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The Vulnerability of Common Shareholders in VC-Backed Firms

by

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The Vulnerability of Common Shareholders in VC-Backed Firms

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Abstract

The capital structure and governance of venture-backed startups have received significant attention from economists and legal academics. Much of this literature has focused on venture capitalists' use of preferred stock and control rights – including board control -- to reduce agency costs. Recently, it has also been suggested that VCs' use of preferred stock is tax-driven. However, scholars have failed to notice that these arrangements, whatever their explanation, lead to a highly unusual and perhaps unique corporate governance structure: one in which preferred shareholders, not common shareholders, control the board and the corporation. The purpose of this paper is threefold: (1) to highlight the unusual governance structure of venture-backed startups; (2) to show that this structure leaves common shareholders vulnerable to opportunistic behavior by preferred-holding VCs, especially under current corporate law doctrines; and (3) to consider changes in these doctrines and the tax laws that would reduce common shareholder vulnerability and enlarge the startup pie for all its investors.

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I. Introduction

Venture capitalists (VCs) play a significant role in the financing of high-risk, technology-based business ventures, investing billions of dollars annually in emerging companies.[1] VCs also provide valuable management and strategic advice to these startups, many of which are founded by entrepreneurs with little business experience.[2] As a result, venture capital is considered to be 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 the funds' limited partners,[5] the

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[1] See, e.g., Ernst & Young LLP and VentureOne, *Later-Stage Investments Push Overall U.S. Venture-Capital Investment to Highest Level In Four Quarters,* (July 2005) <http://www.ey.com/global/content.nsf/US/Media_-_Release_-_07-25-05DC> (visited Aug 2005), (reporting a total of $10.11 billion of VC investment in the U.S. during the first two quarters of 2005, and a total of $21.28 billion in all of 2004).

[2] *See* David Denis, *Entrepreneurial Finance: an Overview of the Issues and Evidence*, 10 J. CORP. FIN. 301, 305 (2004); Joshua Lerner, *Venture Capitalists and the Oversight of Private Firms*, 50 J. FIN. 301(1995).

[3] *See* Bristow, Benjamin and Petillon, *Venture Capital Formation and Access: Lingering Impediments of the Investment Company Act of 1940*, COLUM. BUS. L. REV. 77 (2004); Joshua Lerner, *Boom and Bust in the Venture Capital Industry and the Impact on Innovation*, FEDERAL RESERVE BANK OF ATLANTA ECONOMIC REVIEW, 2002(4), 25.

[4] *See,* e.g., Leslie Jeng & Philippe Wells , *The Determinants of Venture Capital Funding: Evidence Across Countries, 6* J. CORP. FIN. 241 (2000); Thomas Hellmann & Manju Puri , *The Interaction between Product Market and Financing Strategy: The Role of Venture Capital*, 13 REV. FIN. STUD. 959 (2000); George Triantis , *Financial Contract Design in the World of Venture Capital*, 68 U. CHI. L. REV. 305 (2001); Douglas Cumming, *Adverse Selection and Capital Structure: Evidence from Venture Capital* (working paper, 2004); and Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 901 (2003).

[5] See, e.g., Michael D. Klausner, & Kate Litvak, *What Economists Have Taught Us About Venture Capital Contracting*, in Bridging the Entrepreneurial Financing Gap: Linking Governance With Regulatory Policy, (Michael Whincop, ed., Ashgate, 2001); Kate Litvak, *Governance Through Exit: Default Penalties and Walkaway Options in Venture Capital Partnership Agreements*, 40 WILLAMETTE L. REV 771; and William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. Fin. Econ. 473

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

Much of this literature has focused on the structure of VCs' cash flow and control rights in these portfolio companies. VCs' cash flow rights differ significantly from those of other shareholders. Founders, early "angel" investors, and employees hold common stock. In contrast, VCs almost always invest through convertible preferred stock that provides substantial liquidation preferences.

VCs also typically receive extensive control rights in venture-backed startups. Like preferred shareholders in public companies, VCs obtain substantial protective provisions through 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 usually obtain board control. As a result, preferred-owning VCs have substantial power over other participants in the startup.

The literature on VC investment arrangements argues that these arrangements reflect the parties' efforts to minimize agency and tax costs. 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 common-holding

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(1990);Paul Gompers & Josh Lerner, *The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 39 J. L. & Econ. 463 (1996).

[6] See, e.g., Paul A. Gompers, *Optimal Investment, Monitoring, and the Staging of Venture Capital*, 50 J. Fin. 1461 (1995); and Fenn, Liang & Prowse, *The Economics of the Private Equity Market,* BD. OF GOVERNORS OF THE FED. RESERVE SYS., Staff Studies Series No. 168, 1995. For further empirical work see, e.g., Steven Kaplan & Per Stromberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis Of Venture Capital Contracts*, 70 REV. ECON. STUD. 281 (2003).

[7] See, e.g., Thomas Hellmann & Manju Puri, *Venture Capital and the Professionalization of Start-Up Firms: Empirical Evidence*, 57 J. Fin. 169 (2002); Lerner (1995), *supra* note x; Malcolm Baker and Paul A. Gompers, *The Determinants of Board Structure at the Initial Public Offering*, 46 J. Law & Econ. 569 (2003); and Gompers (1995) *supra* note x.

[8] See e.g., Bernard Black & Ronald Gilson, *Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets*, 47 J. FIN. ECON., 243 (1998); D. Gordon Smith, *Control Over Exit in Venture Capital Relationships* (SSRN Elec. Paper Coll. No. 272231, 2001); and Douglas J. Cumming & Jeffrey G. MacIntosh, *A Cross-Country Comparison of Full and Partial Venture Capital Exits*, 27 J. Banking & Finance 511 (2003).

founders with stronger incentives to generate value, and board control may enable VCs to more easily monitor and replace poorly-performing managers. Two prominent legal academics have also recently argued that VCs' use of preferred stock may result from an implicit tax penalty for the use of common stock. In particular, VCs' use of common stock would effectively subject the firm's employee compensation to a higher tax rate, reducing investors' returns.[9]

Surprisingly, little attention has been given to the fact that the combination of VCs' cash flow and control rights, whatever their origin, 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 paper is threefold: (1) to highlight the unusual governance arrangement of venture-backed startups; (2) to show that this structure leaves common shareholders vulnerable to preferred opportunism,[10] especially under current legal rules; and (3) to propose changes to the tax and corporate laws aimed at reducing common shareholder vulnerability and increasing the size of the startup pie for all investors.

Our first objective is to draw attention to an important point that has been overlooked in the literature: VCs' investments in startups create a corporate governance structure that is, as far as we know, 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 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. This standard arrangement --- common in control with no fiduciary duty owed to the preferred --- is considered generally desirable because, among other things, common shareholders generally have the greatest incentive to increase corporate value. While

[9] Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 901 (2003).

[10] We use the term "opportunism" to mean self-serving, value-reducing behavior.

there is a risk of common-shareholder opportunism, preferred shareholders typically negotiate elaborate provisions in their stock contracts to protect their interests.

In contrast, in a venture-backed startup the preferred usually receive *both* protective provisions *and* board control. Moreover, in the only case that has considered the issue, a Delaware court ruled that a preferred-controlled board is permitted to advance the interests of preferred at the expense of common. This case, together with the many cases holding that common-controlled board owe no fiduciary duty to the preferred, suggests that courts have adopted what we call a "control primacy" approach to fiduciary duties: a board controlled by a particular class of stock does not, in making business decisions, owe a fiduciary duty to other classes of stock. Under control primacy, preferred shareholders in venture-backed startups therefore occupy the traditional "inside" position of common shareholders, while the common occupies the traditional "outside" position of the preferred. However, unlike preferred shareholders in common-controlled firms, the common in preferred-controlled firms lack contractual class-specific protective provisions.

The second purpose of this paper is to show that control by preferred-owning VCs leaves common shareholders vulnerable to value-reducing behavior by the preferred, a vulnerability exacerbated by judges' willingness to limit the fiduciary protection accorded to non-controlling common. Thus, while VCs' cash-flow and control rights may reduce entrepreneur agency and tax costs, they likely give rise to another set of costs. In particular, we show that preferred-owning VCs may – at certain stages of a startup's life -- have an incentive to choose lower-value, lower-risk investment and exit strategies over higher-value, higher risk strategies. 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.[11] We also show that the possible legal and nonlegal mechanisms for

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[11] 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 through common stock). VCs might push for quick IPOs for grandstanding purposes, i.e. in order to attract attention that will help them raise subsequent funds (at the expense of even their own limited investors). See

preventing value-reducing behavior -- (1) shareholder voting requirements; (2) appraisal rights; and (3) VC's reputational considerations -- are unlikely to be very effective.

We also explain that the expectation of preferred opportunism may distort the decision-making of current and potential common stockholders even before VCs invest. To begin with, the prospect of preferred opportunism makes it more expensive for entrepreneurs to raise capital from investors who typically invest through common, such as angel investors. In addition, preferred opportunism might reduce entrepreneurs' willingness to turn to VC financing, even in cases where VC financing could add considerable value. Finally, the possibility of preferred opportunism could reduce the incentive effects of the common stock and options heavily used to compensate employees of such companies. We show that if, as is likely, capital and labor markets are not perfectly competitive, the distortions caused by preferred opportunism are likely to be borne, at least in part, by all of the parties, including the VCs themselves. Thus, reducing these distortions would, over time, benefit all the parties.

The third and final purpose of this paper is to examine how these distortions could be mitigated or eliminated by altering the mandatory legal framework within which entrepreneurs and VCs contract. The problems we identify all arise from (a) the existence of a dual-class equity structure and (b) the vulnerability of the non-controlling common to opportunism by the controlling preferred.

We first propose that the implicit tax penalty for VCs' use of common be eliminated. In those cases where VCs' use of preferred is caused by tax considerations, leveling the tax playing field would lead VCs to invest through common, thereby

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Paul A. Gompers, *Grandstanding in the Venture Capital Industry*, 42 J. FIN. ECON. 133 (1996); Peggy M. Lee and Sunil Wahal, *Grandstanding, Certification and the Underpricing of Venture Capital Backed IPOs*, 73 J. FIN. ECON. 375 (2004) (describing the 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., *Alantec, infra note x ; Latif v. Nishan, infra note x*). In this paper, 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.

eliminating all the agency costs we identify in this paper. Consequently, we present several approaches for putting common and preferred on an equal tax footing.

Because VCs' use of preferred stock is unlikely to be tax-driven in every case, some dual-class structures are likely to persist even if the tax playing field is leveled. In these cases, it is worth considering whether fiduciary duty rules might be modified to provide better protection to the non-controlling class, particularly when that class is the common. As an alternative to the current control primacy approach, we put forward for consideration a new "balancing approach" to fiduciary duties in preferred-controlled startups. Under this approach, a board would be considered to violate its duty of loyalty to the corporation and its shareholders if the board takes steps to benefit preferred shareholders that imposed a substantially greater cost on common. We show that adoption of such a duty would tend to discourage preferred-controlled boards from making decisions that substantially reduce total shareholder value in order to increase the value of the preferred.

To be clear, our analysis and proposals do not assume that VCs and entrepreneurs are failing to contract efficiently. Although we are skeptical that entrepreneurs are always well advised and fully informed when contracting with VCs,[12] for purposes of this paper we assume that entrepreneurs and VCs negotiate arrangements that maximize the size of the pie within the framework provided by existing corporate and tax law. Our claim is that this legal framework --- and in particular the tax system's penalty for the use of common and courts' control primacy approach -- is not optimized to maximize startup value; accordingly, modifying these rules may enable the parties to share in an even larger pie.

