Communications, Inc. S'holders Litig., No. Civ. A. 16470, 2005 WL 3642727, at *1, *4 (Del. Ch. Dec. 21, 2005, revised Jan. 10, 2006) (permitting Series A common shareholders to sue board, which held mostly Series B common stock, for agreeing to merger that provided large premium to Series B).

The courts have also held that a common-controlled board owes a fiduciary duty to other parties when the firm is insolvent or on the verge of insolvency. *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. Civ. A. 12150, 1991 WL 277613, at *3, *33 (Del. Ch. Dec. 30, 1991) (holding that directors of insolvent firm owe duty to both shareholders and creditors); Alon Chaver & Jesse M. Fried, *Managers' Fiduciary Duty upon the Firm's Insolvency: Accounting for Performance Creditors*, 55 VAND. L. REV. 1813, 1824 (2002) (reporting that most courts considering issue have held that managers of insolvent firm owe fiduciary duty both to creditors and to shareholders).

[25] 705 A.2d 1040 (Del. Ch. 1997).

uidation preference. Remaining independent offered common shareholders the possibility of upside gain, but it would put the preferred shareholders' investment at greater risk. The board, seeking to benefit common shareholders, obtained debt financing to enable Genta to continue operating. The preferred sought to block the deal in court. They argued that the deal constituted a sale of control, thereby triggering *Revlon* duties and requiring the board to put the company up for auction. Had the company been put up for auction, the court noted, the preferred shareholders' underwater liquidation preferences would have allowed them to outbid any competitors, seize control, liquidate the company, and wipe out the common.

The court rejected the preferred shareholders' claim, on the ground that boards are free to pursue the interests of common shareholders at the expense of the preferred. According to the court:

> While the facts out of which this dispute arises indisputably entail the imposition by the board of (or continuation of) economic risks upon the preferred stock. . . and while this board action was taken for the benefit largely of the common stock, those facts do not constitute a breach of duty. . . . The special protections offered to the preferred are contractual in nature. . . . [G]enerally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of common stock—as the good faith judgment of the board sees them to be—to the interests created by the special rights, preferences, etc., of preferred stock, where there is a conflict.[26]

*Equity-Linked* is consistent with a long line of Delaware cases holding that boards controlled by common shareholders can take steps that jeopardize preferred shareholders' economic interests as long as they adhere to the contractual provisions bargained for by the preferred shareholders.[27] As long as the preferreds' contractual rights are respected, the board is free to take steps that impose substantial costs on preferred shareholders in order to benefit the common shareholders.[28]

---

[26] *Id.* at 1042.

[27] *See, e.g.*, Rosan v. Chi. Milwaukee Corp., C.A. No. 10526, 1990 WL 13482, at *1, *4, *8 (Del. Ch. Feb. 6, 1990) (dismissing claim of breach of fiduciary duties in planned spinoff that allegedly attempted to circumvent distribution of liquidation preference on grounds that preferreds' rights are purely contractual); Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 594 (Del. Ch. 1986) ("[W]ith respect to matters relating to preferences or limitations that distinguish preferred stock from common, the duty of the corporation and its directors is essentially contractual and the scope of the duty is appropriately defined by reference to the specific words evidencing that contract . . . .").

[28] It may well be that for Genta's shareholders as a group, continuing to operate was the value-maximizing strategy and the one that, ex ante, all shareholders would have agreed to. However, the court did not base its decision on what was desirable for share-

### C. *Efficiency Justifications*

As we have seen, courts permit common-controlled boards to advance the interests of the common, even if in doing so directors impose even larger costs on the preferred. Thus, a common-controlled board might have an incentive to act opportunistically—that is, to take steps that increase the value of common stock but reduce the value of other investors' interests by an even greater amount. For example, a board seeking to maximize common shareholder value might undertake excessively risky projects that make common shareholders better off but reduce aggregate shareholder value.

Economically-oriented legal scholars have offered two explanations of why it is generally desirable to give common shareholders control of the board and permit them to pursue their interests at the expense of other parties.[29] First, common shareholders are residual claimants to the value created by the enterprise: They are entitled to what remains after all other investors (preferred shareholders and creditors) are paid. As residual claimants, common shareholders tend to be affected most, on the margin, by changes in firm value. Accordingly, their interests are generally aligned with the goal of maximizing corporate value.[30] Thus, giving common shareholders control of the board and permitting them to use this control to advance their own interests should increase corporate value.

A second justification for common shareholders' special position is that common shareholders are uniquely vulnerable to insider opportunism and thus need board control and fiduciary duty protection to advance and protect their interests.[31] Other groups, such as preferred

---

holders as a group. Rather, it concluded that a common-dominated board is free to advance the interests of common shareholders as long as the contractual protections of the preferred are not violated.

[29] *See, e.g.*, REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 33–34 (2004) (noting that because shareholders are residual claimants they have control over company, albeit indirectly through selection of directors).

[30] Although common shareholders are generally the most residual claimants, they are certainly not the firm's only residual claimants. Because of the ever-present possibility of insolvency, all investors, including creditors, and non-investor stakeholders such as employees, can be considered residual claimants. Indeed, when a firm is insolvent, shareholders may no longer have much or any residual interest in the firm; the main (or only) residual investor claimants will be creditors. However, shareholders are thought to be the class of investors whose interests are *generally* most closely aligned with total corporate value. *See* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 403–04 (1983) ("As the residual claimants, the shareholders are the group with the appropriate incentives . . . to make discretionary decisions.").

[31] *See* Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L.

shareholders, creditors, and even employees, enter into contracts with the corporation that specify the corporation's obligations to them. They can use these contracts to bargain for whatever protections are efficient for the parties. And should unforeseen contingencies arise, courts can protect these parties by "gap-filling"—that is, construing their contracts, in light of their original intent, to cover these unexpected scenarios. In contrast, common shareholders do not enter into such contracts with the corporation and must rely solely on board control and fiduciary duties to protect their interests.

## II
## VC-BACKED FIRMS: PREFERRED SHAREHOLDERS IN CONTROL

This Part considers the governance structure of venture-backed startups. Section A begins by discussing VCs' use of convertible preferred stock to invest in startups. It then explains how the use of this type of security can reduce both entrepreneur agency costs and the tax cost of stock compensation provided to employees. In Section B, we show that VCs generally acquire at least de facto control of the board, and we explain why they do so. The combination of VCs' cash flow and control rights creates an unusual and apparently unique corporate governance arrangement: Preferred shareholders, not common shareholders, control the board and the firm.

### *A. VCs' Use of Preferred*

We first briefly describe VCs' widespread use of preferred stock when investing in their U.S. portfolio companies. We then discuss the agency cost and tax explanations for this pattern.

#### *1. The Pattern*

In the United States, VC-backed startups almost always issue two classes of stock: common and preferred. The common is held by the founders, employees, angel investors and, in certain cases, strategic partners and third-party service providers.[32] The preferred is held by VCs, who invest in startups almost exclusively through this type of

REV. 23, 25 (1991) ("[F]iduciary duties are owed to residual claimants and residual claimants alone because this is the group that faces the most severe set of contracting problems . . . .").

[32] Common shares make up a large fraction of a startup's outstanding shares. One study finds that, among firms about to go public, almost half the shares are in the form of common. *See* Steven N. Kaplan et al., *What Are Firms? Evolution from Birth to Public Companies* 24 (Ctr. for Research in Security Prices, Working Paper No. 603, 2005), *available at* http://ssrn.com/abstract=657721.

security.[33] In fact, most venture-backed startups issue a new series of preferred stock for each round of financing.[34]

Like most preferred stock, VCs' preferred shares carry a liquidation preference and are convertible into common.[35] Thus, to the extent that VCs retain their preferred stock, their cash flow rights are debt-like; to the extent that they convert, their preferred stock offers the same cash flow rights as common stock.[36]

However, unlike the liquidation preferences of most public company preferred stock, VCs' liquidation preferences often far exceed the original purchase price of the stock: The liquidation preference of VC preferred stock sometimes confers the right to be paid a multiple of the purchase price before common shareholders may receive any payment.[37] Depending on the circumstances, these multiples can be quite high, as much as six times the original purchase price or higher.[38]

---

[33] *See* Kaplan & Strömberg, *supra* note 6, at 313.

[34] While some of the rights of the preferred stockholders may be class rights, each series of preferred stock is assigned its own exclusive rights and preferences. This, in turn, may give rise to conflicts of interest within the preferred class. *See, e.g.*, D. Gordon Smith, *Independent Legal Significance, Good Faith, and the Interpretation of Venture Capital Contracts*, 40 WILLAMETTE L. REV. 825, 825–26 (2004) (describing *Benchmark Capital Partners IV, L.P. v. Vague*, No. Civ.A. 19719, 2002 WL 1732423 (Del. Ch. July 15, 2002), in which junior preferred stockholders sued senior preferred stockholders for breach of contractual protective provisions). Indeed, in certain situations, the interests of the lowest-ranked preferred may be closer to those of common than to those of the highest-ranked preferred. For ease of exposition, we focus on the case in which there is only one series of preferred stock. However, the agency costs we identify in Part III, *infra*, would also arise if there were multiple series of preferred stock, and the legal reforms we suggest in Part IV, *infra*, would also improve contracting in such a setting.

[35] *See* Kaplan & Strömberg, *supra* note 6, at 284 tbl.1 (finding that most VC financings in the United States involve convertible preferred). Typically, each preferred share can initially be converted into a single common share. *See* Richard A. Mann et al., *Starting From Scratch: A Lawyer's Guide to Representing a Startup Company*, 56 ARK. L. REV. 773, 860 (2004) (outlining sample term sheet that provides for conversion of preferred stock into common stock).

[36] VCs' convertible preferred stock will sometimes have "participation rights." Such participating preferred stock entitles holders not only to a liquidation preference but also to share with common shareholders, on a pro-rata basis, in any additional value available for distribution to shareholders, usually up to a specified amount (say, three times the original investment amount). Thus, the VCs will convert their preferred shares into common stock only if the amount they would receive as common stockholders exceeds the sum of their liquidation preference and the value of their participation rights. For ease of exposition, we will assume throughout that VCs' preferred stock is non-participating.

[37] *See* Mann et al., *supra* note 35, at 858–60.

[38] *See, e.g., id.*; Vyvyan Tenorio, *VCs Ponder How to Incentivize Managers After Down Rounds*, THE DAILY DEAL, Jan. 29, 2002 (reporting deal with liquidation preferences of twelve times original purchase price). When the preferred are entitled to cumulative dividends, the liquidation preferences are even larger, because they include, in addition to the multiple, any unpaid dividends (even if not declared). *See* Michael Woronoff & Jonathan Rosen, *Effective vs. Nominal Valuations in Venture Capital Investing*, N.Y.U. J.L. & BUS. (forthcoming) (manuscript at 15, available at http://ssrn.com/abstract=803124).

Thus, VC preferred stock is often much more debt-like in its cash flow rights than is typical preferred stock. We consider below the agency cost and tax-related explanations that have been advanced for VCs' widespread use of preferred stock.

### 2. *Reducing Entrepreneur Opportunism*

VCs' use of preferred stock may help reduce a number of agency costs associated with investing in startups. We describe two ways that preferred stock can reduce the cost to the parties of entrepreneur opportunism. Our goal here is not to describe systematically every potential agency cost reducing effect of preferred stock, but rather to give the reader a sense of some of its potentially important non-tax benefits.

First, VCs' use of preferred stock might reduce an information asymmetry problem that arises at the pre-investment stage. Before the VCs invest, the founder might have more information than the VCs about the actual value of the business. The VCs may worry that the entrepreneur knows the firm is worth very little and hopes to sell them overpriced equity. However, the entrepreneur will not profit unless the value of the company turns out to be greater than any liquidation preferences given to the VCs. Thus, by giving the VCs preferred stock with liquidation preferences, the entrepreneur can credibly signal her belief that the company is worth more than the liquidation preference granted to the VCs.[39]

VCs' use of preferred stock with liquidation preferences may also provide founders with desirable incentive effects after they receive funding. The founder holds common stock. If the firm does poorly, the founder will therefore get less than her pro rata share of the firm's value, and nothing at all if the firm's value is less than the liquidation preference. If the firm does well, and the VCs convert into common, the founder receives her pro rata share of the firm's value. Thus, founders may have a greater incentive to increase startup value than they would under an all-common capital structure.[40]

---

[39] *Cf.* Sahlman, *supra* note 5, at 510–11 (arguing that VCs use preferred stock with liquidation preferences to sort for entrepreneurs who are "confident of their own abilities and deeply committed to the venture"); Jeremy C. Stein, *Convertible Bonds As Backdoor Equity Financing*, 32 J. FIN. ECON. 3, 3–4 (1992) (arguing that large corporations use convertible debt to "mitigate[ ] the adverse-selection costs associated with direct equity sales").

[40] *Cf.* Sahlman, *supra* note 5, at 510–11 (noting that shifting risk onto entrepreneurs increases their incentive to build value).