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[12] Cf. Manuel A. Utset, Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital-Financed Firms, 2002 WIS. L. REV. 45, 100 (arguing that entrepreneurs are overly-optimistic and inexperienced, and accept VC financing terms that might not be in their favor). See also Mark C. Suchman, Daniel J. Steward, & Clifford A. Westfall, *The Legal Environment of Entrepreneurship: Observation on the Legitimation of Venture Finance in Silicon Valley,* in (Schoonhoven, C.B. and Romanelli, E., eds. 2001), *The Entrepreneurship Dynamic*. Stanford, California, USA: Stanford University Press, pp. 349-382, (arguing that financing terms are standard across investments, and suggesting that they are not optimally tailored to each start-up.)

The remainder of the paper proceeds as follows. Part II describes the standard corporate governance arrangement, in which common controls the board, and directors do not owe a fiduciary duty to preferred shareholders (or any other investors). Part III highlights the unusual corporate governance arrangements of venture-backed startups: one in which those 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 and tax benefits of these arrangements. Part IV shows that these unusual arrangements are likely to leave common vulnerable to opportunistic behavior by preferred-controlled boards, thereby giving rise to a different set of agency costs. Part V presents our tax and fiduciary duty proposals which are designed to improve the legal framework within which entrepreneurs and VCs contract. Part VI concludes.

II. Standard Corporate Governance

This Part describes the governance arrangements of a typical corporation. As Section A explains, the board is elected and controlled by common shareholders. Section B describes the courts' longstanding position that directors of a common-controlled board owe a fiduciary duty only to the common. Section C explains why this standard arrangement is generally believed to promote desirable governance.

A. Common in Control

A corporation is controlled by its board of directors. The board manages the business and affairs of the company[13], and initiates fundamental transactions – such as mergers, IPOs, or liquidations.[14] 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 (if necessary) replaces 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.

In a typical corporation, the right to vote for directors resides exclusively with the common shareholders. Preferred shareholders and creditors do not participate in board elections. Thus, common shareholders are on the "inside," and other investors are on the "outside."

To be sure, preferred stock agreements often give preferred shareholders the right to vote as a class on certain corporate transactions and changes that could materially affect their interests. For example, preferred shareholders often have the right to vote on

[13] 8 Del. C. 141(a); Cal. Corp. Code §300(a); MBCA §8.01.

[14] 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).

matters such as amendments to the certificate of incorporations, mergers, and consolidations. However, in most public companies, preferred stock agreements and certificates of incorporation do not give preferred shareholders the right to vote in the election of directors.[15]

Similarly, large lenders, like preferred shareholders, might bargain for the right to block certain corporate transactions that adversely affect their interests. For example, creditors often bargain for restrictions on the firm's ability to engage in additional borrowing and issue dividends.[16] But, like preferred shareholders, creditors generally do not elect any directors to the board.[17] As a result, board control is in the hands of common shareholders, and the board can be expected to advance the common shareholders' interests even at the expense of other investors.

B. Control Primacy: Fiduciary Duty Only to Common

A corporate board is considered to owe a fiduciary duty of loyalty to the corporation and its shareholders. The directors' corporate duty of loyalty requires them to promote the best interests of the corporation and its shareholders. Among other

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[15] *See* D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1469 (2002). 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., Harvey R. Miller, *Corporate Governance in Chapter 11: The Fiduciary Relationship between Directors and Stockholders of Solvent and Insolvent Corporations,* 23 SETON HALL L. REV. 1467, 1506 (1993). 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 qua preferred shareholders.

[16] See, e.g. George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CALIF. L. REV. 1073 (1995).

[17] Of course, to the extent that the debt is convertible into common stock, creditors can vote after they convert their debt into stock. But, like preferred shareholders, they rarely if ever can vote for directors as creditors. *See* Alexander J. Triantis & George G. Triantis, *The Washington University Interdisciplinary Conference on Bankruptcy and Insolvency Theory: Conversion Rights and the Design of Financial Contracts*, 72 WASH. U. L. Q. 1231, 1253 (1994).

things, the duty of loyalty prohibits a director from taking actions – such as self-dealing or taking a corporate opportunity-- that would benefit himself personally at the expense of the corporation and its shareholders.[18] Violating this duty may subject directors to personal liability.

In firms that have issued two or more classes of stock, courts could interpret directors' fiduciary duties to prohibit directors from unfairly favoring their class of stock at the expense of other types of shareholders. However, under what may be called the "control primacy" approach, courts have until now generally allowed a board controlled by one class of shares to ignore the effects of its decisions on other classes.[19] Thus, courts have uniformly held that 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 they do not violate specific provisions of the preferred stock agreement.[20]

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[18] Such duties are generally enforced through derivative or direct litigation.

[19] Our analysis focuses on the case law of Delaware, the state in which the plurality (if not the majority) of venture-backed startups are incorporated. The laws of California, the second most popular state of incorporation for startups, are somewhat more favorable to non-controlling classes of stock, but plaintiffs' ability to bring fiduciary suits is much more limited than in Delaware because appraisal is considered shareholders' exclusive remedy in connection with a merger. Thus, on balance, California's law is not more favorable to non-controlling classes of stock.

[20] See, e.g., Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 1986 Del. Ch. LEXIS 509; See, e.g., D. Gordon Smith, The Critical Resource Theory of Fiduciary Duty, 55 VAND. L. REV. 1399, 1471 (2002). Delaware courts have twice departed from "control primacy" in situations involving zero-sum transactions (such as the allocation of merger proceeds or the repurchase of one class of stock), holding that the board has a fiduciary duty to treat all classes fairly. See, In re FLS Holdings, Inc. Shareholders Litig., 1993 Del. Ch. LEXIS 57 (requiring a common-controlled board to treat the preferred shareholders fairly in the allocation of merger proceeds); and General Motors Class H Shareholders Litig., 734 A.2d 611, 1999 Del. Ch. Lexis 59.

The courts also recognize an exception when the firm is insolvent or on the verge of insolvency. In that case, even directors of a common-controlled board are considered to owe a duty to creditors (instead of or in addition to common shareholders). See Alon Chaver & Jesse M. Fried, *Managers' Fiduciary Duty Upon the Firm's Insolvency: Accounting for Performance Creditors*, 55 VAND. L. REV. 1813 (2002) ; Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. Civ.A.12150, 1991 Del. Ch. LEXIS 215 (1991) (holding that insolvent firm directors owe a duty to both shareholders and creditors).

For example, in *Equity-Linked Investors, L.P. v. Adams,*[21] a firm ("Genta") with a common-controlled board faced a choice between liquidating (through dissolution or a sale) and continuing to operate as an independent entity. Liquidation would yield less than the $30 million liquidation preference of the preferred stock. Remaining independent offered the possibility of upside gain that would accrue to the common shareholders, but would put the preferred shareholders at greater risk. The board decided to obtain debt financing that would enable Genta to continue operating. The preferred challenged the transaction, alleging a breach of fiduciary duty to the preferred shareholders.

The court rejected the claim, writing:

> "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."

Equity-Linked is consistent with a long line of Delaware cases holding that boards controlled by common shareholders do not owe a fiduciary duty to preferred shareholders. 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. [22]

C. Desirability

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[21] 705 A.2d 1040, Del.Ch.,1997.

[22] As we will describe in Part IV, under the control primacy approach the courts also allow a preferred-controlled board to serve the interests of the preferred at the expense of the common.

Common shareholders' control of the board and their status as the sole beneficiaries of directors' fiduciary duties, are generally considered desirable by economically-oriented legal scholars.[23]

One reason common control is considered desirable is that the common are residual claimants in the value created by the enterprise: they are entitled to what remains after all other investors (preferred shareholders and creditors) are paid first. As residual claimants, common shareholders tend to be affected most, on the margin, from changes in firm value. Accordingly, their private interests are generally aligned with the goal of maximizing corporate value. Consequently, the common and their representatives on the board can be expected to favor decisions that increase corporate value.

In contrast, the interests of other investors are generally not as well aligned with corporate value maximization. Creditors do not benefit from an increase in corporate value above the sum of their total claims; they have no right to and do not share in any value above that amount. Thus, in many situations, they have no incentive to boost corporate value; in other situations, they might engage in excessively conservative strategies that fail to maximize corporate value.[24]

Likewise, the preferreds' interests are generally not as well aligned with corporate value maximization. Because of their liquidation preferences and preferred dividends, these shareholders may be more risk averse than is optimal for the enterprise as a whole.[25] Even when their preferred stock is convertible into common stock, there are situations in which preferred shareholders might have little interest in taking risks to

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[23] *See,* e.g., Reinier Kraakman et al., *The Anatomy of Corporate Law: A Comparative and Functional Approach*, OXFORD UNIVERSITY PRESS, 33-34, (2004).

[24] Of course, the interests of creditors holding convertible debt are better aligned with the goal of maximizing corporate value than the interests of creditors holding ordinary debt. But even convertible debt holders rarely are given the right to vote. *See* Triantis and Triantis, supra note x.

[25] See infra Part IV.

increase firm value.[26] Thus, even shareholders holding convertible preferred stock are not always interested in maximizing the value of the corporation as a whole.

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.[27] 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, common shareholders are thought to be the class of investors whose interests are *generally* most closely aligned with total corporate value.[28]

In addition, the common shareholders lack mechanisms other than board control and fiduciary duties to advance and protect their interests. [29] Other groups, such as preferred 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, the common do not enter into such contracts with the corporation, and must rely solely on board control and fiduciary duties to protect their interests.

Because common shareholders are not the only residual claimants, they may have an incentive to act in ways that reduce total corporate value. Common shareholders enjoy most of the upside from distributions and riskier strategies but bear less of the cost

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[26] See infra Part IV.

[27] See Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty,* 98 MICH. L. REV. 214 (1999).

[28] *See supra* note __.

[29] Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 Stetson L. Rev. 22, 23 (1991).

on the downside should the firm fail. Thus, a common-controlled board might have an incentive to act "opportunistically," by which we mean take steps that increase the value of common stock while reducing 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 or distribute too much cash.

However, creditors and preferred shareholders are believed to anticipate the possibility that a common-controlled board will act opportunistically, and they can use their contractual arrangements with the firm to protect their interests. These arrangements, in turn, reduce the costs of standard "common-in-control" corporate governance and, according to commentators, make it a generally desirable arrangement.

III. Venture-Backed Startups' Unique Governance

Having examined the typical corporate governance arrangement in Part II, we now turn to consider the governance structure of venture-backed startups. We begin in Section A by discussing VCs' investment through preferred stock, and the agency and tax-cost explanations for the use of this security. In Section B, we consider VCs' control rights, including board control. As Section C explains, 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, under the control primacy approach to fiduciary duties, the board owes a duty only to the preferred.

A. VCs' Use of Preferred Stock

1. Omnipresence of Preferred

In the United States, venture-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. [30] The preferred is held by VCs, who invest in startups almost exclusively through this form of security. [31]

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[30] Common shares make up a large fraction of the firm's outstanding shares. One study finds that, among firms about to go public, almost half the shares are in the form of common. The study finds that median VC share ownership is 53%; median founder ownership is 12%; median manager ownership is around 7%. (Because these are medians, not means, they need not add up to 100%.)The balance of the shares is owned by non-VC investors, other employees, and business partners. See Steven N. Kaplan, Berk A. Sensoy, and Per Stromberg, "What are Firms? Evolution from Birth to Public Companies" 26 (working paper, January 2005).

[31] *See* Kaplan & Stromberg (2003), *supra* note _. In fact, most venture-backed startups issue a new series of preferred stock each round of financing. While some of the rights of the preferred stockholders may be class rights, each series of preferred stock is assigned its own exclusive rights

Like most public company preferred, VCs' preferred shares are convertible into common.[32] Thus, to the extent VCs convert, their preferred stock offers the same payout as common stock. Nevertheless, the VCs' preferred stock is different from common stock in important respects that make it "less residual" than the common stock. Most importantly, like public company preferred stock, VCs' preferred stock generally has liquidation preferences ahead of common stock.[33] Furthermore, unlike public company preferred, the amount of these preferences often far exceeds the payment of the purchase price originally paid for the stock:[34] the liquidation preference of VC preferred stock sometimes confers the right to payment of a multiple of the purchase price before common shareholders can receive any payment. Depending on the circumstances, such multiples can be quite high, as much as six times the original purchase price, or even higher.[35] Thus, VC preferred stock is, relative to common stock and even public company preferred, much more debt-like in its cash flow rights. Both agency-cost and tax-related explanations have been advanced for VCs' widespread use of preferred.

2. Agency Cost Explanations

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and preferences. This, in turn, may give rise to conflicts of interests 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 (Analyzing the Benchmark case where junior series of preferred sued senior preferred for breach of their 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. This assumption does not materially affect the analysis.

[32] Typically, each preferred share can initially be converted into a single common share *See* Mann, O'Sullivan, Robbins, & Roberts (2004), *supra* note _, at 860.

[33] *See* Kaplan & Stromberg (2003), *supra* note __, at __ (finding that 97% of VC financings involve securities senior to common).

[34] *See Id*.

[35] *See,* e.g., Vyvyan Tenorio, *VCs Reconsider Tough Terms for Entrepreneurs,* The Deal.com (Jan 2002), (reporting a deal with liquidation preferences of 12 times the original purchase price).Furthermore, when the preferred are entitled to cumulative dividends, the liquidation preferences are even larger because they include, in addition to the multiple, any declared and unpaid dividends.

VCs' use of preferred stock may help reduce a number of agency costs associated with investing in startups.[36] As we explain below, preferred stock may well reduce the cost of entrepreneur opportunism and, to some extent, deter it. Our goal here is not to systematically describe each and every potential agency-cost reducing effect of preferred, but rather to give the reader a sense of its possible benefits.

To begin, VCs' use of preferred stock may provide founders with desirable incentive effects once they receive funding. It leaves founders, who hold common stock, a smaller share of the total distribution in the event of poor performance. Thus, a decrease in the value of the company disproportionately hurts founders. Accordingly, founders have a greater incentive to increase startup value.[37]

The VCs' use of preferred stock might also solve an information-asymmetry problem. At the investment stage, the founder might know more about the actual value of the firm than the VCs, such as the fact that the firm is worth very little. An entrepreneur's willingness to issue convertible preferred shares signals that the entrepreneur believes the company is worth more than the liquidation preference granted to the VCs.[38]

Agency cost explanations alone, however, may not entirely explain the use of preferred stock by U.S. VCs; tax considerations also play a role. It is to this subject that we now turn.

3. Tax Explanation

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[36] *See*, e.g., Erik Berglof, *A Control Theory of Venture Capital Finance*, 10 J.L. ECON. & ORG. 247, 248 (1994) (showing how the use of convertible preferred can protect the investors against dilution from a future buyer of the firm.)

[37] *See* Sahlman (1990), *supra* note __, at 510-511.

[38] See, e.g., Jeremy C. Stein, *Convertible Bonds as Backdoor Equity Financing*, 32 J. Fin. Econ. 3, 15 (1992); Sahlman (1990), *supra* note __, at 510-1.

Another explanation for VCs' use of preferred stock is that the U.S. tax rules and their enforcement inadvertently subsidize the use of that security. In particular, 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 start-up. [39] 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 is offering stock to its employees.[40]

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. Any subsequent appreciation above that value is taxed later, upon sale, at the much lower capital gains rate. Thus, everything else being equal, reducing the IRS-deemed grant-date stock value provides a joint benefit to the parties. Although employees' capital gains might be higher, their ordinary income -- taxed at a higher rate – is lower.[41] However, the IRS may challenge a grant-date value that it can easily show is too low, somewhat limiting the parties' ability to claim an arbitrarily low value.

Consider the example of VCs investing in ABC Corporation. Suppose they are willing to pay $10.00 per share for ABC's common stock. If the investment takes the form of common stock sold to the VCs for $10.00 per share, when ABC subsequently gives employees incentive stock, it cannot assign, for tax purposes, a value less than $10.00. That price, reached through arm's-length bargaining (i.e. as a result of negotiations between independent parties), presumptively establishes the market value of ABC's common stock. Should the IRS conduct an audit they could impose significant

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[39] *See* R. Gilson & D. Schizer, *supra* note _, and Sahlman (1990), supra note _, at 510.

[40] The same principles apply when the firm uses stock options for compensation. See Gilson and Schizer, supra note x, at 895-7.

[41] The corporation can deduct the grant date value of the stock in computing its taxable income. Thus, everything else being equal, the higher the value, the greater is the deduction and tax savings for the corporation. However, most startups lack taxable income for several years. See Gilson and Schizer, supra note _, at 913.

penalties on the parties for unreasonably understating the value of the incentive compensation.[42]

Now consider the case in which VCs invest with preferred stock – especially preferred stock with large liquidation preferences and other rights. The startup can argue that 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. Accordingly, the startup can assign a low value for tax purposes to the common stock given to employees, with little fear of IRS penalties. VCs' use of preferred stock rather than common stock thus permits the parties to reduce the tax imposed on employees, enabling the firm to pay less on a pre-tax basis to employees.

Suppose, for example, that the VCs investing in ABC are willing to purchase certain preferred stock for $15.00 per share. The preferred stock is in fact worth more than the common because it carries additional rights, including a liquidation preference. Thus, the VCs are willing to pay $5.00 more per share than the $10.00 they are willing to pay per share of common stock. For simplicity, suppose that if the preferred stock is issued, the common stock will continue to be worth $10.00 per share.[43] However, now there is no "smoking gun" evidence that the common stock is worth $10.00 per share. ABC can now more comfortably take the position, for tax purposes, that the common stock is worth an amount much lower than its actual value, say $1.50 per share. In fact, start-ups commonly take the position, for tax purposes, that the common stock is worth 10% of the price most recently paid for the preferred stock.[44]

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[42] *See*, e.g., 26 USCS § 6662 (civil penalty for accuracy-related tax underpayment); 26 USCS § 6663 (civil penalty for fraudulent tax underpayment); 26 USCS § 7201 (criminal penalties for the felony of attempting to evade or defeat tax); and 26 USCS § 6701 (criminal penalties for aiding and abetting the understatement of tax liability).

[43] The value of the common stock could continue to be worth $10 per share if, for example, the cost to common shareholders of granting the preferred shareholders special rights was exactly $5 per share of preferred stock issued.

[44] *See*, e.g., Sahlman (1990), *supra* note x, at 510; and Gilson & Schizer , supra note x, at footnote 86.

Although this example focused on common stock, the same principle applies to option compensation. The tax paid on option compensation depends on the value, for tax purposes, of the underlying common stock. Thus, the use of preferred stock can reduce the tax cost of employee options by allowing the company to assign a lower value to the underlying common stock.[45] 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. In fact, there is evidence that VC's use of common stock outside the US, where this tax penalty is not imposed, is far more frequent than in the US.[46] Thus, it is possible that at least some VCs use of preferred rather than common stock is because of tax considerations.[47]

B. VC Control of the Board

1. Extent of VC Control

Like preferred shareholders in public companies, VCs are usually granted specific veto rights called protective provisions.[48] These provisions require VC approval for

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[45] *See* Gilson & Schizer (2003), supra note x, at 895-901.

[46] See Steven N. Kaplan, Frederic Martel, and Per Stromberg, *How Do Legal Differences and Learning Affect Financial Contracts?* (working paper, 2004)p.8 (reporting that 28% of VCs out of a sample of VC financing outside the U.S. used common stock, vs. 1% in the U.S.); Douglas J. Cumming, *Capital Structure in Venture Finance*, 11 J. CORP. FIN. 550 (2005) (reporting the use of a variety of different types of securities, instead of convertible preferred stock, in Canadian venture financing transactions.); and Josh Lerner and Antoinette Schoar, *Transaction Structures in the Developing World: Evidence from Private Equity* (working paper, 2004) (reporting that the use of preferred stock in developing nations is far less frequent than it is in the U.S. and the U.K.).

[47] However, Kaplan, Martel, and Stromberg, (2004) supra note X, find a strong positive correlation between the use of convertible preferred (and U.S. style contracts in general) outside the U.S. and VC funds' survival rates. And, suggest that learning costs and lack of experience may influence the use of non-convertible stock and render some of the contracts outside the U.S. less effective than the corresponding U.S. style contracts. Cf. Douglas Cumming & Sofia Atiqah binti Johan, *Advice and Monitoring in Venture Finance*, (working paper, Jan. 2005), (finding a positive correlation between the use of convertible securities and "VCs' efforts on advice," in a study of European VCs.)

certain transactions, such as the sale of all or substantially all of the company's assets. [49] These rights include all those typically found in public company preferred stock, plus others. In fact, the 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 decision-making. [50]

However, protective provisions and staged financing only give VCs the ability to block transactions unfavorable to them; they do not give VCs the ability to initiate and oversee various corporate actions. Thus, in addition to protective provisions, in most startups VCs acquire control over the board either immediately or during a subsequent round of financing. As Part II.A explained, the board manages the business and affairs of the firm. It initiates, subject to shareholder approval, fundamental transactions such as mergers, IPOs, or liquidations.[51] Startup boards – unlike public company boards -- are also frequently and intimately involved in strategic decision making and personnel issues. Therefore, board control gives VCs substantial power over and above whatever contractual provisions they have negotiated.[52]

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[48] *See,* e.g., Richard A. Mann, Michael O'Sullivan, Larry Robbins, & Barry S. Roberts, *Starting From Scratch: A Lawyer's Guide To Representing A Start-Up Company*, 56 ARK. L. REV. 773, 861 (2004).

[49] *See* Id.

[50] See Gordon Smith (2005) *supra* note __. See, also, Manuel Utset (2002) *supra* note __, at 64-66. Cf. Gompers (1995) *supra* note __.

[51] 8 Del. C. 141(a); Cal. Corp. Code §300(a).

[52] Certain additional contractual rights, such as redemption, registration, and drag-along rights, found in the financing contracts at different frequencies, may seem, on its face, to offer VCs significant control over the company. These rights, however, are rarely used. The weakness of these rights, as opposed to actual control of the board, lies both in the explicit restrictions of the use of the rights as well as in practical constraints. For example, redemption rights, when granted are usually available only after 5 years following the investment and usually entitle the VC to receive only the original purchase price. Moreover, the company is likely not to have the required cash at the time the right is exercised. Similarly, demand-registration rights are usually only exercisable 4 years following the investment or some time after the IPO. High costs and lack of crucial managerial

Most academics studying venture-backed startups have failed to appreciate how frequently VCs effectively control startup boards. [53] Economists examining investment documents have found that, by the last financing round, VCs formally take a majority of the board seats in only about 25% of startups.[54] In about 15% of startups, common shareholders maintain a majority of board seats through successive financings. In the remaining 60% or so neither common shareholders nor VCs end up with a majority of the seats; instead, the "swing votes" are held by so-called "independent directors," industry experts and other outsiders whom the common stockholders and the VCs mutually agree to appoint.

However, what these studies have missed is that the "independent directors" on startup boards are usually acquaintances of, and recommended by, the highly-networked VCs. Entrepreneurs frequently lack sufficient contacts to recommend persons to fill these positions. Therefore, according to VCs we have interviewed, VCs are usually the ones to suggest independent directors and entrepreneurs generally acquiesce to the VCs' recommendations.

Such acquiescence is likely to serve entrepreneurs' interest – at least as long as the entrepreneurs' interest and those of the VCs are aligned. The independent directors may well bring with them useful contacts and experience, which can be tremendously valuable to the new firm.[55]

However, as Gordon Smith has pointed out, if there is a conflict of interest between the VCs and the entrepreneur or VCs and common shareholders, these independent

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support stop the VCs from using these rights. In addition, drag-along rights which sometimes allow the VCs to force key employees to sell their stock in a sale of the company are often restricted so that the common will not end up empty-handed by, for example, setting valuation thresholds.