### 3. *Reducing Taxes*

Although VCs investing in American startups almost always use preferred stock, U.S. and foreign VCs investing outside the United States—where the same agency problems are likely to arise—often use other instruments, such as common stock.[41]

This pattern suggests that agency cost explanations cannot entirely explain the almost universal use of preferred stock by VCs investing in U.S. startups. Tax considerations that are unique to the United States may also play a role. In particular, U.S. tax law and the manner in which it is enforced may inadvertently subsidize the use of that security. As we explain below, the use of preferred stock rather than common stock can reduce the tax cost of equity-based incentive compensation given to founders and other employees of the startup.[42]

The manner in which the VCs' use of preferred stock reduces the tax cost of incentive compensation is most easily illustrated with an example of a firm that offers fully vested stock to its employees.[43] Under current tax law, an employee receiving stock compensation is generally taxed at ordinary income rates on what the Internal Revenue Service (IRS) considers to be the grant-date value of the stock.[44] Any subsequent appreciation above that value is taxed later, upon sale, at the generally lower capital gains rate. Thus, everything else being equal, *reporting* a lower grant-date stock value to the IRS provides a joint benefit to the parties. Although the capital gains later reported to the IRS might be higher, the ordinary income reported to

---

[41] VCs' use of common stock is far more frequent abroad than in the United States. *See* Douglas J. Cumming, *Capital Structure in Venture Finance*, 11 J. CORP. FIN. 550, 581–82 (2005) (reporting use of variety of different types of securities, including common stock, in Canadian venture financing transactions); Steven N. Kaplan, Frederic Martel & Per Strömberg, How Do Legal Differences and Learning Affect Financial Contracts? 8 (June 16, 2004) (unpublished manuscript, available at http://ssrn.com/abstract=557007) (reporting that 28% of VCs, out of sample of VC financing outside United States, used common stock, compared to 1% in United States); Josh Lerner & Antoinette Schoar, *Transaction Structures in the Developing World: Evidence from Private Equity* 1–3 (MIT Sloan Sch. of Mgmt., Working Paper No. 4468-04, 2004), *available at* http://ssrn.com/abstract=511202 (reporting that use of preferred stock in developing nations is far less frequent than in United States and United Kingdom).

[42] *See* Gilson & Schizer, *supra* note 4, at 877 (arguing that VCs' use of convertible preferred stock is driven in part by tax considerations); Sahlman, *supra* note 5, at 510 (discussing tax advantage of VCs' use of preferred stock).

[43] In fact, most startups give employees unvested stock options. However, as we explain shortly, the same principles apply when the firm uses such stock options for compensation.

[44] *See* 26 U.S.C. § 83(a) (2000) (general tax rule for property transferred in connection with performance of services).

the IRS, which is taxed at a higher rate, is lower.[45] However, the parties cannot report an arbitrarily low grant-date value for the stock; the IRS may challenge a grant-date value that it can easily show is too low.

Consider the example of VCs investing in ABC Corporation. Suppose the VCs are willing to pay either $10 per share for ABC's common stock, or $15 per share for certain preferred stock. And suppose that the preferred stock is in fact worth exactly $15 per share because its rights, including a liquidation preference, provide the holder with $15 of expected cash flow from ABC. Thus, after issuance of the preferred, the common stock would continue to be worth $10 per share.[46]

If the VCs' investment takes the form of common stock purchased for $10 per share, when ABC subsequently gives employees common stock, it cannot report, for tax purposes, that the stock's grant-date value is less than $10. The fact that third parties bargaining at arm's length have paid $10 per share of ABC's common stock presumptively establishes $10 as the market value of that stock. Should the IRS conduct an audit, it could impose significant penalties upon the parties for unreasonably understating the value of the incentive compensation provided to the employees.[47]

Now consider the case in which VCs invest by purchasing preferred stock for $15 per share. The price the VCs pay for the preferred stock does not indicate the value of the common stock, which has fewer rights and is subordinate to the preferred stock in liquidation. In the absence of strong evidence that its common stock is worth $10 per share, ABC can take an aggressive tax-reporting position on the value of the stock. While ABC's common stock is in fact worth $10 per share, ABC can report a much lower value to the IRS, say $1.50 per share. In fact, startups commonly take the position, for tax purposes, that the common stock is worth 10% of the price most

[45] The corporation can deduct the reported grant-date value of the stock in computing its taxable income. Thus, everything else being equal, the higher the reported value, the greater the deduction and tax savings for the corporation. However, most startups lack taxable income for several years and are thus unable to benefit fully from this deduction. *Cf.* Gilson & Schizer, *supra* note 4, at 913 (describing conditions that must be present for firm to take full advantage of tax benefit).

[46] ABC's common stock continues to be worth $10 per share because the cost to ABC of issuing preferred shares is $15 per share and ABC receives $15 per preferred share issued.

[47] *See, e.g.*, 26 U.S.C. § 6662 (2000), *amended by* Pub. L. No. 109-135, § 403(x), 119 Stat. 2577, 2629 (2005) (civil penalty for accuracy-related tax underpayment); *id.* § 6663 (civil penalty for fraudulent tax underpayment); *id.* § 6701 (penalties for aiding and abetting understatement of tax liability); *id.* § 7201 (criminal penalties for felony of attempting to evade or defeat tax).

recently paid for the preferred stock.[48] Accordingly, VCs' use of preferred stock rather than common stock permits the parties to reduce the tax imposed on employees, enabling the firm to pay less on a pre-tax basis to employees.

Although this example focuses on vested common stock, the same principle applies to vested and unvested option compensation, the most common form of equity compensation in startups. The tax owed on option compensation depends on the reported grant-date value of the underlying common stock. Thus, the use of preferred stock can reduce the tax cost of all types of equity-based compensation by allowing the company to assign a lower value to the underlying common stock.[49] In short, the tax law penalizes VCs using common stock by making it more costly for startups to provide all types of incentive compensation—both stock and stock options—to employees. Given the much more frequent use of common stock financing outside the United States, where this tax subsidy for preferred is absent,[50] it is plausible that at least some VCs investing in U.S. startups use preferred rather than common stock solely to reduce taxes.[51]

### *B. VCs' Control of the Board*

Having seen that VCs' cash flow rights in the United States almost always take the form of preferred stock, we now turn to consider their control rights. VCs investing in startups typically receive extensive control rights, often including board control. We will describe the extent of these control rights and then offer two types of agency-cost explanations for VC control of the board. In particular, VC board control can reduce or prevent (1) entrepreneur opportunism—agency costs inflicted by the founder that would arise whether VCs invested through common or preferred stock; and (2) common shareholder opportunism—agency costs that can arise when the VCs invest through preferred stock and the common shareholders control the board.

---

[48] *See, e.g.*, Gilson & Schizer, *supra* note 4, at 900 n.86; Sahlman, *supra* note 5, at 510. In October 2005, the IRS issued proposed regulations under section 409A of the Internal Revenue Code that may limit private companies' ability to use arbitrarily low valuations of stock for tax reporting purposes. Application of Section 409A to Nonqualified Deferred Compensation Plans, 70 Fed. Reg. 57,930, 57,962 (proposed Oct. 4, 2005) (to be codified at 26 C.F.R. pt. 1). We discuss these proposed regulations and their likely effect in Part IV.A.1, *infra*.

[49] *See* Gilson & Schizer, *supra* note 4, at 895–901.

[50] *See supra* note 41.

[51] *Cf.* Gilson & Schizer, *supra* note 4, at 889 (suggesting that U.S. tax law may explain why VCs' use of convertible preferred stock is so common in United States).

### 1. *Extent of VC Control*

Like most preferred shareholders, VCs usually receive specific veto rights called protective provisions.[52] These provisions require VC approval for certain transactions, such as the sale of all or substantially all of the company's assets.[53] VCs' contractual rights include all those typically found in public company preferred stock, plus others. In fact, VCs typically negotiate for a catch-all provision in addition to a list of provisions that explicitly require their consent for most major transactions. Such catch-all provisions allow the preferred shareholders to veto any action that materially modifies their rights under their agreement with the company. Staged financing—the ability to withhold cash—also gives VCs substantial influence over corporate decisionmaking.[54]

More importantly, VCs also acquire control over the board in most startups, either immediately or during a subsequent round of financing. Protective provisions and staged financing only give VCs the power to block transactions unfavorable to them. Board control gives them the additional ability to *initiate* fundamental transactions such as mergers, IPOs, and liquidations.[55] Board control also gives them power to manage the business and oversee the day-to-day operation of the firm. Startup boards—unlike public company boards—are frequently and intimately involved in strategic decisionmaking and personnel issues. In short, board control gives VCs substantial power over and above whatever contractual provisions they have negotiated.

Many academics studying venture-backed startups have failed to appreciate how frequently VCs effectively control startup boards.[56] Economists examining investment documents have concluded that, by the last financing round, VCs control a majority of the board seats in

---

[52] *See, e.g.*, Mann et al., *supra* note 35, at 861–62 (describing principal terms of typical VC financing transaction).

[53] *See id.*

[54] *See* Smith, *supra* note 8, at 323 (describing VCs' use of stage financing to gain control of board); Utset, *supra* note 14, at 64–66 (describing stage financing as mechanism that reduces amount that VCs risk, helps discipline entrepreneur, and increases VCs' bargaining leverage); *cf.* Gompers, *supra* note 6, at 1461 (arguing that staged financing is used to facilitate monitoring).

[55] DEL. CODE ANN. tit. 8, § 141(a) (2004); CAL. CORP. CODE § 300(a) (West 1990).

[56] *See* William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 900–01 (2002) (concluding that VCs acquire control in only small minority of cases); Kaplan & Strömberg, *supra* note 6, at 289–90 (finding, in survey of 119 startups, that VCs acquired majority of board seats in only 25% of firms). *But see* Utset, *supra* note 14, at 61 & n.40 (arguing that generally VCs negotiate for outright direct control or at least de facto control over board).

only about 25% of startups.[57] In about 15% of startups, common-owning founders maintain a majority of board seats through successive financings. In the remaining 60% of startups, neither founders nor VCs end up with a majority of the seats.[58] Instead, the swing votes are held by directors whom the common stockholders and the VCs mutually appoint.[59] These "independent directors" are usually industry experts and other outsiders whose experience and connections are expected to add value to the enterprise.

However, these studies have missed two important points. First, the common shareholders sitting on the board usually include one or more executives whose interests may be closely aligned with those of the VCs. Executives who have been appointed by the VCs may feel some loyalty to them. In addition, the executives' employment relationship with the firm can be used to induce them to favor the interests of the VCs over other investors. For example, a common-owning CEO can be given a large bonus, retention package, or other side payment to arrange and support a merger that benefits preferred shareholders at the expense of common stockholders.[60] Thus, the "representatives" of the common shareholders on the board cannot always be expected to faithfully represent their interests.

Second, the so-called "independent directors" are often not truly independent of the VCs. Many of these directors are chosen by the VCs, who tend to have much larger professional networks than the entrepreneurs or other common shareholders.[61] The common shareholders generally acquiesce to the VCs' recommendations. Such acquiescence is likely to serve common shareholders' interests ex ante. In many states of the world, the interests of common shareholders and preferred stockholders are aligned. Both wish to see the firm increase in value. And the independent directors may well bring with them useful contacts and experience, which can be tremendously valuable to the new firm.[62]

---

[57] Kaplan & Strömberg, *supra* note 6, at 289–90 (reporting results of survey of VC-backed firms).

[58] *Id.*

[59] *Cf.* Kaplan et al., *supra* note 32, at 26 (reporting that, by time of IPO, VCs control median of three directorships, with management and outsiders each controlling median of two directorships).

[60] *See* Complaint at 5, Latif v. Nishan Sys., Inc., No. 1-03-CV-004939 (Cal. Super. Ct. Dec. 27, 2004) (claiming that VC-appointed CEO was bribed to support merger that allocated almost no proceeds to common shareholders).

[61] *See, e.g.*, Utset, *supra* note 14, at 105 & n.204 (noting that highlighting VCs' significant network of contacts is important part of VCs' sale strategy).

[62] *See, e.g.*, *id.* at 97–99 (describing how VCs provide value by helping in "professionalization" of startups).

However, as Gordon Smith has pointed out, if there is a conflict of interest between the VCs and the entrepreneur or between the VCs and common shareholders, these independent directors may well have an incentive to side with the VCs.[63] Many of these outside directors have—or can expect to have—long-term professional and business ties with the VCs, who are more likely to be repeat players than are most of the common shareholders. Cooperative outside directors can expect to be recommended for other board seats or even invited to join the VC fund as a "venture partner." Thus, in many cases outside directors are not truly independent. Because VCs often have considerable influence over the common shareholder representatives on the board as well as the independent directors, the percentage of startup boards effectively controlled by VCs may well be much higher than a study of financing documents would suggest.

### 2. *Reducing Entrepreneur Opportunism*

The standard explanations for VCs' acquisition of board control involve entrepreneur agency costs. The entrepreneur frequently has little business experience and may lack the ability to run the company after it reaches a certain size. As a result, the entrepreneur may, despite her best efforts, mismanage the VCs' investment. Even if the entrepreneur is able to run the business, her goals may differ from those of the investors. The VCs seek the highest possible return on their investment. The entrepreneur draws a salary and thus will prefer continuation even if the business ought to be shut down. The entrepreneur may also use the VCs' money to provide private benefits to herself—such as a high salary and perks—at the expense of investors' returns.[64]

Board control allows the VCs to monitor the operations of the firm,[65] control entrepreneur opportunism,[66] and replace the entrepre-

[63] *See* Smith, *supra* note 8, at 320 & n.21 (comparing outside directors' predisposition "to favor those who are part of the 'in' group" with "structural bias" identified in large corporations); Bratton, *supra* note 56, at 921 (suggesting that information asymmetries as well as bargaining power and skill may render independent director "highly susceptible to the influence" of VCs). Our conversations with local VCs confirm this claim. While the independent directors might hold common stock in the startup, the value and anticipated value of their ties to the VCs (which include appointments to other boards, or as a venture partner in a VC fund) are likely to far outweigh the incentive effects of the common stock in situations where common and preferred stockholders have different interests.

[64] *See* Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473, 476 (1992) (analyzing effects of entrepreneurs' non-monetary interests on financial contracts between entrepreneurs and investors and on contingent control allocations).

[65] *See* Utset, *supra* note 14, at 58–60 (discussing importance of VC control in reducing investment risks).

neur with a professional manager should the founder not be up to the task.[67] Indeed, VCs eventually end up replacing most founders.[68]

### 3. *Reducing Common-Shareholder Opportunism*

In addition to reducing entrepreneur agency costs, VC control eliminates the agency costs associated with common-shareholder control. A common-controlled board owes a duty to common shareholders and is free to take steps to benefit the common, even at the expense of the preferred and of total shareholder value.[69] However, under the courts' control-contingent approach to fiduciary duties, a preferred-controlled board is not obligated to serve common shareholders' interests. Indeed, as we explain below, a preferred-controlled board can take steps that reduce the value of the common stock. Thus, VCs' acquisition of board control not only reduces entrepreneur opportunism but also prevents common shareholder opportunism.[70]

Consider the case of *Orban v. Field*,[71] which illustrates how shifting board control to preferred shareholders substantially changes the board's fiduciary duties. In *Orban*, as in *Equity-Linked*,[72] the preferred shareholders wanted the company sold immediately, even at a price below their liquidation preferences. Unlike in *Equity-Linked*, however, preferred shareholders controlled the *Orban* board, and the court allowed them to use this control to effect a sale of the company that wiped out common shareholders.

The facts were as follows: The preferred-dominated board of Office Mart arranged for Office Mart to be acquired by Staples in a

---

[66] *Cf.* D. Gordon Smith, *Venture Capital Contracting in the Information Age*, 2 J. SMALL & EMERGING BUS. L. 133, 138–40 (1998) (referring to VC-entrepreneur relationship as "cooperative relationship" in which there are potential agency costs to both parties).

[67] *See* Aghion & Bolton, *supra* note 64, at 490 (analyzing control allocations in startups); Bratton, *supra* note 56, at 894–95 (arguing that board control enables VCs to replace poor managers).

[68] Even in venture-backed firms that do well enough to go through an IPO, founders' involvement declines from the time the firms receive VC financing to the time of the IPO and thereafter. *See* Kaplan et al., *supra* note 32, at 21 (reporting that at time of IPO 43% of CEOs are non-founders); Utset, *supra* note 14, at 92–95 (describing "founder's disease"—VCs' "assumption that entrepreneurs will be unable to make the transition to effective managers"); Noam Wasserman, *Founder-CEO Succession and the Paradox of Entrepreneurial Success*, 14 ORG. SCI. 149 (2003) (examining factors affecting founder-CEO succession at Internet startups).

[69] *See supra* Part I.B.

[70] *Cf.* Bratton, *supra* note 56, at 935 (identifying board control by VCs as necessary to protect preferred shareholders in face of "intrinsically unreliable" contractual protections).

[71] No. 12820, 1997 Del. Ch. LEXIS 48 (Apr. 1, 1997).

[72] *See supra* notes 25–26 and accompanying text.

merger providing no payout to common shareholders.[73] The common shareholders' approval was not required to effect the merger—the VC financing provisions allowed preferred shareholders to vote alongside common shareholders on an as-converted basis (as if their stock had been converted into common shares). However, for accounting reasons, Staples insisted that at least 90% of Office Mart's common shares be voted in favor of the transaction.[74] Common shareholders, led by Office Mart's founder and former CEO George Orban, refused to back the deal, demanding $4 million in exchange for their votes.[75]

Office Mart's board then used corporate resources to arrange a series of transactions that enabled the preferred shareholders to overcome common shareholder opposition. In particular, the preferred-controlled board gave funds to preferred shareholders to exercise warrants to buy common shares, which they did, diluting the "pure" common position down to less than 10% of the class.[76] The preferred shareholders, now holding over 90% of the common stock, voted their common stock in favor of the merger, which allowed the transaction to go forward and wiped out the common shareholders.

Orban sued Office Mart's board, alleging that the board had violated its duty of loyalty to common shareholders. The court ruled for the preferred-controlled board, writing: "[I]t cannot be said that the Board breached a duty of loyalty in making this decision. . . . The common stockholders had no legal right to a portion of the merger consideration under Delaware law or the corporate charter."[77]

One could question the court's reasoning in *Orban* on doctrinal grounds. The issue here was not, as the court implies, how to divide the proceeds of an already-effected merger. In fact, the merger had not yet occurred. Rather, the issue was whether a preferred-controlled board could use corporate resources to dilute the voting power of common shareholders objecting to a proposed merger in order to force through a transaction that benefited the preferred and left common shareholders with nothing. Permitting the board to take such steps appears inconsistent with *Equity-Linked*, where the same court held that "it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of common stock—as the good faith judgment of the board sees them to be—to the inter-

[73] *See Orban*, 1997 Del. Ch. LEXIS 48, at *2.

[74] *Id.* at *17.

[75] *Id.* at *22.

[76] *Id.* at *23–24.

[77] *Id.* at *32.

ests created by the special rights, preferences, etc., of preferred stock."[78]

However, from an economic perspective, the court may well have reached the right result. The court noted that "[t]he Staples' transaction appeared . . . to be the best available transaction."[79] It also observed that "[t]here is no claim that . . . the merger . . . was not in the best interests of the corporation,"[80] suggesting that common shareholders could have prevailed by showing that the challenged transaction was not in the "best interests of the corporation." Thus, the Staples transaction may have maximized value for shareholders as a group. If so, this is the outcome that all shareholders—preferred and common—presumably would have wanted ex ante.[81]

In any event, *Orban* establishes that a preferred-controlled board does not owe a fiduciary duty specifically to the common shareholders and that it has wide discretion to benefit the preferred shareholders instead.[82] Together, *Equity-Linked* and *Orban* indicate that the courts have adopted what we call a "control-contingent" approach to fiduciary duties: The identity of those controlling the board affects

---

78 Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1042 (Del. Ch. 1997).

79 *Orban*, 1997 Del. Ch. LEXIS 48, at *32.

80 *Id.* at *26 n.23.

81 *See supra* note 22 (discussing Kaldor-Hicks efficiency). It is important to recognize, however, that the options "available" to the company were likely affected by the financial interests of those controlling the board. The preferred-controlled Office Mart board had little incentive to pursue transactions that, like the financing in *Equity-Linked*, would keep the company operating as an independent entity but put the preferred shareholders at greater risk. The board might even have turned such proposals away, without informing common shareholders. Thus we cannot be certain that the Staples transaction was in fact the transaction most likely to maximize aggregate shareholder value. In Part III, *infra*, we discuss in more detail the potential agency costs of preferred shareholder control.

82 Indeed, this is how *Orban* is read by sophisticated lawyers in Silicon Valley. *See, e.g.*, Matthew P. Quilter et al., *Duties of Directors: Venture Capitalist Board Representatives and Conflicts of Interest*, *in* VENTURE CAPITAL 2002, at 1117–18 (PLI Corp. L. & Practice, Course Handbook Series No. B-1312, 2002). The laws of California, another popular state of incorporation for startups, appear to be more favorable to non-controlling classes of stock because of the strong protection afforded minority shareholders. *See, e.g.*, Jones v. H.F. Ahmanson & Co., 460 P.2d 464, 471 (Cal. 1969) ("[M]ajority shareholders . . . have a fiduciary responsibility to the minority [shareholders] . . . to use their ability to control the corporation in a fair, just, and equitable manner."). However, plaintiffs' ability to bring fiduciary suits is much more limited than in Delaware because controlling shareholders can thwart such suits by conducting a merger with an unrelated entity; once the firm has merged, shareholders' only remedy, even for alleged fiduciary violations that occurred prior to merger, is appraisal. *See* CAL. CORP. CODE § 1312 (West 1990); Sturgeon Petroleums Ltd. v. Merchants Petroleum Co., 195 Cal. Rptr. 29 (1983) (holding that section 1312 restricts shareholder remedies to appraisal unless merging corporations were previously affiliated); Steinberg v. Amplica, Inc., 729 P.2d 683, 693–94 (Cal. 1986) (holding that appraisal statute bars damage suits for pre-merger fiduciary duty violations where plaintiff deliberately opted against seeking appraisal). Thus, on balance, California law may not be more favorable to non-controlling classes of stock.

the content of the board's duties. A common-controlled board is free to serve the interests of common shareholders at the expense of the preferred shareholders and aggregate shareholder value. In contrast, a preferred-controlled board can make business decisions that serve the preferred at the expense of common, as long as those decisions can be defended as in the best interests of the corporation.

The courts' control-contingent approach to fiduciary duties thus provides the parties with an additional economic incentive to give VCs board control. When common shareholders control the board, they are permitted to use their power to act opportunistically toward the preferred. When preferred shareholders control the board, they are not required to serve the interests of common shareholders, and may even take steps to reduce the value of the common stock. Thus, preferred shareholder control eliminates the agency costs associated with common shareholder control. As we explore in the next Part, however, preferred shareholder control of the board is likely to give rise to its own set of agency costs and distortions.

## III
## AGENCY COSTS OF PREFERRED SHAREHOLDER CONTROL

This Part describes the agency costs that can arise when preferred-owning VCs control, indirectly or directly, the board of a startup. We focus on those costs that arise solely because of differences in the cash flow rights of preferred and common shareholders—differences that tend to be more pronounced in venture-backed companies than elsewhere because of VCs' often large liquidation preferences. Because of the difference in cash flow rights, there may well be situations in which the interests of the preferred shareholders controlling the board diverge from the goal of maximizing total shareholder value—that is, the combined value of the preferred and common shares.[83] In these situations, preferred shareholders controlling the board may act opportunistically—that is, benefit their class at the expense of shareholders as a group.

As Section A explains, preferred-owning VCs in control of the board may, in certain situations, make excessively conservative business decisions, such as choosing immediate "liquidity events" (major corporate transactions that would end the independent life of the company, such as dissolution or a sale of the business) over higher-

[83] For simplicity, we assume that the board's decisions affect only the value of the firm's equity. This assumption does not materially affect the analysis. In fact, most startups have little debt. *See* Denis, *supra* note 2, at 304 ("Because [startups] are typically not yet profitable and lack tangible assets, debt financing is usually not an option.").

value strategies involving more risk. The costs of this value-reducing behavior are borne, in the first instance, by common shareholders. Section B explains why various legal and non-legal mechanisms, including fiduciary duty litigation, shareholder voting, appraisal rights, and VCs' reputational considerations, are unlikely to be very effective at preventing these distortions.

Section C identifies two pre-financing distortions that can arise even before preferred shareholders take control of the board. It demonstrates that the mere expectation of preferred opportunism later in the startup's life can (1) make it more difficult and expensive for entrepreneurs to get very early stage funding from angel investors; and (2) reduce the financial value and incentive effects of the equity-based compensation provided to employees.

Section D explains that, to the extent that labor and capital markets are competitive and efficient, the agency costs associated with preferred shareholder control are ultimately borne by the entrepreneur. Thus, the entrepreneur has an incentive to choose arrangements that reduce these costs. However, the entrepreneur's ability to reduce these costs is constrained, in part because current tax and corporate fiduciary rules make certain alternative arrangements either too costly or impossible.

### *A. Distorted Strategies and Bias Toward Exit*

This Section identifies and describes the distortions that can arise after preferred shareholders take control of the board. In general, the debt-like nature of their cash flow rights may cause preferred shareholders controlling the board to choose lower-risk, lower-value business strategies over higher-risk strategies that would maximize aggregate shareholder value. For example, preferred shareholders are likely to have a bias toward exit—that is, a preference for immediate liquidity events (e.g., dissolution, private sale, or IPO) even when the expected value of remaining an independent private company is higher. We then explain why renegotiation cannot be counted on to eliminate these distortions.