[53] *See* Kaplan and Stromberg (2003), *supra* note _. But see Utset (2002), *supra* note __, at 61-2.

[54] *See* Kaplan & Stromberg (2003), *supra* note _.

[55] See, e.g., Utset (2002) *supra* note __, at 97-100 (describing how VCs provide value by helping in the "professionalization" of start-ups.)

directors are likely to have an incentive to side with the VCs.[56] 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 the entrepreneurs they are financing. 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, outside directors are in many cases not truly independent. Should a conflict between the VCs and other investors arise, they often can be expected to side with the VCs.[57] As a result, the percentage of start-up boards effectively controlled by VCs may well be closer to 80-90%, much higher than a study of formal documents would suggest.[58]

2. Agency Cost Explanations

VCs' acquisition of board control may be driven by entrepreneur agency cost considerations. The entrepreneur frequently has little business experience and may lack the ability to rapidly build the company. As a result, the entrepreneur may, despite her best efforts, mismanage the VCs' investment. Even if the entrepreneur has business experience, her goals may differ from that of the investors. The entrepreneur draws a salary and thus will prefer continuation even if the business should be shut down. The

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[56] See Gordon Smith, *Control and Exit in Venture Capital Relationships* (working paper, 2005) 6 (comparing the outside directors' predisposition to the 'structural bias' identified in large corporations.); and Lucian Bebchuk & Jesse Fried, *The Over-Rating of Director Independence* (working paper, 2005). 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) is likely to far outweigh the incentive effects of the common stock in situations where the common and the preferred stockholders have different interests.

[57] Cf. Bratton (2002), *supra* note _, at 921, (suggesting that information asymmetries as well as bargaining power and skill may render the independent director 'highly susceptible to the influence' of the VC.)

[58] Cf. Steven N. Kaplan, Berk A. Sensoy, and Per Stromberg, "What are Firms" Evolution from Birth to Public Companies" 28 (working paper, January 2005)(reporting that, by the time of the IPO, median VC directorships is 3, median management directorships is 2, and median outside directorships is 2).

entrepreneur may also use the VCs' money to provide private benefits to herself – such as a high salary, prestige, and perks -- at the expense of investors' returns.[59]

Board control allows the VCs to monitor the operations of the firm,[60] control entrepreneur opportunism,[61] and replace the entrepreneur with a professional manager should the entrepreneur not prove up to the task.[62] Indeed, VCs eventually end up replacing most founding entrepreneurs.[63]

3. The Role of Control Primacy

VCs have another incentive to acquire board control: to prevent common shareholders from controlling the boards and inflicting costs on the preferred shareholders, which the control primacy approach to fiduciary duty would allow. Under longstanding corporate law doctrine, a common-controlled board would be free to take steps to reduce the value of the preferred. Thus, given VCs' use of preferred, the VCs may insist on obtaining board control in order to prevent common opportunism.[64]

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[59] See Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473 (1992).

[60] *See* Utset (2002) *supra* note __ at 58-60 (discussing the importance of VCs control in reducing the investment risks.)

[61] *See* D. Gordon Smith, *Venture Capital Contracting in the Information Age,* 2 J. SMALL & EMERGING BUS. L. 133, 138-140 (1998), and Sahlman (1990), *supra* note _.

[62] See Philippe Aghion & Patrick Bolton, An Incomplete Contracts Approach to Financial Contracting, 59 REV. ECON. STUD. 473 (1992), Bratton (2002), *supra* note _, D. Gordon Smith, Control and Exit in Venture Capital Relationship, working paper (Jan 2005).

[63] 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 Steven N. Kaplan, Berk A. Sensoy, and Per Stromberg, "What are Firms" Evolution from Birth to Public Companies" 23 (working paper, January 2005)(reporting that at time of IPO 43% CEOs are non-founders); Noam Wasserman, "Founder-CEO Succession and the Paradox of Entrepreneurial Success," 14 *Organization Science 149 (2003)*. See, also, Utset (2002) *supra* note __, at 92-6 (describing the 'founder's disease' – the VCs' "assumption that entrepreneurs will be unable to make the transition to effective managers.")

Moreover, the only Delaware case involving a venture-backed startup with a *preferred-dominated* board, *Orban v. Field,* makes it clear that, when the preferred control the board, directors do not owe a fiduciary duty specifically to the common shareholders and have wide discretion to benefit the preferred shareholders instead. [65] This case, along with the many cases holding that common-controlled boards owe no fiduciary duty to the preferred, suggest that courts have adopted what we call a "control primacy" approach to fiduciary duties: a board controlled by a particular class of shareholders need not take into account the effects of its action on other classes of stockholders.[66]

In *Orban*, the preferred-dominated board of Office Mart arranged for Office Mart to be acquired by Staples in a merger under terms providing no payout to common shareholders. 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 shareholders vote in favor of the transaction. Common shareholders, led by Office Mart's founder and former CEO Orban, refused to back the deal, demanding $4 million in exchange for their votes.

Office Mart's board then used corporate resources to arrange a series of transactions that enabled the preferred shareholders to exercise warrants to buy common shares, diluting the "pure" common position down to less than 10% of the

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[64] See Bratton, supra note x, at 935.

[65] See Orban, 1997 WL 15381 (Del. Ch.), interpreted by lawyers to mean that preferred-controlled boards can advance the interests of preferred at the expense of the common, see, e.g. Matthew P. Quilter, Austin Choi, & Sayre E. Stevick (Fenwick & West LLP), *Duties of Directors: Venture Capitalist Board Representatives and Conflicts of interest,* 1312 PRACTICING LAW INSTITUTE CORP 1101 (June 2002) p 6.

[66] While a board may ignore the interests of one class of shares in favor of the controlling class, it may not disadvantage the shareholders of a solvent company in favor of the creditors, see Blackmore Partners, L.P. v. Energy LLC, 864 A. 2 80 (Del Supr. 2004). The control primacy approach focuses on conflicts of interest among different classes of shares; it does not affect the duty of the board in conflicts between the shareholders and other stakeholders.

class. The preferred shareholders holding over 90% of the common stock then voted their common stock in favor of the merger, allowing the transaction to go forward and wiping out the common shareholders. Orban sued, alleging that the board had violated its duty of loyalty to common shareholders. The court ruled for the preferred controlled board, writing: "It 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."

To be sure, common shareholders had no legal right to a portion of the merger consideration. But it is also true that the preferred shareholders, qua shareholders, did not have the legal right to compel the firm to merge. The board had discretion over whether to even consider a merger. It could have legally used this discretion to benefit common shareholders by either keeping the firm going as a separate entity (as the Genta board did) or by extracting value from the preferred shareholders in exchange for a merger agreement. However, under the control primacy approach, the preferred-controlled board was not under any obligation to consider the effect of its decision on the common.

Moreover, when Staples insisted on obtaining 90% approval by common shareholders, the board was certainly not under a duty to dilute the common shareholders, rendering their votes unnecessary to effectuate the merger. It had a choice whether to facilitate dilution of the common shareholders. Had the board not diluted the common shareholders, the preferred shareholders could have been expected to pay for the common shareholders' consent. Yet, the court permitted the board to use its discretion and corporate resources to help the preferred shareholders eliminate the common shareholders' bargaining power.

It is worth considering what a hypothetical common-controlled board would have done in this case. If Office Mart's board had been controlled by the common, as was the board of Genta in *Equity Investors,* it would have used its discretion to benefit the common shareholder. Obviously, it would not have liquidated the company through a merger that wiped out the common. Instead, it would have either have kept the

company afloat in order to preserve the upside value of the common stock (as Genta's board did), or agreed to approve the preferred-benefiting merger on the condition that the preferred stockholders share part of their merger proceeds with the common. Had Office Mart's board been controlled by common, it might have even used Staple's requirement that 90% of Office Mart's common approve the merger as an opportunity to extract additional value for common shareholders. And, as long as this hypothetical common-controlled board did not violate any of the preferred shareholders' contractual rights, it would have been permitted to do so under the control primacy approach.

Orban thus indicates that just as common-controlled boards are free to serve the interests of common shareholders at the expense of preferred, preferred controlled boards are free to serve the preferred at the expense of common. This control primacy approach thus gives preferred-holding VCs two reasons to obtain board control. First, board control protects preferred-owning VCs against the common-serving opportunism that might occur if the board were controlled by common. Second, board control allows VCs to advance their own interests as preferred stockholders at the expense of the common. As we explore in the next Part, however, preferred dominion under a regime of control primacy can give rise to its own set of agency costs and distortions.

IV. Agency Costs of Preferred Control

This Part describes the agency costs that can arise when preferred-owning VCs control, indirectly or directly, the board of a start-up. We focus on those costs that arise solely because of the different cash flow rights of preferred and common shareholders – differences that tend to be more pronounced in the venture-backed company than elsewhere.[67] Because of the difference in payoffs, 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 joint value of the preferred and common shareholders.[68] In these situations, preferred shareholders controlling the board are likely to act opportunistically -- in ways that 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 preferring immediate "liquidity events" (a major corporate transaction that would end the independent life of the company, such as liquidation, merger, IPO) over higher-value strategies involving more risk. Under the control primacy approach to fiduciary duties, preferred-control boards are free to make such decisions, even if they reduce total shareholder value. The costs of this value-reducing opportunism are borne, in the first instance, by common shareholders. Section B explains why various legal and non-legal mechanisms, including shareholder voting, appraisal rights, VCs' reputational

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[67] VC control of the board might enable them to engage in other forms of opportunism that reduce corporate value, such as self-dealing or the taking of corporate opportunities. But these forms of opportunism are not a function of the VCs holding preferred stock. They arise even if the VCs own common stock. We therefore do not address these forms of opportunism in this paper, which focuses on the problems that arise solely from the fact that those controlling the board represent the interests of preferred shareholders rather than those of common shareholders. See supra note _.

[68] 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 (2004), *supra* note _, at 304.

considerations, and ex-post renegotiation are unlikely to substantially reduce these distortions.

Section C identifies three "pre-financing" distortions that can arise even before preferred shareholders take control of the board merely because of the expectation of preferred opportunism. The 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; (2) cause founders to forego potentially value-adding VC financing because of fear of subsequent opportunistic behavior by the VCs; and (3) reduce entrepreneurs' and employees' willingness to found/join startups knowing that much of their compensation will come in the form of common stock that subsequently may be devalued by preferred shareholders controlling the board. Section D considers the incidence of both the "post-financing" and "pre-financing" costs.

A. Distorted Strategies and Bias toward Exit

This Section first identifies and analyzes the distortions that can arise after preferred shareholders take control of the board. In particular, in certain situations a preferred-controlled board may choose lower-risk, lower-value business strategies over higher-risk, higher- value strategies, such as pushing for immediate liquidity events (merger, liquidation, or IPO) even when the expected value of remaining independent is higher.[69] We then consider the possibility that these distortions can be eliminated through renegotiation.