#### *1. The Problem*

Because of the preferred shareholders' liquidation preferences, they sometimes gain less from increases in firm value than they lose from decreases in firm value. This effect may cause a board dominated by preferred shareholders to choose lower-risk, lower-value investment strategies over higher-risk, higher-value investment strategies. Preferred shareholders' debt-like cash flow rights are likely to

also affect the choice between (1) selling or dissolving the company; and (2) maintaining the company as an independent private business. In particular, preferred-dominated boards may favor immediate "liquidity events" (such as a dissolution or sale of the business) even if operating the firm as a stand-alone going concern would generate more value for shareholders. The reason is simple: Liquidity events promise a certain payout, much of which the preferred shareholders can capture through their liquidation preferences. Continuing to operate the firm as an independent company may expose the preferred-owning VCs to risk without sufficient opportunity for gain.

Consider the following example. The capital structure of Startup Corporation consists of two classes of shares: a class of convertible preferred shares and a class of common stock. Startup has issued 50 shares of common stock to its founders and employees. In addition, 50 shares of the convertible preferred stock have been issued to VC investors at a price of $1 a share. Each preferred share may be converted into a single share of common stock.

Like all preferred stock, Startup's preferred shares come with a liquidation preference: the right to receive, in a liquidity event, a certain amount prior, and in preference, to the common shares. Assume that the preferred shares carry a 2X liquidation preference. Accordingly, the preferred shareholders are entitled to receive up to two times the purchase price of the stock (or a total of $100) in a liquidity event.

Suppose that Startup can choose between (1) a sale that yields $110 with certainty; and (2) remaining independent. If Startup remains independent, there are two equally likely outcomes: Success, which yields a payoff of $300; and Failure, which yields a payoff of $0. The expected value associated with remaining independent is thus $150 (50% x $300 + 50% x $0). Remaining independent maximizes total shareholder value and is thus the most desirable strategy from an aggregate shareholder perspective.[84]

| Strategy | Outcome(s) | Expected Value |
|---|---|---|
| Sale | 100% x $110 | $110 |
| Remain Independent | 50% x $300<br>50% x $0 | $150 |

*Sale*: The sale generates proceeds of $110. The liquidation preference grants the preferred shareholders the right to receive $100. If the preferred shareholders were to convert to common, they would

[84] We assume throughout the Article that all shareholders—both common and preferred—are risk-neutral and seek to maximize the expected value of their shares.

own 50% of the outstanding shares and therefore receive $55 (50%) of the $110 payout. The preferred shareholders will thus choose to enjoy their liquidation preference rather than convert. The remainder of the payout, $10, goes to common shareholders.

| Strategy | Outcome | Expected Value | Preferred | Common |
|---|---|---|---|---|
| Sale | 100% x $110 | $110 | $100 | $10 |

*Remaining Independent*: Suppose the venture is successful and the payoff is $300. If preferred shareholders do not convert their shares into common, they receive only their liquidation preference of $100. If, on the other hand, the preferred shareholders convert into common, they will own 50% of the outstanding common shares and be entitled to receive $150 (50%) of the $300 payoff. Thus, the preferred shareholders will convert to common stock and receive $150. The original common shareholders will receive $150. If the venture fails, preferred shareholders and common shareholders each receive $0. Accordingly, the expected value to both preferred shareholders and common shareholders of Startup of remaining independent is $75 (50% x $150), less than the value to preferred shareholders associated with selling Startup for $110.

| Strategy | Outcome(s) | Expected Value | Preferred | Common |
|---|---|---|---|---|
| Sale | 100% x $110 | $110 | $100 | $10 |
| Remain Independent | 50% x $300<br>50% x $0 | $150 | $75<br>(50% x $150) | $75<br>(50% x $150) |

To the extent that preferred shareholders control Startup's board, they will have an incentive to sell Startup, even though a sale generates less value for shareholders as a group than keeping Startup independent. Selling Startup yields the preferred $25 more ($100 vs. $75). However, it provides the common shareholders with $65 less ($10 vs. $75). Thus, selling Startup reduces aggregate shareholder value by $40 ($110 vs. $150).

We do not claim that preferred-controlled boards will always choose low-value strategies over high-value strategies, or that they will always choose exit when remaining independent generates more value for shareholders. The distortions we have described are most likely to arise when, as is often the case, the firm is neither a complete failure nor a stunning success.[85] If the potential payout from remaining independent is sufficiently high, preferred shareholders

[85] *See, e.g.*, Sahlman, *supra* note 5, at 484 fig.1 (reporting that over 30% of capital invested by VCs results in partial or total loss, and another 30% of VC investments results in payoff of less than 100%).

would not, despite their debt-like cash flow rights, push for a sale. Rather, our point is that in many situations, the divergence of interests between preferred and common shareholders will cause a preferred-dominated board to make decisions that fail to maximize total shareholder value.[86]

To be sure, when a firm has issued preferred stock, a board dominated by common shareholders will not always choose the optimal strategy either. A common-dominated board might have an incentive to choose a high-risk strategy with less expected value for shareholders as a group than a lower-risk alternative. Indeed, the risk of common opportunism may be one reason preferred-owning VCs receive control of the board.[87] Again, our point is simply that in many situations, the divergence of interests between preferred and common shareholders will cause a preferred-dominated board to push for a liquidity event or other low-risk, low-value strategy that fails to maximize shareholder value.[88]

### 2. *The Difficulty of Renegotiation*

We have seen that a preferred-controlled board may choose a course of action that benefits the preferred but hurts common shareholders by an even larger amount. Returning to our example, the preferred shareholders are better off selling Startup for $110 even though

---

[86] Note that even if VCs owned only common stock, VCs might still push for premature liquidity events because of agency problems between the VCs and their own investors. *See, e.g.*, Smith, *supra* note 8, at 318 (arguing that "liquidity or publicity needs" may motivate VCs to favor premature exit). For purposes of this Article, however, we focus only on those distortions that arise out of the dual-class ownership structure of venture-backed startups.

[87] *See supra* Part II.B.3.

[88] There might be other distortions in exit decisions arising from VCs' use of preferred stock and the structure of their financing contracts. For example, VC financings typically include provisions requiring the VCs to convert their preferred stock into common stock upon completion of a "qualified" IPO—an IPO above a certain per-share dollar threshold and above a minimum amount of total proceeds. Such provisions may bias VCs as a group (and in particular *participating* preferred shareholders, i.e. preferred shareholders who have rights to a liquidation preference and to share pro-rata with the common in any remaining value) in favor of a private sale or non-qualified IPO that yields less value for shareholders as a group. *See* Thomas Hellmann, IPOs, Acquisitions and the Use of Convertible Securities in Venture Capital 4–5 (Jan. 2004) (unpublished manuscript, available at http://strategy.sauder.ubc.ca/hellmann/pdfs/Hellmann_IPO_Acq_Jan_2004.pdf) (explaining potential benefits of automatic conversion feature as well as its potential costs).

Note that if VCs invested through common stock to begin with, this exit distortion, like the bias toward exit we identify in this Article, would not arise. In Part III.D.1, *infra*, we explain why the tax system makes it expensive for the parties to avoid these agency costs by using an all-common capital structure. In Part IV.A.2, *infra*, we put forward for consideration a new approach to the tax treatment of stock compensation that would eliminate the penalty for VCs' use of common and might therefore lead some startups to use all-common capital structures.

the expected value associated with keeping Startup independent is higher—$150. Sale yields the preferred shareholders $100, while maintaining Startup as an independent business gives preferred shares an expected value of only $75. Thus, the preferred shareholders gain $25 by selling Startup. The common shares, on the other hand, would be worth $65 more if Startup were not sold.

In principle, the parties could renegotiate their arrangement so that keeping Startup independent—which provides $40 more in expected aggregate shareholder value ($150 vs. $110)—makes both the preferred and common shareholders better off. For example, common shareholders could make themselves and the preferred shareholders better off by giving the preferred shareholders 25 of their 50 shares of common stock. If Startup remains independent and is successful, the preferred shareholders would now capture 75% of the $300 payoff, or $225. The value to the preferred shareholders of keeping Startup independent would now be $112.50 (50% x $225) rather than only $75. The value to the preferred of selling Startup would now be $105 rather than $100; in addition to the $100 liquidation preference, the preferred shareholders would be entitled, on account of their ownership of 50% of the common stock, to $5 of the remaining $10. Thus, the preferred-controlled board would have an incentive to keep Startup independent. The common's 25 remaining shares would be worth $37.50 (50% x $75) if Startup remains independent, more than the $10 their 50 shares would be worth if they do not give the 25 shares of common stock to the preferred and Startup is sold. Thus, both preferred and common shareholders have an incentive to enter into this arrangement. More generally, parties facing the possibility of an inefficient outcome may be able to reach the value-maximizing result through renegotiation.

However, while successful renegotiation might take place from time to time, it is unlikely to prevent preferred-controlled boards from making value-reducing decisions in many cases. Significant information asymmetry between the preferred shareholders controlling the board and the common shareholders will often make renegotiation extremely difficult. There may be dozens of common shareholders, including employees and angel investors, many of whom never were—or no longer are—actively involved with the company. Convincing these shareholders that they would benefit by surrendering value to preferred shareholders may be difficult. Bargaining might therefore fail even if, as in this example, renegotiation would generate a surplus.

Moreover, even if renegotiation could succeed in the face of a major transaction that would end the independent life of the firm, renegotiation is unlikely to work in cases where the board must make

incremental decisions that cumulatively have a large impact on the value of the corporation. For example, consider a preferred-controlled board inclined to sell the company to benefit the preferred, even though keeping the company independent would, under the appropriate CEO, maximize aggregate shareholder value. Suppose the current CEO resigns. The preferred-controlled board may have little incentive to invest time, money, and effort in seeking the CEO candidate who is best suited for building the company as an independent concern. Rather, the directors may hire an executive who is less capable but good enough to manage the firm until it is sold. Once such a CEO is chosen, the best course of action may actually be to sell the company. In this type of situation, where it is hard to verify the alternatives available to the board and their likely payoffs, the board will find it very difficult to persuade the common shareholders to share some of their upside potential with the preferred shareholders to improve the board's incentives and decisionmaking. Transaction costs would render renegotiating around this type of decision economically prohibitive, especially when there are many common shareholders.

### *B. Legal and Non-Legal Constraints on Preferred Shareholder Opportunism*

Section A explained why a preferred-dominated board may favor strategies that reduce aggregate shareholder value, and why renegotiation cannot always head off such value-reducing decisions. This Section considers the possibility that other legal and non-legal mechanisms might constrain preferred shareholder opportunism, such as (1) fiduciary duty litigation; (2) shareholder voting requirements; (3) appraisal; and (4) VCs' reputational considerations. We show that, both individually and collectively, these mechanisms are unlikely to eliminate the distortions identified in Section A.

#### *1. Fiduciary Duty Litigation*

Common shareholders might seek to protect themselves from preferred opportunism by suing directors for breach of their fiduciary duty. Under *Orban* and the courts' control-contingent approach to fiduciary duty, a preferred-controlled board is not obligated to pursue the interests of common shareholders. Rather, a preferred-controlled board may make decisions that favor the preferred at the expense of the common. Thus, a common shareholder could not prevail by showing that the board acted in ways that benefited preferred shareholders at the expense of common shareholders. However, *Orban*

suggests that a common shareholder might be able to prevail by showing that a preferred-controlled board's decision was not in the "best interests of the corporation."[89]

However, there are four reasons why the threat of such suits is unlikely to always deter preferred-controlled boards from acting in ways that reduce aggregate shareholder value. First, the term "best interests of the corporation" is not clearly defined. To the extent that courts interpret the "best interests of the corporation" to mean something other than the maximization of shareholder value, common shareholders will not be able to prevail by showing that a particular transaction or decision was value-reducing.

Second, even if the courts define "best interests of the corporation" to mean the best interests of shareholders as a group, it may be difficult for common shareholders—many of whom do not sit on the board or have positions within the company—to show that shareholders would be better off under an alternative to the challenged transaction or decision. Moreover, the alternatives "available" to the company will likely have been shaped by the financial interests of those controlling the board. For example, a preferred-controlled board has little incentive to explore transactions that, like the financing in *Equity-Linked*, would keep the company operating as an independent entity but put the preferred shareholders at great risk. The VCs might have turned away such proposals without informing common shareholders or even other board members. Thus, even if courts permitted common shareholders to prevail by showing that the board's decision reduced aggregate shareholder value, it would be difficult for common shareholders to make such a showing.

Third, aggrieved common shareholders will often lack the financial ability to sue the VCs. Lawyers will generally not take such cases on a contingency basis, because the amounts involved in any given case are likely to be relatively small and the defendants can be expected to engage in a scorched-earth defense. The plaintiffs would thus need to finance the (potentially extensive) litigation themselves. But the common shareholders most likely to be hurt by preferred opportunism—former employees, including founders, angel investors, and other parties that supplied informal financing to the startup—are

[89] *See* Orban v. Field, No. 12820, 1997 Del. Ch. LEXIS 48, at *27 n.23 (Apr. 1, 1997) (noting, before ruling against common shareholder plaintiff, that plaintiff failed to claim that challenged transaction was not in best interests of corporation).

unlikely to have the substantial resources necessary to finance such litigation.[90]

Finally, there may be reputational costs to litigating against VCs. The founders and employees holding common stock may wish to raise money from VCs in the future for other ventures, or work at other VC-backed startups. Acquiring a reputation as a "troublemaker" who sues VCs is likely to make it more difficult to raise funds from VCs or to obtain positions at VC-backed firms in the future.[91] All in all, the threat of fiduciary duty litigation is unlikely to impose much constraint on VC opportunism, especially under the courts' control-contingent approach to fiduciary duties.

### 2. *Shareholder Voting*

Corporate law requires that shareholders approve, by majority vote, certain "structural" or "organic" changes that will substantially alter their investment interest, such as mergers, dissolutions, and amendments to the certificate of incorporation.[92] This power gives shareholders some ability to protect themselves from insider opportunism.[93] In principle, shareholders' ability to block specified transactions should make it difficult for the board to use these types of transactions to hurt shareholders.

Unfortunately, however, in venture-backed startups, the voting mechanism offers little protection to *common* shareholders. To begin with, most important business decisions do not require any shareholder approval. Thus, the board generally has complete discretion in most of the decisions it faces. For example, absent an explicit bylaw to

---

[90] Many law firms in Silicon Valley may well be unwilling to take such a case even for hourly fees for fear of offending the venture capitalists who, directly or indirectly, supply them with much of their business.

[91] Consider the recent example of Epinions.com. The cofounders of Epinions.com, including a very successful entrepreneur named Naval Ravikant, filed suit against several prominent VC firms for fraud in connection with a merger that wiped out their common shares. Before the lawsuit, Ravikant had become a partner at another VC firm, Dot Edu Ventures. Shortly after the lawsuit was filed, Dot Edu Ventures expelled Ravikant under pressure from other VC firms, who may have threatened to exclude Dot Edu Ventures from deals unless it pushed out Ravikant. According to one person close to the situation: "[Ravikant] had better win this suit and he better hope that he makes enough for life, because he'll never work as a VC again." Constance Loizos, *VC Gets Frozen Out After Joining Suit*, PRIVATE EQUITY WK., Feb. 4, 2005, http://www.privateequityweek.com/pew/freearticles/1107338724787.html (alteration in original).

[92] *See, e.g.*, DEL. CODE ANN. tit. 8, § 242(b)(1) (2001) (amendment to certificate or articles of incorporation); *id.* § 251(c) (Supp. 2004) (mergers); *id.* § 275 (dissolution).

[93] *Cf.* Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1578–79 (1989) (explaining how, notwithstanding shareholders' voting rights, management can bundle proposals to force shareholders to accept value-decreasing proposals favored by insiders).

the contrary or the need to change the corporate charter, the board is free to make whatever business and investment decisions it wishes.[94]

Moreover, even when a transaction does require shareholder approval, corporate law generally does not require a separate vote for each class of shareholders, including common shareholders. Rather, it is sufficient that holders of a majority of the firm's outstanding stock entitled to vote on the transaction approve it.[95] And VC financing arrangements typically allow the VCs to vote their preferred shares together with common stockholders when such stockholder-wide votes are required.[96] Importantly, VCs can vote on these issues without converting into common stock and thereby losing the privileges assigned to the preferred stock.[97] If preferred shareholders' voting power exceeds that of the common shareholders, the preferred shareholders can dictate the outcome of the vote. In fact, VCs obtain majority voting power in over 60% of venture-backed startups by the second round of VC financing.[98] By the time the startup must make exit decisions, common stockholders generally will have lost the ability to block transactions that hurt their interests.

Finally, even if common shareholders have a class right to veto a transaction, a preferred-controlled board can take various steps to neutralize common-shareholder opposition and force through a transaction that hurts "pure" common (those common shareholders with no other financial interest in the firm). One technique for overcoming common shareholders' veto right is cross-voting. In a cross-voting scheme, preferred shareholders acquire a majority of the common stock, either by partially converting their shares into common stock or by exercising warrants to buy common stock. They then vote those

---

[94] *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2004).

[95] *See, e.g.*, *id.* § 271(a) (stating that sale, lease, or exchange of all or substantially all of property and assets requires approval by holders of majority of outstanding stock). California law requires a separate class vote, CAL. CORP. CODE § 1201(a) (West 1990), and it also subjects "quasi-California" corporations (corporations doing business in California but incorporated elsewhere) to California law, *id.* § 2115. In a recent case, however, the Delaware Supreme Court, citing the internal affairs doctrine, refused to apply section 2115 and California class voting rules to a merger of a California-based Delaware corporation, permitting the merger to go forward without a separate class vote. *See* Vantagepoint Venture Partners 1996 v. Examen, Inc., 871 A.2d 1108, 1114–18 (Del. 2005).

[96] *See* Smith, *supra* note 24, at 1471 (observing that preferred-owning VCs vote as single class with common shareholders).

[97] Preferred shareholders are entitled either to one vote per preferred share or to the number of votes they would have if their preferred stock were converted into common stock. Thus, if each preferred share would convert into five common shares, the holder of a single preferred share would get five votes.

[98] *See* Kaplan & Strömberg, *supra* note 6, at 288 tbl.2, 290, 310 tbl.8 (reporting VCs obtain explicit voting control in over 40% of first VC round financings and in over 60% of second VC rounds).

shares in favor of a transaction that hurts common shareholders but benefits the preferred.[99] Recall that cross-voting was the strategy used in *Orban*, where the preferred-controlled board facilitated a transaction in which preferred shareholders exercised warrants to buy over 90% of the common stock.[100]

Another technique for acquiring control over the common class is vote buying, which is relatively easy in the startup context: A preferred-controlled board can issue additional common shares to employees who expect to gain—as employees—from the board's proposed transaction and therefore will vote their common shares in favor of the transaction.[101] The board can also pay employees to exercise options that are underwater[102] and thereby acquire common stock.[103] Alternatively, the board can increase the compensation of employees holding large amounts of stock to induce them to vote a particular way. Although vote buying may be illegal in some (or all) of these cases, it is very difficult to prove that the purpose of a particular payment is to buy votes.

Both cross-voting and vote buying can prevent common stockholders from blocking harmful transactions, even when a separate class vote by common stockholders is required. As a result, common shareholders often cannot count on their voting rights to protect them from preferred opportunism.

### 3. *Appraisal Rights*

Corporate law gives shareholders the right to sell their stock back to the corporation for a judicially determined "fair value" in limited circumstances. To the extent that the appraisal remedy permits common shareholders to compel the firm to buy back their stock for the value it would have had absent preferred opportunism, common shareholders could prevent preferred shareholders from diverting value from them. Anticipating that common shareholders would seek

---

[99] For a general discussion of different types of conflicts in shareholder voting, see Zohar Goshen, *Voting (Insincerely) in Corporate Law*, 2 THEORETICAL INQ. L. 815 (2001), which analyzes efficiency costs when shareholder voting on corporate transactions is driven in part by other interests.

[100] *See* Orban v. Field, No. 12820, 1997 Del. Ch. LEXIS 48, at *23–24 (Apr. 1, 1997); *supra* Part II.B.3.

[101] *See* Jeffrey A. Blomberg, *The Lurking Danger in Insider-Led Financings: On Protecting Directors from Charges of Self-Dealing*, BUS. L. TODAY, May/June 2003, http://www.abanet.org/buslaw/blt/2003-05-06/blomberg.html.

[102] An option is considered to be underwater when its exercise price is higher than the value of the underlying stock, and thus not worth exercising.

[103] *Cf.* Complaint at 5, Latif v. Nishan Sys., Inc., No. 1-03-CV-004939 (Cal. Super. Ct. Dec. 27, 2004) (claiming that VC-appointed CEO was bribed to accelerate exercise of common stock options and vote common shares in favor of VC-favored merger).

appraisal, a preferred-dominated board might be reluctant to engage in opportunistic behavior at common shareholders' expense.

Unfortunately, the appraisal remedy is an extremely weak constraint on preferred opportunism. First, as with shareholder voting, appraisal rights are rarely available. In Delaware, where the plurality of startups are incorporated, appraisal rights are generally triggered only by a statutory merger.[104] A preferred-dominated board could push through any other type of transaction, including transactions that are economically equivalent to a statutory merger, without triggering appraisal rights.

Moreover, even when appraisal rights are available, common shareholders are unlikely to receive, in present expected value terms, the actual value of their shares. Appraisal litigation is complicated and expensive.[105] Litigation may take years, and shareholders often receive no money until it is concluded.[106] During this time, the corporation could become insolvent, in which case the appraisal claim would be subordinated to the claims of ordinary creditors. If the corporation remains solvent, it must, at the end of the litigation, pay interest on the determined "fair value" from the date of the merger.[107] However, the rate at which the corporation must pay interest is typically set too low to compensate the shareholders for the time value of money and the risk of nonpayment.[108]

Finally, many shareholders find it difficult to meet the complicated procedural requirements and deadlines of the appraisal remedy. A shareholder must notify the company of her intent not to approve the disputed transaction, abstain or vote against the transaction, and

---

104 *See, e.g.*, Hariton v. Arco Elecs., Inc., 188 A.2d 123, 124–25 (Del. Ch. 1963) (holding, based on independent legal significance rule, that sale of assets transaction accomplishing same results as merger does not trigger appraisal rights).

105 *See* Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1, 40 (1995) (describing the onerous requirements of appraisal). In Delaware, shareholders seeking appraisal are barred from using class action suits. Because each shareholder must pursue his own individual claim, shareholders lose the important economic benefits of class actions, which spread the costs of litigation and facilitate contingency financing.

106 *See, e.g.*, Richard T. Hossfeld, Note, *Short-Form Mergers After* Glassman v. Unocal Exploration Corp.*: Time to Reform Appraisal*, 53 DUKE L.J. 1337, 1353 (2004) (noting that shareholders seeking appraisal "must also hold an illiquid claim for almost two years, foregoing investment in other promising opportunities that may arise in the interim").

107 *See* Francis I. duPont & Co. v. Universal City Studios, Inc., 343 A.2d 629, 632 (Del. Ch. 1975) (noting court's discretion to "allow interest from the effective date of the merger to the date of payment of cash").

108 *See* Alexander Khutorsky, Note, *Coming in From the Cold: Reforming Shareholders' Appraisal Rights in Freeze-Out Transactions*, 1997 COLUM. BUS. L. REV. 133, 160 (recommending setting "statutory rate of interest [at] the 'borrower's' cost of debt" to fairly compensate dissenting shareholders, where "borrower" is majority shareholder).

subsequently file a petition requesting appraisal no more than 120 days following the transaction.[109] As a result, even if appraisal forced the firm to pay common shareholders the actual value of their shares, the board would reasonably expect very few shareholders to exercise this right.

The shortcomings of the appraisal remedy are widely known. Commentators have long recognized that appraisal is a remedy that few shareholders will seek under any circumstance.[110] Appraisal, at least as it is currently structured, is thus unlikely to protect common shareholders from preferred opportunism.

### 4. *Reputational Considerations*

A number of commentators have argued that even though VCs may not be legally constrained from acting opportunistically, reputational considerations will nevertheless deter VCs from such behavior.[111] Unfortunately, however, reputational considerations may not always prevent VCs from acting in ways that reduce aggregate shareholder value. Indeed, the reputational concerns of *entrepreneurs* may well exacerbate the problems we have identified.

The argument that VCs are constrained by reputational considerations from acting opportunistically toward common shareholders might go as follows: VCs often compete to fund the best startups.[112] The dimensions along which VCs compete are the "terms" of the deal as well as reputation, especially the reputation for successfully steering their portfolio companies to IPOs. Everything else being equal, a VC fund that acquires a reputation for engaging in value-reducing transactions designed to transfer value from common share-

---

109 *See* Peter V. Letsou, *The Role of Appraisal in Corporate Law*, 39 B.C. L. REV. 1121, 1156–60 (1998) (describing and analyzing procedural rules of appraisal remedy).

110 Melvin A. Eisenberg, *The Legal Rules of Shareholders and Management in Modern Corporate Decisionmaking*, 57 CAL. L. REV. 1, 85 (1969) (arguing that no shareholder "in his right mind" will invoke appraisal unless "the change from which he dissents is shockingly improvident" and "the fair value of the shares before the change will far exceed the value of his shares after the change").

111 *See* Black & Gilson, *supra* note 8, at 262–63 (1998) (arguing that geographical proximity between VCs and investment portfolios gives rise to reputation market constraints, deterring opportunistic acts by VCs); Sahlman, *supra* note 5, at 513 (arguing that VCs refrain from abusing their power because they wish to attract best entrepreneurs, who can choose other VCs or alternative sources of capital). *But see* Utset, *supra* note 14, at 112 n.223 (suggesting reputational considerations are insufficient to prevent VCs from acting opportunistically).

112 *See* Sahlman, *supra* note 5, at 513.

holders to preferred shareholders would lose good deals to other VCs with better reputations.[113]

Such an argument implicitly assumes that an entrepreneur's interests are completely aligned with those of the company's common shareholders when the entrepreneur seeks VC financing. However, to the extent that the entrepreneur expects to retain a senior management position, her interests may well diverge from those of common shareholders. Such an entrepreneur will expect to receive salary, additional stock grants, and perhaps a retention agreement before the company is sold. Her interest is in maximizing the joint value of her current stock and her future compensation. In contrast, common shareholders qua common shareholders care only about the value of their stock. Thus, in screening VCs, entrepreneurs cannot be expected to perfectly represent the interests of common shareholders as a class.