1. The Problem

[69] To be sure, VCs might push for liquidity events immaturely even if they own only common stock. The rush to exit can be motivated, for example, by grandstanding, see supra note X, or by other fund considerations, see Gordon Smith (2005), supra note X. *See,* also, Manuel Utset (2002) *supra* note X, at 110-2 for additional reasons why the entrepreneurs and the VCs might disagree on a decision to exit (such as the entrepreneur's desire to retain her employment place and the VC's wish to focus on more successful portfolio companies)

Because of the preferred shareholders' liquidation preference, in certain situations they will 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 strategies over higher-risk, higher-value investment strategies. Preferred shareholders' payoff asymmetry is likely to affect not only investment decisions but also the choice between (a) steering the company toward a liquidity event and (b) continuing to run the company as an independent business. In particular, the difference in payoffs will bias preferred-dominated boards in favor of immediate "liquidity events" (liquidation, merger, IPO) even if expected firm value would be higher when operating the firm as a private going concern. The reason is simple. Liquidity events promise a certain payout. Continuing to operate the firm as an independent company may expose the preferred-owning VCs to risk without sufficient opportunity for gain.[70]

Consider the following example. The capital structure of a company (Startup) is equally divided into 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 stock comes with a liquidation preference: the right to receive, in a distribution event (e.g., liquidation, merger, IPO), a certain amount prior to and in preference to the common shares. Assuming that the preferred shares have a 2X liquidation preference, the preferred shareholders are entitled to receive up to two times the purchase price of the stock (or a total of $100) in a distribution event.

Suppose that Startup can choose between (a) a merger that will yield $110 with certainty and (b) remaining independent, which promises a payoff of $300 with 50%

[70] Many portfolio companies do not succeed, see, e.g., Sahlman (1990), *supra* note __, reporting that over 30% of the capital invested by VCs results in partial or total loss, and another 30% of VC investments results in a payoff of less than 2 to 1. These data may provide a rough estimate to the range in which preferred opportunism might arise.

probability and $0 with a 50% probability. The expected value of independence is $150. From the shareholders' perspective as a group, Startup should remain independent because doing so maximizes shareholder value.[71]

Strategy	Outcome(s)	Expected Value
Merger	100% x $110	$110
Remain Independent	50% x $300 50% x $0	$150

Merger. The preferred shareholders will be better off enjoying their liquidation preference than converting. The liquidation preference grants the preferred shareholders the right to receive $100, which is more than their pro-rata share (50%) of the $110 distribution. The rest of the payout, $10, will go to the common stockholders.

Strategy	Outcome(s)	Expected Value	Preferred	Common
Merger	100% x $110	$110	$100	$10
Remain Independent	50% x $300 50% x $0	$150		

Remaining Independent. If there is a good outcome, with a payoff of $300, preferred shareholders will convert to common stock and receive $150. The original common

[71] To be sure, risk averse parties might prefer a lower-risk/lower-value project to a higher-risk/higher-value project. But we are assuming risk-neutrality throughout this paper for ease of exposition. The assumption does not change any of the analysis.

shareholders will receive $150. If there is a bad outcome, preferred shareholders and common shareholders will receive $0. Thus, the expected value to preferred shareholders and common shareholders of remaining independent is $75, less than the value to preferred shareholders of the merger.

Strategy	Outcome(s)	Expected Value	Preferred	Common
Merger	100% x $110	$110	$100	$10
Remain Independent	50% x $300 50% x $0	$150	$75 (50% x $150)	$75 (50% x $150)

To the extent that the preferred shareholders control the board, these shareholders will have an incentive to effect the merger even though it generates less value for shareholders as a group. The preferred shares will be worth $100 rather than $75, and the common shares will be worth $10 rather than $75. Under the control primacy approach to fiduciary duties, the board is not obligated to take into account the interests of the common shareholders.

We are not claiming that preferred shareholders will always choose low-value strategies over high-value strategies, or that they will always choose exit over remaining independent. If, in our example, the payout from remaining independent were sufficiently high – in this example more than $400 on the up-side, a preferred shareholder board would not push for a merger. Rather, our point is that in many situations the divergence of interests between preferred and common shareholders will cause a preferred-dominated board to choose projects that do not maximize total value for all shareholders.

Similarly, a board dominated by common shareholders will not always choose the optimal strategy for shareholders. The problem of differential cash flow rights cuts both ways. A common-dominated board might have an incentive to choose a high-risk

strategy that promises less expected value for shareholders as a group than a lower-risk strategy. And under the control primacy approach, a board choosing such a strategy would not be in violation of its fiduciary duty. Indeed, as we noted in Part III.B, fear of common opportunism may be one reason why, under the control primacy approach to fiduciary duties, preferred-owning VCs often insist on control of the board. 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. And, under the control primacy approach to board fiduciary duties, they are free to do so. [72]

2. Renegotiation

We have seen that a preferred-controlled board may choose a course of action that benefits the preferred but costs common shareholders by an even larger amount. In our example, the preferred are better off selling the company for $110 even though keeping the company independent provides an expected value of $150. In principle, the parties could renegotiate their arrangement to give the preferred an incentive to keep the firm independent and make both the preferred and common shareholders better off. For example, common shareholders could give the preferred shareholders 50% of their 50

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[72] There might be other distortions in exit decisions arising from the structure of VC 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 a minimum amount of total proceeds. Apparently, investment banks are reluctant to take public companies that have outstanding preferred shares. The forced conversion provision is designed to prevent individual VCs from trying to hold up an IPO in exchange for a side payment from other VCs. However, such provisions may bias VCs as a group (and in particular *participating* preferred shareholders, i.e. preferred who have rights to a liquidation preference and to share pro-rata with common in any remaining value) in favor of a merger 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*, 21 STETSON L. REV. 23, ___ (2002). Note that if VCs invested in common to begin with, none of these exit distortions would arise, a point to which we return in Part V when we explore various changes to the tax rules designed to eliminate the penalty for VCs' use of common.

shares of common stock. For the preferred, the value of remaining independent would now be $112.50 rather than $75, more than the $100 value to them of merging. The common's 25 remaining shares would be worth $37.50 if the firm remained independent, more than the $10 their 50 shares would be worth in a merger. As this example illustrates, the parties have an incentive to reach the value maximizing result through renegotiation.

While successful renegotiation might take place from time to time, it is unlikely to avoid value-reducing decisions in many cases. There is likely to be significant information asymmetry between the preferred shareholders controlling the board and the common shareholders, many of whom are no longer actively involved with the company. Under such conditions, bargaining might fail even if, as in this example, renegotiation would generate a surplus.

Moreover, even if renegotiation could work in the face of an impending liquidity event (i.e., a major corporate transaction that would end the independent life of the company), renegotiation is unlikely to work in cases where the board must make small, incremental decisions that cumulatively could have a large impact on the value of the corporation. For example consider a board seeking to sell the company in order to benefit the preferred. If the CEO resigns, the preferred-controlled board will not expend effort seeking a replacement of the caliber needed to grow the company as an independent concern, but rather will make do with somebody who can serve as a caretaker until the firm is sold. In this type of situation it is difficult to imagine the board going to common shareholders and asking for a small concession in order to search more diligently for a CEO who might benefit their interests. Transaction costs would render renegotiating around this type of decision economically prohibitive, especially when there are many common shareholders.

Finally, even if renegotiation were successful, common shareholders would still get less than they would under a regime in which the board sought to maximize total shareholder value. As a result, decision making by entrepreneurs and other common shareholders would still be distorted ex ante, as we show in Section C.

B. Possible Legal and NonLegal Constraints

Section A explained how common shareholders may be vulnerable to value-reducing opportunism by a preferred-dominated board under the control primacy approach to fiduciary duties. This Section considers the possibility that other legal and non-legal mechanism might constrain value-reducing behavior, such as (1) shareholder voting requirements; (2) appraisal; and (3) VCs' reputational considerations. We show that, both individually and collectively, these mechanisms are unlikely to substantially reduce the distortions identified in Section A.

1. Shareholder Voting

In addition to board elections, shareholders are entitled to vote on certain so-called "structural" or "organic" changes that will substantially alter, or terminate, their investment interest. Corporate law requires that shareholders approve certain major corporate transactions and changes – such as mergers, dissolutions, and amendments to the certificate of incorporation.[73] Thus, shareholders can block transactions and changes that they feel would hurt them. This power gives shareholders some ability to protect themselves from insider opportunism.[74] In principle, shareholders' power to block specified transactions should ensure that, with respect to those types of transactions, the board does not hurt shareholders.

Unfortunately, however, in venture-backed startups the voting mechanism is of little use for protecting *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

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[73] *See, e.g.,* DGCL 251(c) (mergers); DGCL 242(b)(1) (amendment to certificate or articles of incorporation).

[74] Cf. Jeff Gordon, *Contractual Freedom in Corporate Law: the Mandatory Structure Of Corporate Law*, 89 COLUM. L. REV. 1549, 1578-9 (1989) (explaining how management can bundle proposals to force shareholders to accept value-decreasing proposals favored by insiders).

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

Moreover, even in those unusual transactions that require shareholder approval, corporate law generally does not require a separate vote for each class of shareholders, including *common* shareholders, but rather approval by holders of a majority of the firm's outstanding stock entitled to vote on the transaction.[75] And VC financing arrangements typically allow the VCs to vote their preferred shares together with common stockholders when such stockholder-wide votes are required.[76] Importantly, VCs can vote on these issues without converting into common stock and thereby losing the privileges assigned to the preferred stock.[77] To the extent the preferred shareholders' voting power exceeds that of the common shareholders, the preferred shareholders can dictate the outcome of the vote. In fact, by the second VC financing round, VCs obtain majority voting power in over 60% of venture backed startups.[78] By the time the startup must make exit decisions, common stockholders will generally have lost the ability to block transactions that hurt their interests.

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[75] *See*, e.g., Del. Code. Ann. tit. 8, Section 271(a) (stating that a sale, lease or exchange of all or substantially all of its property and assets requires approval by holders of a majority of the outstanding stock). California law requires a separate class vote, and Section 2115 of the Cal. Corp. Code subjects 'quasi-California' corporations (corporations doing business in California but incorporated elsewhere) to California law. 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., 2005 Del. LEXIS 179.

[76] *See* D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1471 (2002).

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

[78] *See id*., Steven N. Kaplan & Per Stromberg (2003), *supra* note x: They report that founders relinquish voting control by the second VC round in all but 11.5% of the financing rounds. VCs obtain explicit voting control in over 40% of first VC round financings and in over 60% of second VC rounds.

Finally, even if common shareholders have the right to vote alone as a class, a preferred board can take various steps to force through a transaction that hurts "pure" common (those common shareholders with no other financial interest in the firm). Several techniques have been used to achieve control over the common class. One is "cross-voting,"in which preferred shareholders partially convert their shares into common stock, or exercise warrants to buy common stock in order to acquire a majority of the common stock.[79] Cross-voting was the strategy used in *Orban*[80], where the preferred-controlled board facilitated a transaction in which preferred shareholders exercised warrants to buy enough common stock to control the class vote. Another is vote-buying, which is relatively easy in the start-up context: the board can issue additional common shares to employees who would gain from the board's proposed course of action.[81] Or the board can pay employees to exercise options that are underwater and acquire common stock. [82] Alternatively, the board can increase the compensation or retention agreements of employees holding large amounts of stock to induce them to vote their shares a particular way. 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. In short, common shareholders often cannot count on voting rights to protect themselves from preferred opportunism – whether or not the action sought by the preferred shareholders requires a class vote by the common.

2. Appraisal Rights

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[79] See supra Part II.C.2 For general discussions of 'conflict of interest voting', *see* Zohar Goshen, *Voting (Insincerely) in Corporate Law*, 2 THEORETICAL INQ. L. 815 (2001); Frank Partnoy and Shaun P. Martin, Encumbered Shares, __ Ill. L. Rev. __ (2005).

[80] See supra Part III.B.3.

[81] See Alantec, *supra* note __.

[82] *See* Latif v. Nishan Systems, Inc., et al. (Santa Clara Sup. Ct., No. 1-03-CV-004-939).

Corporate law gives shareholders the right to sell their stock back to the corporation for a judicially appraised "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, the common shareholders could prevent the preferred shareholders from diverting value from them. Anticipating that common shareholders would seek appraisal, a preferred-dominated board might be reluctant to engage in opportunistic behavior at the common shareholders' expense.