Moreover, even if the interests of common shareholders and entrepreneurs completely overlapped, and entrepreneurs declined financing from VCs that had acted opportunistically in the past toward common shareholders, it is far from clear that VCs would be deterred from making value-reducing decisions. First, VCs would know that entrepreneurs are unlikely to obtain information about a particular VC's opportunistic behavior. Second, even if entrepreneurs can be expected to learn of such behavior, many VCs would conclude that the benefits of such behavior—in the form of higher returns—outweigh the costs.

To begin with, it will be extremely difficult for outsiders to acquire accurate information about VCs' behavior towards common shareholders in their other portfolio companies.[114] These portfolio firms are small private companies. Unlike public companies, they do not release detailed information to the SEC. Nor are they covered by analysts and financial journalists. Boards that engage in value-decreasing behavior cannot be expected to publicize it. Outsiders will

---

113 *Cf.* Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 J. CORP. L. 913, 929 (1999) (arguing that VCs refrain from wrongfully discharging founder-CEO, even though it would trigger stock buyback at cost, because of reputational considerations).

114 *See, e.g.*, Smith, *supra* note 66, at 174 (suggesting that, despite supposed importance of reputation in VC financing, "the market for venture capitalist reputation is both informationally and fundamentally inefficient . . . . because of the absence of a centralized location . . . where various assessments of venture capital reputation can be 'traded' "); Utset, *supra* note 14, at 112 n.223 ("Entrepreneurs . . . face significant informational constraints, both in identifying potential sources of financing, and in finding entrepreneurs with credible information about their prior dealings with a venture capitalist.").

learn about preferred opportunism only if common shareholders come forward to complain.

However, those hurt by preferred opportunism—the common shareholders—may not even know it. Within the startup, information does not always flow freely. Important conversations are often held outside of board meetings. Directors representing common shareholders can be left in the dark.[115] Common shareholders who do not sit on the board know even less about what is going on than these directors. If the board decides not to explore a particular opportunity or not to put effort into a strategy that would benefit common shareholders, very few people are likely to be aware of the decision. Thus, VCs know that their value-reducing behavior is unlikely to be detected.

Moreover, even when common shareholders believe that VCs have acted opportunistically, they have little incentive to try to disseminate the information widely. There is little personal benefit to doing so.[116] On the other hand, if the common shareholder is an entrepreneur who hopes to raise funding from VCs in the future, publicizing VC opportunism is likely to be very costly. At least in Silicon Valley, VCs are a tight-knit community. An attack against one VC is considered to be an attack against all. Publicly criticizing VCs may ruin an entrepreneur's chances of getting funding for another startup. Thus, VCs know that even if their opportunism is detected, those aware of it may not, because of reputational considerations, try to publicize it widely. As a result, the likelihood that outsiders will learn about VC opportunism is quite low.

Finally, even if an aggrieved party could be expected to tarnish a VC's reputation by disseminating information about the VC's opportunism, that VC may sometimes prefer to pay that price to extract a higher return from his investment. It is important to remember that there is considerable turnover in the VC industry. Most VCs fail to deliver positive returns to their investors and eventually leave the business.[117] New VC firms, and those with poor track records, have rela-

---

115 *See* Complaint at 5–10, Latif v. Nishan Sys., Inc., No. 1-03-CV004939 (Cal. Super. Ct. Dec. 27, 2004) (alleging VC directors withheld critical information from other board members around time of proposed sale of company).

116 The complaining common shareholder might hope to "punish" the VCs by tarnishing their reputations. However, it is far from clear that outsiders will believe him. In the absence of a substantial amount of information, the community will have difficulty determining whether the VCs in fact acted opportunistically, or whether the common shareholder is simply bitter because things did not turn out as well as he had hoped.

117 Since 1980, the bottom 75% of VC funds have, on average, produced *negative* returns for their investors. Jeffrey M. Leavitt, *Burned Angels: The Coming Wave of Minority Shareholder Oppression Claims in Venture Capital Startup Companies*, 6 N.C. J.L.

tively short expected lifespans. If VCs fail to generate adequate returns in their current funds, they may not be able to raise new ones. Accordingly, most VCs care less about their reputations in dealing with common shareholders, which would hurt them (if at all) only in the future, than about maximizing returns on their current investments.

To be sure, there are well-known VC firms with long and successful histories that can expect to remain in business for quite some time. Because of their excellent track records, these top-tier VC firms have no difficulty attracting the most promising entrepreneurs and money from limited investors. And their partners have, over time, become extremely wealthy. Such firms may be willing to sacrifice some return in order to preserve or build their good reputations, or simply because they want to be fair (or at least seen to be fair).

But most VC firms are in a much more precarious position. In deciding whether to act opportunistically to boost their fund's returns, these VCs are unlikely to be deterred by the possibility that their opportunism would become widely known and affect their ability to attract good deals in the future. If they cannot generate sufficient returns in their current funds, there will be no future. Thus, even if a VC firm believed that it would incur reputational costs by acting opportunistically, it might be willing to incur these costs to achieve higher returns. In sum, reputational considerations—either alone or together with fiduciary duties, shareholder voting rights, and appraisal—are unlikely to solve the problem of preferred shareholder opportunism in startups.

### *C. Pre-Financing Distortions*

Section A identified certain costs and distortions that arise *after* preferred shareholders take control of the board, and Section B explained why various legal and non-legal constraints—fiduciary duties, shareholder voting rights, the appraisal remedy, and VCs' reputational considerations—are unlikely to prevent value-reducing preferred opportunism. This Section describes two distortions that arise when investors and employees anticipate the possibility that common shareholders will subsequently be vulnerable to opportunism by a preferred-dominated board. In particular, the mere possibility of preferred opportunism can (1) increase the cost of "angel" and other

& TECH. 223, 268 (2005). Funds come and go. For example, during the period 1997–2003, the number of VC firms investing more than doubled, from 885 firms managing $65 billion to 1984 firms managing $251.4 billion. *Id.* at 223. But in 2004, the number of VC firms declined by 21%. *Fewer VCs & Fewer Startups*, RED HERRING, Apr. 15, 2005, http://www.redherring.com/PrintArticle.aspx?a=11808&sector=Capital.

informal sources of financing, which are important sources of capital for early-stage startups; and (2) diminish the financial value and incentive effects of options and common stock held by founders and employees of the startup.

### *1. Increased Cost of Angel Financing*

Many startups are unable to secure VC or other institutional financing in the first year or so of the business, when risk is highest. These early-stage firms may turn to informal sources of financing to fund their activities. One important source of informal financing is wealthy individual investors, referred to as "angels," who can serve an important role by supplying seed capital.[118] In fact, the total amount of angel financing in the United States may be twice that of total VC financing.[119]

Angel financing tends to differ from VC financing in a number of important respects besides timing. The amounts invested in a firm by an *individual* angel investor (as opposed to the total amount of angel financing) is likely to be much smaller than the amounts invested by individual VC firms. And angels tend to lack the expertise and connections that would enable them to contribute to the enterprise by serving on the board or otherwise monitoring the business.

Because angels invest less than VCs and are generally less sophisticated, their financing agreements are much more informal. Unlike VCs, angels generally do not acquire control rights and board positions. Most importantly, angels frequently invest through common equity.[120] Thus, they become vulnerable to preferred opportunism when preferred-owning VCs later take control of the board. To the extent that angel investors anticipate that later-investing VCs will take control of the board and act opportunistically, the angels will expect a lower return from their investment. This, in turn, may discourage angels from investing in startups through common stock, or it may cause them to demand a larger stake in exchange for their investment, thus raising the cost of seed capital to entrepreneurs.

---

[118] *See* Rudy Aernoudt, *Business Angels: The Smartest Money for Starters? Plea for a Renewed Policy Focus on Business Angels*, 10 INT'L J. BUS. 272, 272 (2005) (describing importance of angels to entrepreneurship, especially amidst shift in VCs' investing away from very young companies toward more mature late-stage investments).

[119] ANDREW WONG, ANGEL FINANCE: THE OTHER VENTURE CAPITAL 1–2 (2002), http://www.angelcapitalassociation.org/dir_downloads/resources/Research_AndrewWong.pdf (highlighting studies on size of angel finance market by National Venture Capital Association, Small Business Association, and scholars); Sahlman, *supra* note 5, at 475 (noting vast majority of new businesses seek external funding from sources other than VCs).

[120] *See* WONG, *supra* note 119, at 3.

To be sure, each angel could insist on receiving preferred stock with protective provisions rather than common stock, or a note that is convertible into preferred stock. Such arrangements might offer protection from subsequent opportunism by VCs. In fact, when a group of angels invests collectively and puts a significant amount of money in a startup, it will often incur the expense of negotiating for and creating preferred stock arrangements. But to the extent that the market for capital is competitive, these transaction costs are likely to be passed on to the entrepreneur in the form of worse investment terms. Thus, whether angel investors react to the prospect of preferred opportunism by offering less for a startup's common shares or by demanding preferred shares, the possibility of such value-reducing behavior increases the cost of angel financing to the entrepreneur.[121]

### 2. *Reduced Incentive Effect of Common Stock*

Emerging firms rely heavily on equity compensation to attract and incentivize employees. Equity compensation allows liquidity-constrained firms, which are unable to pay competitive salaries and cash bonuses, to compete in the labor market for talented employees. In addition, equity compensation aligns the interests of employees with those of shareholders. Indeed, the tax explanation for VCs' use of preferred stock depends on startups heavily using stock and option compensation to pay employees.[122]

This equity compensation almost always takes the form of common stock and options to purchase common stock. For this equity compensation to serve as a substitute for cash, it must have value. And for the equity to create desirable incentives, employees must anticipate that they will benefit, qua common shareholders, from the value that their efforts create.

As we have shown, however, a preferred-controlled board might take steps that reduce or even eliminate the value of common stock. For example, a preferred-controlled board might have an incentive to opportunistically liquidate the company (through a sale, for example), leaving the common shareholders with little if any value. The prospect of such opportunistic behavior will both reduce the value of the

[121] In addition to seeking angel financing, cash-starved, early-stage firms may also attempt to turn their employees, service providers, and suppliers into informal sources of financing by paying them in common stock rather than in cash. To the extent that these parties anticipate that subsequently investing VCs will take control of the board and act opportunistically, they will place a lower value on the stock offered by the startup. This, in turn, may make it more difficult for early-stage startups to use common stock to pay for expenses.

[122] *See supra* Part II.A.3.

equity compensation given to employees and dilute its desirable incentive effects.

To provide sufficient incentives and value to employees, the startup will therefore be required to give them more cash and stock. And to the extent that the entrepreneur is the residual claimant on the enterprise's value, she will bear the cost of this additional compensation. Thus, the prospect of preferred opportunism increases not only the entrepreneur's cost of angel financing but also her cost of compensating and motivating employees.

### *D. Legal Constraints on Private Ordering*

We have seen that the corporate governance structure of venture-backed startups—in which preferred-owning VCs control the board—can give rise to preferred opportunism, imposing costs on the parties both before and after VCs provide financing.

To the extent that preferred opportunism generates social costs—such as distorted business decisions—those costs must be borne by someone. The precise incidence of these costs depends on the efficiency and competitiveness of various markets (including the labor market, the market for angel financing, and the market for VC financing), and, to the extent that any of these markets are not perfectly competitive, on the parties' relative bargaining power.

However, for expositional convenience let us assume that markets are perfectly competitive and efficient and that the entrepreneur is the residual claimant on the enterprise's value. The entrepreneur raises capital from both angel investors and VCs by providing them with enough cash flow rights to give them a competitive return on their capital. The founder also hires workers by offering them cash and stock that give them, in expected value terms, the market rate for their labor. The surplus, if any, goes to the entrepreneur. Thus, the entrepreneur reaps all of the benefit and bears all of the costs of the parties' arrangements, including those arising out of VC control of the board. To the extent that preferred control gives rise to distorted board decisionmaking, increases the cost of angel financing, and undermines employee incentives, the entrepreneur fully bears these costs and has an incentive to reduce them.

These costs arise because (1) the firm has issued preferred stock to VCs; (2) the VCs obtain at least de facto control of the startup; and (3) control gives preferred-holding VCs the ability to act opportunistically at the expense of common shareholders. Thus, the entrepreneur could reduce or eliminate these agency costs by (1) issuing only common stock to VCs; (2) giving common shareholders rather than

preferred shareholders control of the startup; or (3) better constraining the controlling VCs' ability to act opportunistically. Unfortunately, the legal system—and in particular the tax system and corporate fiduciary law—makes each of these approaches either impossible or more costly than it needs to be.