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

In addition, it is unclear whether courts would, in determining fair value, give common shareholders what they would have received in the absence of preferred opportunism. The appraisal proceeding tends to focus on the shares' value at the time of the appraisal. Any value-reducing misconduct that took place prior to the appraisal triggering event may not be accounted for in the appraisal process.[83]

Moreover, even if appraisal rights were available and designed to provide the pre-opportunism value of the shares, common shareholders are unlikely to receive, in present expected value terms, the "fair value" of their shares because appraisal litigation is complicated and expensive.[84] Litigation may take years, and shareholders often

[83] *See* Michelle M. Pepin, *Exclusivity of Appraisal - The Possibility of Extinguishing Shareholder Claims*, 42 Case W. Res. 955 (1992).

[84] *See* Richard T. Hossfeld, *Short-Form Mergers After Glassman v. Unocal Exploration Corp.: Time to Reform Appraisal*, 53 DUKE L.J. 1337, 1339 (2004). 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.

receive no money until it is concluded. [85] 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. 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. [86]

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, to abstain or vote against the transaction, and subsequently to file a petition requesting appraisal no more than 120 days following the transaction. This short period in which the shareholder may exercise the appraisal right may not enable her to discover the required evidence for proving allegations of wrongdoing to justify the petition.[87]

Most of these shortcomings of the appraisal remedy have already been widely recognized and discussed. Commentators have appropriately described it as "a remedy of desperation" that, unsurprisingly, few shareholders seek under any circumstance.[88] Appraisal, at least as it is currently structured, is unlikely to protect common shareholders from preferred opportunism.

3. Reputational Considerations

A number of commentators have acknowledged that VCs are not legally constrained from acting opportunistically, especially toward entrepreneurs. But most of

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[85] *See* Hossfeld, supra note ___

[86] *See* Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1 (1995);Alexander Khutorsky, *Coming in From the Cold: Reforming Shareholders' Appraisal Rights in Freeze-Out Transactions,* COLUM. BUS. L. REV. 133 (1997).

[87] *See* Peter V. Letsou, *The Role of Appraisal in Corporate Law*, 39 B.C. L. REV 1121.

[88] *See* Hossfeld (2004), *supra* note x, at 1339.

these commentators have argued that the threat to their reputation will nevertheless deter VCs from opportunistic behavior.[89] Unfortunately, however, reputational considerations are, in most cases, unlikely to prevent VCs from acting in the ways we have described in Section A. Indeed, reputational concerns of both VCs and entrepreneurs are likely to exacerbate – not mitigate – the problems we identified.

The argument that VCs are constrained by reputational considerations from acting opportunistically goes like this: VCs often compete to fund the best start-ups.[90] The dimensions along which VCs compete are "terms" of the deal as well as reputation, especially, the reputation for successfully steering their portfolio companies to IPOs.[91] A VC fund that acquires a reputation for engaging in value-reducing transactions designed to transfer value from founders and other common shareholders to preferred shareholders would, everything else being equal, lose good deals to other VCs with better reputations.[92]

Such an argument implicitly assumes that an entrepreneur's interests are completely aligned with those of other common shareholders. However, to the extent that the entrepreneur's contribution remains important to the enterprise, her interests may well diverge from those of common shareholders. Such entrepreneurs will be provided retention agreements or new stock grants before the company is sold. In contrast, common shareholders qua common shareholders receive only the value of their stock. Thus, in screening VCs, entrepreneurs cannot be expected to perfectly represent the interests of common shareholders.

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[89] See Bernard Black & Ronald Gilson, *Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets*, 47 J. FIN. ECON. 243, 254 (1998); William A. Sahlman (1990), *supra* note x, at 513. But see Manuel Utset, *Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital-Financed Firms*, 2002 WIS. L. REV. 45.

[90] See Sahlman (1990), *supra* note x, at 513.

[91] See Black & Gilson (1998), *supra* note x, at 245

[92] See 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)"

However, assume for argument's sake that the interests of entrepreneurs and common shareholders are perfectly aligned, and that entrepreneurs would seek to turn down financing from VCs who have in the past acted opportunistically toward common shareholders. Even if the interests of common shareholders and entrepreneurs completely overlapped, it is far from clear that VCs would be deterred from acting in the ways described in Section A.

First, it will be extremely difficult for outsiders to acquire information about VCs' behavior towards common shareholders in their other portfolio companies.[93] The firms in which VCs invest are small private companies, not public ones that release detailed information to the SEC and are covered by analysts and financial journalists.[94] Boards that engage in value-decreasing behavior can be expected to go to great lengths to keep information under tight control. Indeed, many of the people who are 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, leaving certain directors in the dark. 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 put effort into a particular strategy that would benefit common shareholders, very few people may be aware of it.

VCs can also be confident that even if an entrepreneur knows that the firm's VCs have engaged in value-decreasing opportunism, that entrepreneur is unlikely to try to publicly disseminate this information. "Going public" with these types of complaints is likely to be very costly. At least in Silicon Valley, VCs are a tight-knit community, and an attack against one VC is considered to be an attack against all. In some instances, entrepreneurs have refused to speak with reporters about their experiences with VCs lest it ruin their chances of getting funding for another startup. Thus, reputational

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[93] *See* Manuel Utset (2002), *supra* note __, at p 112, fn 223.

[94] *See*, e.g., D. Gordon Smith, (1998), supra note X at 174, (suggesting that despite the importance of reputation in VC financing, "the market for venture capitalist reputation is both informationally an fundamentally inefficient… because of an absence of a centralize location…where various assessments of venture capital reputation can be 'traded.'")

considerations may cut in the opposite direction, facilitating rather than preventing preferred opportunism.

Even if the unhappy entrepreneur does go public, the person's complaints are likely to have limited effect on other entrepreneurs' willingness to deal with the VCs. In the absence of a substantial amount of additional information, the community will have difficulty determining whether the VCs acted opportunistically or not. After all, founders are likely to be bitter when their own startup, in which they have invested considerable time, effort, emotional energy, and money, does not do as well as expected, even if the VCs have not been acting opportunistically. Thus, entrepreneurs attempting to learn about VC quality might not be able to determine, from the outside, whether the unhappy founder's complaints reflect value-decreasing behavior or are merely sour grapes. In contrast, there is evidence that entrepreneurs evaluate VCs' quality based on more verifiable data such as the number of prior investments in the relevant industry and the VC's contacts with customers, suppliers, investment bankers, and recruiting resources.[95]

Finally, even if an aggrieved party has the ability to tarnish a VCs' reputation, VCs may sometimes prefer to pay that price in exchange for extracting a higher return from their investment. There is considerable turnover in the VC market. 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.[96] And in 2004, the number of VC firms declined by 21%. [97] New VC firms, and firms that have had poor track records, have a relatively short expected lifespan. If they cannot generate adequate returns in their current funds, they may not be able to raise

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[95] *See* David H. Hsu, *What Do Entrepreneurs Pay for Venture Capital Affiliation?*, 59 J. FIN. 1805 (2004).
[96] Jeffrey M. Leavitt, *Burned Angels: The Coming Wave of Minority Shareholder Oppression Claims in Venture Capital Start-up Companies*, 6 N.C. J.L. & TECH. 223, 223 (2005).

[97] Red Herring Magazine, Fewer VCs & Fewer Startups, (April 15, 2005) <http://www.redherring.com/Artilce.aspx?a=11808&hed=Fewer+VCs+%26+Fewer+Startups>. Furthermore, in Jan. 2002 the Wall Street Journal quoted Josh Lerner saying that approximately 20% of VC firms had closed, see Lisa Bransten, *Fund-Raising Woes Push Barksdale Group to Disband Operation*, WALL ST. J. (Jan 8, 2002).

others. These firms care much less about their reputation in dealing with common shareholders, which would hurt them (if at all) only in the future, than about current performance.

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, they have no difficulty attracting excellent entrepreneurs and money from limited investors. And, their partners have become extremely wealthy. Such firms may be willing to sacrifice some return in order to preserve or build their good reputation, or simply because they want to be fair.

But most VC firms are in a much more precarious position. And, in deciding whether to act opportunistically to boost their fund's returns, these VCs are unlikely to weigh reputational considerations even if they believe that their opportunism would become widely known and affect their ability to attract good deals in the future. Thus, even if entrepreneurs and common shareholders had the ability to harm opportunistic VCs' reputations, many VCs would be willing to accept a worse reputation to achieve higher returns. In sum, reputational considerations -- either alone or together with shareholder voting rights and appraisal – are unlikely to substantially reduce preferred opportunism.

C. Pre-Financing Distortions

Section A identified certain costs that arise *after* preferred shareholders take control of the board, and Section B explained why shareholder voting rights, the appraisal remedy, and VCs' reputational considerations are unlikely to prevent value-reducing preferred opportunism. This Section describes three costs that arise when investors and employees anticipate the possibility that common shareholders will subsequently be devalued by a preferred-dominated board. In particular, anticipated preferred opportunism (1) raises the cost and reduces the availability of "angel" financing, an important early-stage source of capital for startups; (2) makes

entrepreneurs less willing to accept VC financing, even when VC financing can add significant value; and (3) reduces the incentive value of options and common stock held by founders and employees of the startup.

1. Reduced Availability of Angel Financing

Most startups are unable to secure VC or other institutional financing in the first year of the business, when risk is highest. During this period, wealthy individual investors, referred to as "angels," serve an important role by supplying "seed capital." In fact, the total amount of angel financing in the United States exceeds total venture capital financing.[98] Some reports indicate that the total amount of angel financing may have been even twice as large as the amount of venture capital financing.[99]

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 VCs. And angels, unlike VCs, tend to lack expertise that would enable them to contribute additional value to 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 usually invest in straight common equity.[100] Thus, they become vulnerable to preferred opportunism when VCs later take control of the board. To the extent angels anticipate that

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[98] According to the Center for Venture Research at the University of New Hampshire, in the first half of 2004 27,500 ventures received angel funding of a total amount of $12.4 billion. <http://www.unh.edu/news/docs/CVR_Q122004.pdf> (visited June 2005).

[99] *See* Andrew Wong, *Angel Finance: the Other Venture Capital*, Working Paper, University of Chicago (2002); Sahlman (1990), *supra* note _.

[100] *See* Wong (2002) supra note _, Thomas J Chemmanur & Zhaohui Chen, *Angels, Venture Capitalists, and Entrepreneurs: A Dynamic Model of Private Equity Financing*, (working paper ___), and Fen, Liang, & Prowse, *The Economics of the Private Market,* BD. OF GOVERNORS OF THE FED. RESERVE SYS., Staff Studies Series No. 168, 1995.

subsequently-investing VCs will take control of the board and act opportunistically toward common shareholders, the angels will expect a lower return from their investment. This, in turn, may discourage angels from investing in start-ups through common stock, or cause them to demand a larger stake in exchange for their investment, raising the cost of seed capital to entrepreneurs.

To be sure, each angel could insist on receiving preferred stock with protective provisions rather than common stock. Such provisions might offer protection from subsequent opportunism by VCs. In fact, when angels act collectively and invest a significant amount of money in startups, they will often incur the expense of negotiating for preferred stock and bargaining over such provisions. But these transaction costs are likely to be ultimately borne by the entrepreneurs, increasing the cost of angel financing.

And even startups that issue preferred stock to angels may receive their initial capital from individual angel investors, and the transaction costs of contracting over the preferred stock are sufficiently high that it is simply not worthwhile for each small angel investor to negotiate such arrangements. Thus, a substantial portion of angel investing will continue to be in the form of common stock. Should such angel investors anticipate subsequent preferred opportunism, they may be more reluctant to invest or may demand a larger share of the company in exchange for their investment.