### *1. Common-Only Capital Structure?*

Although almost all VC investment in the United States takes the form of convertible preferred stock, VCs elsewhere often invest through common stock. VCs investing in the United States could easily employ a similar arrangement. If the VCs held only common stock, their cash flow rights would be identical to those of other investors. As a result, the agency costs we have identified in this Article, which arise solely from VCs' use of preferred stock, would be eliminated.[123]

However, the use of an all-common capital structure would impose a large tax cost on the firm. The use of preferred stock in the United States reduces the startup's compensation costs by allowing the startup to provide employees with stock that can be undervalued for tax purposes.[124] Switching to an all-common capital structure would therefore raise compensation costs. This tax penalty may be larger than the benefit to the parties of eliminating preferred opportunism.

To be sure, VCs' use of preferred stock can also reduce entrepreneur agency costs. For example, VCs' use of preferred stock with liquidation preferences may often be the most effective way of incentivizing founders to generate value.[125] Thus, there may be times when, even absent the tax penalty for common, it is efficient for VCs to invest through preferred shares. That is, the benefit of using preferred stock to reduce entrepreneur agency costs is greater than the agency costs of preferred control. However, the important point is that even when the agency costs of preferred control are very high and it would otherwise be efficient for the VCs to invest through common, the tax system makes it expensive for the parties to do so.

---

[123] If, on the other hand, the VCs received a combination of common stock and debt in exchange for their investment, the package of securities would also create cash flow rights distinct from those of common shareholders and give rise to the same problems we have identified.

[124] *See supra* Part II.A.3.

[125] *See supra* Part II.A.2.

### 2. *Common-Controlled Board?*

VCs eventually obtain de facto control of the board in most startups.[126] This control, in turn, gives them the ability to act opportunistically toward the common shareholders. However, preferred control is not inevitable; the entrepreneur could insist on an arrangement that preserves common shareholder control. Indeed, in many cases preferred-owning VCs do not control the board.[127]

However, current corporate fiduciary duty rules make it costly to give common shareholders control of the board. Such an arrangement can give rise to common shareholder opportunism. A board controlled by common shareholders is free to pursue the interests of the common at the expense of the preferred and aggregate shareholder value, as long as the preferreds' contractual rights are respected.[128] Courts do not even require that a common-controlled board's actions be in the "best interests of the corporation." Because the courts have been unwilling to impose tighter fiduciary duties on common-controlled boards, the agency costs of common-shareholder control may in many cases far exceed the agency costs of preferred-shareholder control. In these situations, the parties cannot reduce aggregate agency costs by putting common shareholders in control.

To be sure, common-shareholder control of the board could also give rise to other costs. VC control of the board might reduce entrepreneur agency costs by allowing VCs to supervise and replace founders when they do not perform adequately.[129] Giving up board control might, by reducing VCs' ability to engage in such monitoring, increase these entrepreneur agency costs. Thus, even absent the risk of common shareholder opportunism, it might be too costly for the parties to deny VCs control of the board. Again, however, the important point is that current legal rules increase the cost to the parties of taking steps to reduce the agency costs of preferred-shareholder control. Even when entrepreneur agency costs are relatively low, the courts' current approach to fiduciary duty rules may make it too costly for the parties to give common shareholders control.

### 3. *Contracting Against Preferred Opportunism?*

Given that it may be costly to switch to an all-common capital structure or to leave control in the hands of common shareholders, we

---

126 *See supra* Part II.B.1.

127 *See, e.g.*, Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1042, 1044 (Del. Ch. 1997).

128 *See supra* Part I.B.

129 *See supra* Part II.B.2.

can expect to see many startups controlled by preferred shareholders. And, for the reasons explained in Section B of this Part, the various legal and non-legal mechanisms that may impose some constraint on preferred-controlled boards—fiduciary duties, shareholder voting, appraisal rights, and reputational considerations—are unlikely to consistently prevent the preferred from acting opportunistically.

Unfortunately, there is little else the parties currently can do to constrain preferred opportunism. The parties might wish to contractually tighten the fiduciary duties of preferred-controlled boards or the manner in which they are enforced. For example, the parties might wish to define, as a breach of fiduciary duty, any transaction that reduces aggregate shareholder value, even if it might otherwise be in the "best interests of the corporation." However, corporate fiduciary law is considered mandatory and not contractually alterable.[130] Thus, parties who would prefer some other approach to corporate fiduciary duty are unlikely to try to contract for it.

Alternatively, the parties could attempt to devise contractual protection for the common shareholders similar to the protective provisions negotiated by preferred shareholders. But it would be difficult to devise arrangements that are cost-effective. The protective provisions in preferred stock agreements commonly require specified corporate actions to be approved by a majority of the preferred shareholders. One could similarly require that certain transactions be approved by a majority of common shareholders. However, the list of transactions requiring approval will inevitably turn out to be underinclusive. Moreover, such voting protections can, as we argued, be subverted through cross-voting or vote buying.[131] Blanket prohibitions would not be susceptible to such manipulation. But they could easily turn out to be overinclusive, preventing the startup from pursuing value-increasing transactions. In short, the parties' ability to prevent a preferred-controlled board from acting opportunistically is likely to be extremely limited, given the incompleteness of contracts and the parties' inability under current law to contractually tighten fiduciary duties.

---

130 Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1481 (1989) ("[T]he corporation's directors and officers have a duty of loyalty to the corporation that cannot be substantially altered.").

131 *See supra* Part III.B.2.

## IV
## REDUCING THE AGENCY COSTS OF PREFERRED CONTROL

We have seen that the standard governance arrangements of venture-backed startups, in which VCs invest through preferred shares and obtain board control, may leave common shareholders vulnerable to preferred opportunism. In particular, a preferred-controlled board may make decisions that benefit the preferred while imposing a substantially larger cost on the common. The possibility of preferred opportunism may, in turn, increase the cost of angel financing and undermine the financial value and incentive effects of employees' equity-based compensation.

Preferred opportunism can arise when (1) the firm issues preferred stock to VCs; (2) the VCs obtain control of the startup; and (3) VCs use their control to benefit preferred shareholders at the expense of shareholders as a group. The parties' ability to eliminate these costs through private ordering is limited, in part because of tax and corporate fiduciary law rules over which the parties have no control.[132] The tax system imposes a penalty on startups that issue common stock to VCs. And the courts' current approach to fiduciary duties increases agency costs whether common shareholders or preferred shareholders control the board.

This Part explores ways to alter the mandatory legal framework in which VCs and entrepreneurs negotiate to make it easier for the parties to reduce the agency costs of preferred control. Section A puts forward for discussion a proposal designed to eliminate the implicit tax penalty imposed on VCs investing through common stock. Eliminating the tax penalty for the use of common stock would make it cheaper for startups to use only one class of shares—common stock. An all-common capital structure would, in turn, eliminate the distortions we identify in this Article.

Section B proposes that courts permit firms, in their corporate charters, to adopt more restrictive fiduciary duties when the parties believe that such an approach would better serve their interests. By opting into heightened fiduciary duties, startups may be able to directly reduce both the agency costs of common shareholder control and the agency costs of preferred shareholder control. We also offer an example of a more restrictive fiduciary rule that the parties might find attractive: what we call the "balancing" approach. Under this approach, directors would be considered to have violated their fiduciary duty to the corporation and its shareholders if (1) they took steps that favor one group of shareholders over another; and (2) the

[132] *See supra* Part III.D.

cost to the disfavored group exceeded the benefit to the favored group. Such an approach, we explain, may well reduce common-controlled boards' ability to act opportunistically toward preferred shareholders and also reduce preferred-controlled boards' ability to act opportunistically toward common shareholders. Thus, permitting startups to opt into the balancing approach to fiduciary duties could improve corporate governance in both VC-controlled and other startups.

### *A. Leveling the Tax Playing Field*

One way to eliminate the agency costs of preferred control is to adopt an all-common capital structure. However, the U.S. tax code (inadvertently) penalizes startups that issue common stock rather than preferred stock to VCs.[133] The use of preferred stock allows the startup to obscure the value of the common stock underlying employees' incentive compensation. This, in turn, enables the startup to assign a below-market value to the stock with little risk of IRS penalties, reducing the tax burden on employees. The startup and its investors indirectly benefit by enabling the startup to pay employees less. Were the VCs to invest through common stock, the price paid for the common stock would establish its market value, making it impossible for the startups to assign an artificially low value to the stock underlying employees' incentives. Essentially, the tax law penalizes startups that issue common stock to VCs by making it more costly for their portfolio firms to provide equity-based incentive compensation to employees.

From a social perspective, subsidizing the use of preferred stock through the tax system is likely to be inefficient. Suppose that, but for tax considerations, Venture Capitalist (VC) and Entrepreneur (E) would use a single-class structure. Specifically, suppose that in a taxless world, the net benefits of an all-common structure are $100, while the net benefits of a dual-class structure (one in which VC invests through preferred stock) are $50, in part because of the agency costs of preferred control. In such a taxless world, the parties have an incentive to choose the efficient, all-common arrangement.

However, now suppose that the tax savings from VC's use of preferred would be $60. A dual-class structure would now yield the parties a net benefit of $110 ($50 + $60), more than the $100 from a single-class structure. If the parties are informed and rational, they will choose the dual-class structure. However, the social value generated by that arrangement—the net benefit to the parties and the gov-

[133] *See supra* Part II.A.3.

ernment—is $50 less than the alternative single-class structure. From an economic perspective, the tax system inefficiently distorts the parties' arrangement and reduces total social value.

Eliminating this tax distortion will make it easier for the parties to reduce the agency costs of preferred control by switching to an all-common capital structure. Below, we consider various ways to level the tax playing field. We first consider the possibility of tougher enforcement of the tax laws. We explain why tougher enforcement is unlikely to substantially reduce preferred's subsidy. We also argue that this approach to leveling the tax playing field, even if it were successful, may well be socially undesirable because it increases the tax and transaction cost burdens on startups. We then offer for consideration a new approach to the substantive tax treatment of employee stock options that completely levels the tax playing field between preferred and common, need not increase startups' overall tax burden, and substantially reduces transaction costs.

### *1. Tougher Enforcement?*

Given that the tax penalty for VCs' use of common arises from the failure of the IRS to enforce the tax laws effectively when VCs invest through preferred, an obvious way to level the playing field is to change enforcement practices. In particular, the IRS could more aggressively enforce the tax law against preferred-issuing startups.

To induce startups issuing preferred stock to value more accurately the common stock underlying employee compensation, the IRS would need to increase the expected cost to startups of undervaluing their common stock. There are two ways the IRS could increase the expected cost of such tax cheating: (1) increase the likelihood of apprehension and sanction (by, for example, boosting audit frequency); or (2) raise penalties.

In fact, the IRS has recently adopted the second approach: increasing penalties on private firms undervaluing their common stock. In October 2005, the IRS issued proposed regulations[134] that impose additional taxes and penalties when the IRS determines that stock has been undervalued for tax reporting purposes unless the valuation used is, among other things, (1) evidenced by a written report; and (2) performed by a person with significant knowledge and experience or training in performing such valuations.

---

[134] Application of Section 409A to Nonqualified Deferred Compensation Plans, 70 Fed. Reg. 57,930, 57,959 (proposed Oct. 4, 2005) (to be codified at 26 C.F.R. pt. 1); I.R.S. Notice 2006-4, 2006-3 I.R.B. 307, 308 (delaying applicability of certain requirements of proposed regulation until 2007).

The threat of increased penalties may well lead many startups to obtain written appraisals of the value of their common stock. However, it is far from clear that stock valuations themselves will be materially affected by the requirement of a written appraisal. Appraisal is highly subjective. Appraisers hired by startups can be expected to find ways to justify low stock valuations. Should an audit occur, these written valuations will be difficult for the IRS to challenge. The written appraisal requirement may thus have little effect on the tax subsidy to preferred.

To be sure, appraisers may actually insist on valuing the common stock of preferred-issuing firms much closer to its actual value. Such higher valuations would reduce the tax benefit of using preferred-stock financing. If the tax benefit is sufficiently diminished, some firms may move to all-common equity structures, eliminating the agency costs we identified in this Article.

However, even if the proposed regulations lead some firms to finance themselves solely with common stock, it is far from clear that increasing the tax burden on startups in this manner is beneficial overall. First, the proposed regulations impose additional transaction costs on firms. A startup generally provides equity-based incentives to employees when they are hired. New employees join the startup on a regular basis. Thus, the startup may need not only to obtain a written appraisal but also to update it frequently to justify the stock valuations used.

Moreover, the proposed regulations may undesirably increase the overall tax burden on startups. Some commentators have suggested that a tax subsidy to venture-backed firms may generate economy-wide benefits.[135] Aggressively enforcing the valuation of incentive compensation by startups may reduce any such benefits. In sum, tougher enforcement of the tax laws is unlikely to level significantly the tax playing field because of the difficulty of establishing the actual value of startup common stock. And even if it does, such an approach may well be socially undesirable because it would impose higher tax and transaction costs on startups.[136]

---

135 *See* Gilson & Schizer, *supra* note 4, at 910.

136 An alternative enforcement-based approach to leveling the tax playing field would be for the IRS to enforce the tax law *less* aggressively in common-only startups. For example, the IRS could indicate, informally or explicitly, that it will not challenge the value that all-common firms place on stock for incentive compensation purposes, as long as the values are not out of line with the values assigned in preferred-issuing startups. However, even if such an approach were desirable in principle, the IRS is probably institutionally incapable of condoning tax avoidance in this manner.

### 2. *Changing the Substantive Tax Law*

The tax subsidy for preferred could be eliminated by changing the substantive tax law. Below, we put forward for consideration and briefly discuss a new approach to taxing equity-based incentive compensation that would level the tax playing field between preferred and common: assigning all stock and stock option grants a $0 grant-date value for tax purposes. We also explain why this approach would reduce the transaction costs imposed on startups and not necessarily increase their overall tax burden. Because a complete analysis of this approach is beyond the scope of this project, we are not ready to advocate its adoption. Our goal is simply to convince the reader that it may well be desirable to level the tax playing field by changing the substantive tax law, and to offer for consideration and further analysis one way to do so.

Under our $0 grant-date value approach, private firms would assign a grant-date value of $0 to the common stock underlying employee incentive compensation. There would be no tax consequences until the employee sold the underlying stock for cash (or cash equivalent). Upon sale, the gain (sale proceeds less any amount paid by the employee for the stock) would be deductible by the firm as an expense and taxed to the employee at a specified rate.

The tax rate imposed on the gain would depend on the optimal subsidy for the use of equity-based compensation in private companies. A lower tax rate would provide a larger subsidy to private companies that use equity-based compensation. However, a lower rate would also reduce the relative tax cost of equity compensation, perhaps leading to the excessive use of equity-based compensation in these firms. That is, it could cause private firms to use stock-based compensation even when cash compensation is more efficient.[137] In setting the optimal tax rate, one would need to balance the benefit (if any) of subsidizing these private firms against the cost of distorting their compensation arrangements.

This approach has at least two distinct advantages over the current tax system. First, VCs' use of preferred stock rather than common stock would not affect the tax treatment of incentive compensation provided to a startup's employee. Therefore, the parties

[137] To reduce the parties' ability to use stock to provide salary-like compensation at favorable tax rates, the tax rate imposed on the gain from the sale of stock could vary with the holding period. For example, stock sold less than one year after the stock or option grant might be taxed at ordinary income tax rates; stock sold one year or more after the grant date could be taxed at a lower rate.

would not have an incentive to use preferred stock when giving VCs common stock would be a more efficient arrangement.

Second, there would be no need to value the stock at the time the equity-based compensation is granted. Firms would not incur the expense of obtaining written valuations of the common stock underlying employee compensation. And the government and firms would not need to spend money auditing, defending audits, and litigating over grant-date values. Thus, the transaction and enforcement costs of such an approach would be considerably lower than they are under current tax rules.

To be sure, the $0 grant-date approach for private companies may entail its own costs that must be weighed against these two potential benefits. As we have indicated, our goal here is not to develop and fully defend a detailed proposal for taxing incentive compensation. Rather, our aim is to show that leveling the tax playing field may be desirable and to put forward for discussion and further analysis one way it might be done without undesirably increasing the tax and transaction-cost burden on startups.

Nor are we claiming, as a predictive matter, that most VCs would invest through common stock if the implicit tax subsidy for preferred were eliminated. While VCs often invest through common stock in jurisdictions where this tax subsidy does not exist,[138] there are many potential agency-cost reducing benefits to preferred stock that might lead most U.S. startups to continue to issue preferred even absent a tax subsidy.[139] Our claim is that tax considerations may induce some startups to use preferred rather than common stock, and that eliminating the tax distortion would lead to more efficient investment arrangements in those cases.

### *B. Allowing Stricter Fiduciary Duties*

Whether or not the tax playing field is leveled, many startups (as well as established firms) are likely to continue to have two classes of equity, preferred and common, with different cash flow rights. This dual class structure inevitably gives rise to agency problems. Whichever class controls the board has an incentive to favor its own interests at the expense of the other. And, under the Delaware courts' control-contingent approach to fiduciary duties, the controlling class often has substantial leeway to make decisions that favor itself at the expense of other shareholders. In this Section, we propose that firms wishing to adopt more stringent fiduciary duties be permitted to opt into such a

138 *See supra* note 41.

139 *See supra* Part II.A.2.

rule through a provision in their corporate charters. We also put forward the "balancing approach" as an example of a stricter approach to fiduciary duties that parties should be permitted to opt into.

### 1. *Benefits of Private Tailoring*

Under the courts' control-contingent approach to fiduciary law, the content of directors' legal duties depends on the identity of those controlling the board. A common-controlled board is free to favor common shareholders over the preferred in making business decisions, even if doing so reduces total shareholder value. And preferred-controlled boards may advance the interests of the preferred at the expense of common shareholders, as long as their decision can be justified as in the "best interests of the corporation." However, as we have shown, the ambiguity of the "best interests" standard, information asymmetry, lack of financial resources, and reputational considerations may make it difficult for common shareholders to use fiduciary duties to constrain preferred opportunism. Thus, the courts' current approach offers inadequate protection to both preferred shareholders and common shareholders when the other class is in control.

Because corporate fiduciary duties are considered non-contractable,[140] the parties face a fairly stark choice: (1) give control of the board to common shareholders, placing preferred shareholders at risk of common opportunism; or (2) give control of the board to the preferred, placing common at risk of preferred opportunism.[141] The parties can be expected to adopt whichever of the two approaches is least costly, even if they would prefer a third alternative.

Given the parties' limited menu of choices, it is not surprising that the preferred receive control in many startups. Common shareholder control would likely be even more costly in many cases. Among other things, the courts appear to give common-controlled boards even more leeway than preferred-controlled boards to act opportunistically toward other classes of stock.[142] And a common-controlled board is likely to monitor the entrepreneur less effectively than one controlled by more experienced VCs. However, while the

---

[140] *See supra* note 130 and accompanying text.

[141] In principle, the parties could create a board that is not dominated by any single class of shareholders. One could, for example, have a six-person board in which three seats are held by shareholders whose sole interest in the firm is through common stock ownership, and three seats are held by preferred shareholders. However, it will generally be difficult to find individuals whose only interest in the firm is through their ownership of common stock, whose ownership interests are large enough to motivate them to adequately represent the interest of common shareholders as a class, and who are otherwise qualified to sit on the board.

[142] *See supra* Part II.B.3.

parties' choice of arrangement presumably makes them best-off *given* the courts' current approach to fiduciary duties, it is far from clear that this approach—which exposes non-controlling classes to the risk of opportunism—is the most suitable approach to fiduciary duties in startups or indeed in any firm with two or more classes of stock outstanding.

We thus suggest that courts permit a firm to "opt into" tighter fiduciary restrictions on the board through a provision in the corporate charter if the parties believe that such tighter restrictions would be value-increasing.[143] Parties wishing to adopt such tighter restrictions would then be free to do so. There are a number of ways that parties should be allowed to give fiduciary duties more "teeth." First, parties should be able to increase the deterrent effect of current duties by changing procedural rules to increase the likelihood and success of a lawsuit. For example, if courts currently consider conduct *X* to violate a board's fiduciary duty, parties could increase deterrence by shifting the burden or standard of proof in ways that favor plaintiffs. Second, parties should be able to increase the range of conduct considered to be a breach of fiduciary duty. For example, the parties should be permitted to define conduct *Y* as a breach of fiduciary duty even though it may currently be considered legal. And with respect to claims involving conduct not otherwise considered a breach of fiduciary duty, the parties should be permitted to specify procedural rules, such as standing to sue and burdens and standards of proof, as well as the remedies available to plaintiffs. For example, the charter provision could permit only certain types of shareholders to bring a claim involving conduct *Y*, or allow only injunctive actions against *Y* (rather than recovery of damages). Below, we offer an example of a more restrictive approach to fiduciary duties—one that parties might find worth adopting were they permitted to privately tailor their own arrangements.

### 2. *The Balancing Approach*

Under the courts' control-contingent approach to fiduciary duties, there is no legal constraint on the board's ability to favor

[143] There may be situations in which there are benefits to allowing parties to opt into looser fiduciary duty rules. However, there are risks associated with such opting-out. In particular, one party may not be able to anticipate the degree to which the other party can act opportunistically. *Cf.* Melvin A. Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 249 (1995) ("Given the limits of cognition, the core duty-of-loyalty rules should not be subject to a general waiver."). Given the current looseness of boards' fiduciary duty to non-controlling classes of stock, we see little benefit to allowing parties to opt into even looser rules. Thus, we suggest that parties only be permitted to opt into stricter rules than those provided by the courts.

common shareholders over the preferred in making business decisions, even if doing so reduces total shareholder value. And, as a practical matter, preferred-controlled boards may well have the ability to take steps that advance the interests of the preferred at the expense of total shareholder value.

Parties permitted to contract over a board's fiduciary duties may prefer what we call the "balancing approach" to fiduciary duties. Under this approach, directors would violate their fiduciary duty to the corporation and its shareholders if they take steps that favor one (or more) classes of shares over one or more other classes of shares, and the cost they impose on the adversely affected class(es) exceeds the benefit to the favored class(es). For example, a common-controlled board could not take steps to benefit the common at the expense of the preferred if those steps imposed an even larger cost on preferred shareholders. And a preferred-controlled board could not advance the interests of the preferred shareholders at the expense of aggregate shareholder value, even if its actions somehow could be defended as in the "best interests of the corporation." Such a rule—if it could be enforced at sufficiently low cost—would maximize the size of the total pie to be shared by the parties and, presumably, is the rule they would agree to ex ante.

To be sure, both courts and boards face informational constraints. It may be difficult for the board—and courts—to estimate the effect of particular decisions on different classes of shareholders. Such an estimate requires, among other things, valuing the firm under a hypothetical alternative course of action. Directors would understandably be concerned that a court would find them to have breached their fiduciary duties even though they had, in good faith, sought to act in a value-maximizing manner. Board decisionmaking could therefore be paralyzed. Fear of disrupting board decisionmaking may be one reason why courts have developed the control-contingent approach to fiduciary duties, which largely avoids the need to examine the effect of the board's decision on shareholders as a group.

However, it may be possible to design a balancing test that minimizes this problem. For example, the charter provision establishing the balancing test could limit or even eliminate damages, leaving injunctive relief as the primary (or only) remedy. Alternatively, procedural rules could be imposed that make it difficult for plaintiffs to proceed unless they have an extremely strong case. These features could substantially reduce the risk of board paralysis. A properly constructed balancing standard provision might better encourage boards to take into account the effects of their decisions on non-controlling

classes while keeping the risk of meritless suits and their attendant costs acceptably low.

It is worth noting that, even if the likelihood of litigation is low, a balancing approach may well improve board decisionmaking through the creation of better social norms. Many people follow rules—including their contractual commitments—even when doing so is inconsistent with their material self-interest and there is little chance they would be punished for violating those rules.[144] In the context of corporate law, where opportunistic behavior is often difficult to detect and even harder to prove, norms are particularly important.[145] Thus, the parties are likely to be able to affect directors' decisions simply by including in the corporate charter a provision requiring the board to weigh the effects of its decisions on non-controlling classes of stock. If lawyers could tell directors that the corporate charter permits them to advance the controlling class's interests, but only if the other class is not injured by an even larger amount, directors wishing to do the "right thing" might make different decisions than they make now, and these decisions would tend to increase the size of the startup pie for the benefit of all its participants.

Importantly, we are not arguing that most parties permitted to opt into the balancing test or other more restrictive approaches to fiduciary duty would do so, or even that they should do so. Rather, our claim is that the parties may well prefer startup boards to be governed by some approach to fiduciary duties other than the courts' current control-contingent approach, and that courts should allow parties, through charter provisions, to opt into more restrictive fiduciary duty rules than those currently offered by the courts. Of course, if the parties in a startup prefer to leave fiduciary duties to the courts, and to be governed by the case law in *Equity-Linked* and *Orban*, they would be free to do so.

## CONCLUSION

Venture capitalists play a significant role in the economy by financing and nurturing high-risk, technology-based business ventures, investing billions of dollars annually in emerging companies. When investing in these firms, VCs typically receive preferred stock and

144 *See* Robert Cooter & Melvin A. Eisenberg, *Fairness, Character, and Efficiency in Firms*, 149 U. PA. L. REV. 1717, 1723 (2001) ("In deciding what to do, a sense of commitment to norms receives weight relative to the actor's self-interest.").

145 For the role of norms as important and influential forces in corporate law, see, for example, Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1013 (1997) (arguing that people internalize rules and standards because of "sense of self-worth" and not only because of fear of sanction).

extensive control rights. While various explanations for each of these arrangements have been offered, scholars have failed to notice that these arrangements result in a highly unusual corporate governance structure: one in which preferred shareholders, not common shareholders, control the board and the firm.

This Article has documented the unusual governance structure of VC-backed startups and explained why this structure is so pervasive in the United States. It has also demonstrated that preferred shareholder control can give rise to potentially large agency costs, because it leaves common shareholders vulnerable to preferred opportunism. Finally, the Article has put forward possible legal reforms designed to help VCs and entrepreneurs reduce these agency costs and improve corporate governance in startups. We hope that our analysis will be useful to courts, legislatures, and researchers seeking to better understand and improve the corporate governance of venture-backed startups.