2. Reduced Willingness to Use VC Financing

VCs can add value to startups not only by supplying funds but also by providing supervision, advice, and connections. VCs are experienced investors who actively and closely monitor the performance of portfolio company management, replacing personnel as necessary. VCs also help develop the company's internal organization, its business plan, and its marketing strategy. Finally, with their wide network of contacts, VCs can be instrumental in helping the startup form strategic alliances and raise additional funds from other investors.[101]

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[101] *See, e.g.,* Denis (2004), *supra* note _, at 305-307; Hellmann & Puri (2002), *supra* note _.

Despite the potential value that VC investment can add, founders are often nervous about taking VC money. Many attempt to grow their companies without VC investment, relying instead on angel investors, internally generated funds, and debt. [102] Eventually, the entrepreneurs may have no choice but to accept VC financing. However, delay may reduce the value of the firm.

Entrepreneurs' frequent reluctance to obtain VC financing may in part reflect entrepreneurs' desire to retain autonomy and control over their own business, with all the psychological benefits that such an arrangement provides. But it may also reflect fear of opportunistic behavior by VCs that take control of the firm. And such VCs are more likely to engage in opportunistic behavior if their financial payouts diverge from the founder, who holds common stock.

Of course, the entrepreneurs accepting VC financing could try to permanently retain control of the startup, which sometimes occurs. But entrepreneurial control, for reasons explained in Part II.C, increases entrepreneurial agency costs and may expose the VCs to opportunism on the part of a common-controlled board. Thus, in many cases VCs might refuse to invest unless they obtain board control.

3. 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 is intended to align the interests of employees with those of shareholders. Indeed, the tax explanation for the use of

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[102] *See*, e.g., Bill Inmon, *Information Management: Charting the Course: Venture Capitalists and Innovation: 2003*, DM Review Magazine (Nov 2003)<http://www.dmreview.com/article_sub.cfm?articleId=7609> (visited Jan 2005)

preferred stock depends on startups heavily using stock and option compensation to pay employees.[103]

Equity compensation almost always takes the form of common stock and options for common stock. In order for this equity compensation to serve as a substitute for cash, it must have value. And in order for the compensation to create desirable incentives, employees must anticipate that should their work increase the value of the startup, they – as holders of common stock or options on common stock -- will benefit.

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

To be sure, certain key employees, such as the current CEO, will typically have sufficient leverage, when the firm is merged or goes public, to obtain retention agreements providing additional equity. These arrangements can compensate for any reduction in value of the common stock they already own. Consequently, employees who anticipate receiving such side payments will still have strong incentives to increase firm value.

But turnover in startups can be quite high. A startup might not experience a liquidity event for five or so years. Many of the people working at startups, including founders, will no longer be employees at the time of the liquidity event. Because of the possibility of turnover, even executives cannot count on receiving side payments in the event of a future merger.

Moreover, many of those who do anticipate remaining with the startup through the liquidity event might not be confident that they can negotiate retention agreements with the acquirer. For example, even if the founders of the firm are still employed by

[103] See *supra* Part III.B.2.

the firm in some capacity they might not be considered crucial to its future operations at the time of a liquidity event.
As a result, even current key employees cannot predict how long they will remain with the firm, or if they will be able to extract extra value at the time of a liquidity event. Most employees' expected incentive payoff will therefore depend on the value of the common stock.[104]

D. Incidence of the Costs

We have seen that the corporate governance structure of venture-backed startups – in which VC-owning preferred control the board and owe no fiduciary duties to the common – can give rise to preferred opportunism, imposing costs on the parties both before and after VCs provide financing.

To the extent preferred opportunism generates costs – such as distorted business decisions and the reduced availability of angel capital - those costs must be borne by someone. The precise incidence of these costs will depend on the efficiency and competitiveness of various markets (such as the market for entrepreneurs, the market for angel financing, and the market for VC financing) and, to the extent any of these markets are not perfectly competitive, on the parties' relative bargaining power.

The most realistic scenario is that in which none of these markets are perfectly competitive and none of the parties have 100% of the bargaining power. Under these conditions, the costs of preferred opportunism will reduce the surplus that can

[104] Recognizing that the employees' incentives have weakened, VCs sometimes try to get around the problem by giving preferred stock options to management, *see,* e.g., Vyvyan Tenorio (2002), supra note X. But while this might solve the problem going forward, it could actually worsen the incentive problem ex ante. Giving preferred to the managers merely better aligns managers' interests with preferred, reducing common's leverage, and making it more likely that pure common shareholders -- those without any ongoing connection to the firm -- will be hurt. This, in turn, means that founders, who are often no longer with the company, are more likely to suffer from preferred opportunism ex post.

be divided among the parties, and will therefore decrease each party's return. As a result, the costs of preferred opportunism are likely to be borne, to varying degrees, by all of the parties, including the VCs.

It is easy to see that entrepreneurs holding common stock are likely to bear some of the identified costs. A rush to liquidate the company – even if remaining independent would generate more value for shareholders as a group - reduces the value of entrepreneur's common stock. In addition, anticipation of such preferred opportunism might make it more difficult or expensive for entrepreneurs to raise angel financing and to motivate employees with common stock.

How VCs bear part of the costs may be less obvious. But to the extent VCs share in the surplus created by the startup, a diminution of that surplus will reduce the VCs' returns. Knowing that the VCs may subsequently transfer value from common shareholders and take steps that reduce overall startup value, entrepreneurs will give up a smaller fraction of the firm for a fixed amount of VC investment. Entrepreneurs might also be more reluctant to get VC financing in the first instance, reducing the VCs' ability to invest in profitable ventures. In short, while VCs gain ex post from preferred opportunism, they can be expected to "pay" for this opportunism ex ante through worse investment terms. If VCs could be prevented from engaging in such opportunism, the expected surplus – and their expected return – would be higher.

V. Improving the Legal Framework

We have seen that the standard governance arrangements of venture-backed startups, in which VCs invest through preferred shares and control the board, are likely to leave common shareholders vulnerable to preferred opportunism. In this Part, we put forward two proposals for improving the legal framework in which VCs and entrepreneurs negotiate their agreements.

In Section A, we propose eliminating the implicit penalty imposed on VCs investing through common stock. When VCs invest through preferred stock, the startup can provide incentive compensation at a lower tax cost to employees; this, in turn, enables the firm to pay employees less. This tax subsidy may, in some cases, be the decisive factor in the VCs' use of preferred stock. Eliminating the penalty imposed on VCs' use of common stock could thus increase the number of startups in which there is only one class of shares outstanding: common stock. Such a single-class equity structure would eliminate all the distortions we identify in this paper. We offer several possible approaches to leveling the tax playing field.

Even if tax considerations are sometimes pivotal in VCs' decision to invest through preferred, we doubt that they are always the deciding factor. Thus, whether or not the tax penalty for VCs' use of common is eliminated, we expect dual-class equity structures to persist. As we saw in Part II.B. and Part III.C, under the current control primacy approach to fiduciary duties, the class that is in control is free to serve its interests, even if in doing so it imposes substantially larger costs on the non-controlling class. Section B proposes that courts instead employ a "balancing" approach to board fiduciary duties. Under our proposed approach, directors could be held liable for breaching their duty of loyalty to shareholders if (a) they favor one class of shares over another and (b) the cost to the disfavored class is substantially larger than the benefit to the favored class. However, we suggest that ratification by a majority of the informed, disinterested shareholders of the affected classes should shield the board from judicial

review. We show that this approach would, through a variety of mechanisms, reduce the number of value-reducing transactions pushed through by preferred-controlled boards.

Both the tax-leveling and fiduciary balancing proposals are designed to reduce, and in some cases eliminate, the agency costs associated with preferred opportunism and, ultimately, to make both VCs and entrepreneurs better off. It should be emphasized that the proposals are neither mutually exclusive nor mutually dependent. We believe that it would be desirable to adopt both proposals; others may favor one but not the other.

A. Leveling the Tax Playing Field

As we saw in Part III.A, one of the leading explanations for VCs' use of preferred stock is that the U.S. tax code inadvertently subsidizes VCs who invest with preferred stock rather than common stock. Recall that 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 a low value to the stock underlying employees' incentives. Essentially, the tax law penalizes VCs who use common stock by making it more costly for startups to provide incentive compensation to employees. As we explained, there is evidence suggesting that, at least in some cases, a tax penalty may affect VCs' choice of security. In other countries, where such a penalty does not exist, the use of common stock is much more frequent.

From a social perspective, this tax subsidy is likely to be inefficient. Suppose that, but for tax considerations, VC and Entrepreneur (E) would use a single-class structure, i.e. VC would invest through common stock, because the net benefits of such a structure (say, $100) exceed the net benefits of a dual class structure, i.e. when VC invests through

preferred stock, (say, $50). Now suppose that the tax savings from VC's use of preferred would be $60. A dual class structure would yield the parties a net benefit of $110, 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 total value generated by that arrangement – the net benefit to the parties and the government – is $50 less than the alternative single-class structure. From an economic perspective, the tax system inefficiently distorts the parties' arrangement and reduces the total social value.

To the extent that tax law, on the margin, induces parties to adopt less efficient dual-class structures, it would be desirable to level the tax playing field to eliminate this distortion. Given that the tax penalty for common's use arises from the failure of the IRS to properly enforce the tax laws when VCs invest through preferred, an obvious way to level the playing field is to aggressively enforce the tax law. In other words, the IRS could force startups issuing preferred stock to properly value common stock given to employees. But such an approach is, we think, impractical. Valuation is very difficult. Even if valuation were easy, the IRS may be fearful of backlash from the politically powerful Silicon Valley community. Moreover, to the extent a tax subsidy to venture-backed firms generates economy-wide benefits, as some commentators have suggested,[105] aggressively enforcing the valuation of incentive compensation startups may, as a matter of policy, be undesirable. Accordingly, we will focus on two approaches that are more feasible and can be used to provide some degree of subsidy to small firms, assuming for purposes of this paper that such a subsidy is desirable. Our goal here is not to identify the best approach, but rather to describe two options that we think deserve consideration.

1. Informal Approach: IRS Forbearance

Recall that the tax subsidy provided for VCs' use of preferred stock arises not from the tax laws themselves but rather from the way the parties reasonably believe they

105 See Gilson and Schizer, supra note x, at 910.

will be enforced. If the VCs invest through common stock, and the startup claims a below-market value for the common stock underlying employee incentives, it is reasonable for the parties to believe they will be subject to penalties should the IRS do an audit. If, however, the VCs invest through preferred stock, it is reasonable for the parties to believe that the likelihood of penalties is quite low.

One way to level the tax playing field without changing the formal tax law is for the IRS to indicate, informally or explicitly, that it will not challenge the value 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 dual-class startups. In other words, the IRS could indicate that it will be just as lax at enforcing the tax laws when VCs invest through common stock as when they invest through preferred stock even though, should it wish to impose penalties, it would be easier to do so. This informal change could be effected without any legislative action or changes to the tax code.

Of course, the IRS might not be institutionally capable or willing to take such a step. But, to the extent that the IRS wishes to maximize tax revenues, it might be wise for it to do so. Currently, any private firm can under-value the stock used for incentive compensation, and thereby evade taxes, simply by taking an arm's-length investment in the form of preferred stock rather than in the form of common stock.[106] If all private firms – not just those that are venture-backed – were to evade taxes in this way, the IRS would not lose any tax revenue by announcing that it would treat all-common firms the same as dual-class firms. In fact, it might even gain revenue, since the resulting larger pie may well generate more taxable income for the corporation and its investors.

2. Formal Approach: $0 Grant Date Value

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[106] Public firms cannot evade taxes in this manner because market trading establishes the fair market value of their common stock. In addition, private companies with high expected growth rates can more easily evade taxes by using preferred stock because they can assign higher liquidation preferences without substantially affecting expected distributions.

The tax playing field could most easily be leveled by changing the tax rules themselves, a step that would require Congressional action. One approach worth considering would be to allow private firms (those whose stock is not publicly-traded) to assign a grant date value of $0 to the common stock underlying employee incentives. When the employee sold the underlying stock, the gain would be treated at a specified rate independent of the firm's capital structure. Under such a proposal, VCs' use of preferred stock rather than common stock would not affect the tax treatment of incentive compensation. Therefore, the parties would not have an incentive to use preferred stock when it was not otherwise value-increasing.

The rate at which the gains on the stock are subsequently taxed would depend on the degree to which the use of incentive compensation in private companies should be subsidized. The higher the desirable subsidy, the lower the rate is. The rate might also vary, depending on the holding period of the stock. 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 the capital gains rate, or some intermediate rate.

We do not claim to have developed and fully defended a detailed tax proposal for incentive compensation. That is not our purpose. Rather, our objective is to show that leveling the tax playing field would eliminate the tax distortion in favor of preferred stock and to put forward for consideration several ways in which that might be done.

Nor are we claiming, as an empirical matter, that VCs would invest through common stock absent the implicit tax subsidy. There are many potential agency-cost reducing benefits to VCs' use of preferred stock, and these may outweigh the costs of preferred opportunism identified in this paper. Our claim is that if tax considerations, on the margin, induce the parties to use preferred rather than common stock, then eliminating the tax distortion would – in those cases – lead to a more efficient investment arrangement.

B. "Balancing Approach" to 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, in turn, 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.[107]

As we saw in Parts II and III, under the current "control primacy" approach, there is little legal constraint on the board's ability to favor one class over another, even if doing so reduces total shareholder value. Delaware courts have given common-controlled boards substantial leeway to make decisions that favor common shareholders at the expense of the preferred and have similarly given preferred-dominated boards substantial discretion to favor preferred at the expense of common.

Control primacy may be more defensible when the common control the board because the preferred have contractual provisions designed to protect against common opportunism. But it is hard to see how control primacy serves the parties' joint interest when the preferred control the board and common shareholders have no contractual protection. In this situation, control primacy leaves the non-controlling class vulnerable to value-reducing behavior.

Importantly, we are not claiming that directors seeking to advance preferreds' interests at a substantially larger cost to the common face absolutely no risk of liability. The legal system is somewhat unpredictable. Courts could always choose to abandon or

[107] It should be pointed out that as long as VCs use preferred stock with liquidation preferences, a fundamental departure from a pro rata distribution rule, Rock & Wachter's analysis of close corporations does not apply to their portfolio companies. Since, as Rock & Wachter explain, in the regular close corporation context "The limitations on exit, combined with the rule against non pro rata distributions, largely prevent opportunistic behavior by the majority shareholder towards the minority. By locking both into the enterprise, the majority shareholders, in maximizing their own wealth, will, to a large extent, also maximize the wealth of the minority" see *supra note* X, at 38. And Rock & Wachter's observation "that courts should not do anything except enforce the participants' contracts and vigorously prevent non pro rata distributions to shareholders" is likewise inapplicable and calls for a different judicial approach as the proposed balancing approach.

modify control primacy.[108] Alternatively, judges unwilling to overturn or alter control primacy could find directors liable under another doctrine. However, it is unlikely that the current level of protection – and the way it is achieved, through unpredictability – is optimal.

We therefore put forward for consideration, as an alternative to control primacy, a new balancing approach to fiduciary duties that would apply in preferred-controlled startups.[109] Specifically, directors should be considered liable for violating their fiduciary duty of loyalty to shareholders if, in favoring one class of shares over another, the cost they impose on the adversely affected class substantially exceeds the benefit to one or more classes of shareholders.[110] However, we suggest that ratification by a majority of informed, disinterested stockholders of the affected classes should shield the board from judicial review.[111]

In a hypothetical world of perfect information and costless enforcement, preferred and common shareholders would likely prefer a rule in which the board has a fiduciary duty not to act in ways that reduce joint shareholder value. 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. Such a rule 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.

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[108] Indeed, in several cases involving the distribution of merger proceeds, they have already carved out exceptions to control primacy. See supra note x.

[109] It may well be desirable to apply this rule to any firm with multiple classes of equity, including common-controlled venture-backed startups, other private companies, and public firms. However, in this paper we propose its application only in the context of venture-backed startups with preferred-controlled boards, where the noncontrolling class, common shareholders lacking contractual protection, is most vulnerable.

[110] Liability in Delaware would not be precluded by the presence of a liability opt-out provision in the charter pursuant to DGCL 102(b)(7), because that provision does not affect shareholders' ability to recover for breach of duty of loyalty claims.

[111] Cf. Guhan Subramanian, *Fixing Freezeouts*, (working paper, Dec. 2004), (proposing a similar mechanism in the freeze-out context where approval by both a special committee of disinterested directors and the majority of the minority shareholders calls for a business judgment review rather than a stringent court review.)

Unfortunately, information is not perfect and enforcement is costly. 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 stock under a hypothetical alternative course of action. Plaintiffs with merit-less claims may seek to block decisions that would in fact be value-maximizing, and courts could impose liability on boards that had acted legally. Board decision-making could therefore be paralyzed. Fear of paralysis may be one reason why courts have been attracted to the control primacy approach, which avoids the need to examine the effect of the board's decision on shareholders as a group.

The proposed balancing standard is designed to encourage boards to take into account the effects of their decisions on non-controlling classes while reducing the risk of meritless suits and their attendant costs. The rule would not impose liability on boards unless the cost of a decision to the non-controlling class was *substantially* more than the benefit to the controlling class. Thus, even if courts err, they are unlikely to hold liable a board whose decision increased shareholder value. While some might argue for a stricter rule – one that imposes liability on boards taking steps that reduce shareholder value, we believe it prudent to use a more lenient approach to minimize the costs associated with meritless lawsuits.

In addition, our proposed approach allows boards to avoid judicial review altogether by obtaining shareholder ratification of their decisions. Thus, the threat of meritless litigation could be eliminated by obtaining consent from a majority of the affected shareholders. However, the board would be free, to the extent it is currently permitted by corporate law and the firm's charter and shareholder-agreements, to proceed with a contemplated course of action without obtaining shareholder ratification, as long as it is willing to face the risk of litigation.

In Part IV.B., we explained that corporate-law shareholder voting requirements are unlikely to prevent preferred opportunism because a separate vote of the common is not always necessary and, when it is, preferred shareholders can influence the outcome of the common's vote through techniques such as cross-voting and vote-buying.

However, for ratification to insulate the board from judicial review, it is important that only the votes of common shareholders without a conflicting interest (such as an ownership interest in another class or an ongoing employment relationship with the firm) should be counted. Otherwise, preferred-dominated boards could act in ways that substantially reduce shareholder value and then use vote-buying or cross-voting to avoid liability.[112]

To the extent that the board is proposing a value-increasing course of action, the board should be able to obtain ratification from common shareholders by sharing with them some of the increase in value. If the common shareholders demand too much of the surplus in exchange for ratification, the board can proceed with the transaction (assuming all other statutory requirements are met). The common shareholders would be free to challenge the board under the balancing approach. However, to prevail, the common shareholders would need to show that the board took a step that benefited preferred shareholders and imposed a substantially greater cost on common shareholders.

To be sure, the balancing approach cannot completely eliminate the problems identified in this paper. However, we do believe that such a rule will encourage boards to consider the effects of their actions on non-controlling classes and, in certain cases, to strike deals with non-controlling classes to avoid the possibility of judicial review. In our view, there are two mechanisms through which the balancing approach can improve decision making of preferred-backed boards.

The first, and probably most important, mechanism for affecting board behavior is the possibility of legal liability. In many cases, the threat of liability can be expected to cause boards to refrain from actions that reduce shareholder value. Deterrence will of course not be perfect. There will still be significant hurdles to litigating and winning

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[112] It is possible that some of the shareholders will be fired employees who might vindictively seek to block a deal that makes them financially better off. But it is important to emphasize that approval by such shareholders would not be necessary for the deal to go through. Rather, it would only have the effect of insulating the decision from review should the board be sued for violating the balancing test.

such a case. [113] But, the balancing approach will certainly provide more deterrence than control primacy.

The second mechanism through which a balancing approach can desirably affect board decisions is through the creation of better social norms. Many people prefer to follow rules even when doing so is inconsistent with their material self-interest and there is little chance they would be punished for violating those rules.[114] In the context of corporate law, where opportunistic behavior is often difficult to detect and even harder to prove, norms are particularly important.[115] Thus, simply by announcing a rule that boards must weigh the effects of their decisions on non-controlling classes of stock, courts can alter board behavior even if the difficulty of detecting and punishing rule-breakers are quite high.

We have been told by Silicon Valley lawyers that boards frequently ask about their duties to various classes of shareholders in situations where there are conflicts of interest. Currently, lawyers are likely to tell common-controlled boards that, as a matter of current Delaware law, boards are free to advance the interests of their own class of stock. If lawyers were to tell directors that the law permits them to advance the

[113] One reason why plaintiffs will be reluctant to bring such a case is fear of retaliation. Consider the recent example of Epinions.com. The co-founders 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 Venture's other partners expelled Ravikant under pressure from other VC firms, who presumably threatened to refuse to work with Dot Edu Ventures on deals until they pushed out Ravikant. See Constane Loizos, *VC Gets Frozen Out After Joining Suit,* Private Equity Week (Feb 2005) <http://www.privateequityweek.com/pew/freearticles/1107338724787.html> (visited April 2005). 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."

[114] *See* Robert Cooter & Melvin A. Eisenberg, *Symposium Norms & Corporate Law: 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."); Melvin A. Eisenberg, *Symposium: Team Production in Business Organizations: The Conception That the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 IOWA J. CORP. L. 819, 831 (1999).

[115] For the role of norms as important influential forces in corporate law, see, e.g., Thomas Smith (1999), supra note x, at 264; Edward B. Rock, Saints and Sinners: How Does Delaware Law Work?, 44 UCLA L. REV. 1009, 1013 (1997).

controlling class' interests, but only if the other class is not disproportionately injured, we believe that directors interested in doing the "right thing" would 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.

Finally, while our focus here is on the heightened vulnerability of the common when the preferred control the board, and therefore we propose a balancing test tailored to their defense, we would like to point out to possible expansions. A broader and more general concern might rise as a result of the control primacy approach to fiduciary duties. And variations to the balancing approach may help promote more efficient corporate governance structures in similar situations.

For example, despite elaborate contractual rights, common-controlled boards pose a threat to the investment of VCs that triggers an additional set of costs.[116] Similarly, when the preferreds control the board, conflicts among the VCs themselves may arise. This may happen because VCs invest in several rounds of financing creating several series of preferred stock within the preferred class. Each VC firm may have different stakes in different series depending on the extent of its participation in the specific round. Conflicts, thus, may well arise between the controlling preferred group and the non-controlling VCs.[117]

We are not, for now, proposing the general application of the balancing test in these other contexts where there are diverse shareholder claims while controlled rights are centered in one group. This would require further specific examination. We think, however, that our approach may be useful in increasing social welfare if adopted appropriately. We hope to further consider the applications of this approach in future work.

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[116] See e.g. Bratton, supra note x.

[117] While these conflicts within the preferred class maybe, at times, beneficial to the common (as junior series of preferred restrict their demands in fear of senior series subsequent analogous preferential demands) they may cause additional costs for companies seeking to raise VC financing.

Part VI. 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. We have shown that the structure of venture capital investment in these startups, which may in part be driven by tax considerations, leads to a highly unusual corporate governance structure: one in which preferred rather than common shareholders control the board and the corporation. We have also shown that this structure leaves common shareholders vulnerable to preferred opportunism, especially under the courts' current primacy approach to fiduciary duties. Finally, we have suggested changes to the tax and fiduciary doctrines aimed at reducing common shareholder vulnerability and increasing the size of the startup pie for all investors, including the venture capitalists. 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.