Abstract

Members of the academic subcommittee will present current research related to private equity and venture capital. Each presentation will be followed by comments from a practitioner in the relevant field and then open to questions from the audience. This year presentations will cover the following topics: (i) internal corporate governance arrangements in venture backed startups, (ii) deficiencies in negotiation of private equity fund agreements, (iii) the impact of non-traditional investors on the governance of late-stage unicorn firms and (iv) the risk-seeking incentives of partners managing VC funds despite holding a class of senior security (preferred stock). Below is some additional detail on the subject area of the four projects, though since each is still in early draft form this may change somewhat by the time of the ABA conference.

Professor Elizabeth Pollman (Loyola Law School - Los Angeles) will present the first paper, “Startup Governance”. Pollman notes that internal governance arrangements within venture-backed startups are underexplored. “Longstanding theories of corporate ownership and governance do not capture the special features of startups. They can grow large with ownership shared by diverse participants, and they face issues that do not fit the dominant principal-agent paradigm of public corporations or the classic narrative of controlling shareholders in closely-held corporations.” Pollman provides a new “framework for understanding the unique combination of governance issues in startup companies over their life cycles. It shows that venture-backed startups involve heterogeneous shareholders in overlapping governance roles that give rise to vertical and horizontal tensions between founders, investors, executives, and employees.”

Our second paper is authored by William Clayton (BYU Law School), and is titled “The Private Equity Negotiation Myth”. This project explores private equity fund agreements. Clayton shows – contrary to industry claims that fund agreements are highly negotiated – that
large investors seldom have an incentive to bargain for better fund terms. Instead, large PE investors often bargain for individualized protections rather than for better fund-wide terms.

Our third paper - by Anat Alon-Beck (Case Western Reserve University School of Law) – is titled “The New Unicorn Investors - Disruptors or Distractors”. This study explores the impact of non-traditional investors in late-stage mega deals providing funding to large private venture-backed startups (“unicorns”) on the governance arrangements and contractual terms operating within such firms. Put differently, how is the influx of new investors changing the private ordering within such VC-backed firms? Alon-Beck considers various policy reforms and corporate governance principles for unicorn firms.

Professor Jesse Fried (Harvard Law School) will present the final paper, titled “Variance-Seeking VCs”, on our CLE panel. Fried shows that although VCs invest through senior securities (convertible preferred stock), they will often have various incentives to push the portfolio company to take risks that are excessive from common stockholders’ perspective. This incentive for excessive risk comes from largely from the VCs’ compensation structure (carry + management fees on future funds), but also in some cases from the convertible preferred stock itself.
Speaker Bios:

- Anat Alon-Beck is a Professor at Case Western Reserve University School of Law, Cleveland Ohio.
- Brian Broughman is a Professor at Indiana University, Maurer School of Law, Bloomington, Indiana.
- William Clayton is a Professor at BYU Law School, Provo Utah.
- Jesse Fried is a Professor at Harvard Law School, Cambridge Massachusetts.
- Jon Gworek is a Partner at Morse, Barnes-Brown & Pendleton, Boston Massachusetts.
- Robin Painter is a Partner at Proskauer Rose, Boston Massachusetts.
- Elizabeth Pollman is a Professor at Loyola Law School, Los Angeles California.
- Jeff Wolters is a Partner at Morris Nichols, Wilmington Delaware.
Abstract

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

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

All five of the world’s largest companies by market capitalization—Apple, Alphabet, Microsoft, Amazon, and Facebook—began as venture-backed startups.\(^1\) They defied existing theory by growing to significant size with ownership shared between founders, investors, executives, and employees.\(^2\) In the years since these trailblazing startups crossed over into public company status, record-breaking amounts of capital have flowed into new private companies.\(^3\)

Over three hundred “unicorn” startups have reached private valuations described as one billion dollars or more.\(^4\) In 2019, many of these companies reach the 10-year mark and face critical inflection points in their life cycles.\(^5\) Thousands of other startups are following on their heels or hope to do so. Our economy and society are increasingly dominated by companies that start in the proverbial garage or dorm room and, for a critical period, operate with a venture-capital style of ownership and governance.

Corporate law and theory have not kept pace in giving due attention to this development and adapting general principles to fit the special features of startups.\(^6\) Courts apply traditional contract strictures to the preferred stock that venture capitalists hold not as public company debt, but rather as a stake in a distinctive system of shared

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\(^2\) See Henry Hansmann, The Ownership of Enterprise 40-44 (1996) (observing the “nearly complete absence of large firms in which ownership is shared among two or more different types of patrons, such as customers and suppliers or investors and workers” and theorizing the high cost of collective decisionmaking that would result from having different types of owners).

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

\(^4\) Venture capitalist Aileen Lee coined the term “unicorn” in 2013 to capture the elusive and rare nature of mega-hit ventures in a fund that are worth a billion dollars or more. In just several years, the list of unicorns rose to over three hundred private technology companies. Aileen Lee, Welcome to the Unicorn Club: Learning from Billion-Dollar Startups, TECHCRUNCH (Nov. 2, 2013), https://techcrunch.com/2013/11/02/welcome-to-the-unicorn-club/; The Global Unicorn Club, CB INSIGHTS, https://www.cbinsights.com/research-unicorn-companies (last visited Jan. 29, 2019).

\(^5\) See Alfred Lee, Delayed IPOs Undercut Startup Employee Options, THE INFORMATION (July 13, 2018), https://www.theinformation.com/articles/delayed-igos-undercut-startup-employee-options (noting 52 unicorns hit the 10-year mark in 2018 and more will follow in 2019). Notable examples in this batch of unicorns include Airbnb, Uber, Pinterest, Palantir, and SpaceX—some of which have transitioned to public company status.

\(^6\) See Robert P. Bartlett & Eric Talley, Law and Corporate Governance, in THE HANDBOOK OF THE ECONOMICS OF CORPORATE GOVERNANCE 8 (Hermalin & Weisbach eds., forthcoming), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3009451 (“[T]he increasing concentration of economic value in private companies poses somewhat of a challenge for corporate governance scholars, both empirically and theoretically, ... . To the extent this trend continues, the study of governance in privately held firms is likely to become more critical to important policy debates.”).
equity and governance. 7 Recent case law requires startup directors to maximize value for common shareholders, without recognizing that in startups these shareholders do not have a monolithic set of interests and do not represent the firm value. 8

Corporate law literature remains similarly rooted in traditional paradigms of public and closely-held corporations that do not map on well to startups. Landmark works on the separation of ownership and control in public corporations, and a principal-agent theory of the firm, have oriented the field to view reducing managerial agency costs “as the essential function of corporate law.” 9 A smaller body of work on controlled and closely-held corporations has, by contrast, highlighted that these corporations do not share the hallmark feature of widely dispersed shareholders and instead face the potential problem of minority shareholder oppression. 10

Amid this dichotomous approach to corporations, 11 a separate body of venture capital and entrepreneurship literature has emerged to examine specific governance issues in startups. Key work in this field includes, for example, the study of venture capital financing 12 and the use of preferred stock. 13 Some scholars have recently begun

7 See infra Part II.A(2)(b).
8 See infra Part III.B.
studying unicorns, the largest startups by valuation, and have expressed concern about their lack of disclosure and lack of discipline on founders.\textsuperscript{14} Yet, despite growing influence and concern, no article has provided a full account of the unique features of startups and their governance.

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

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

\textsuperscript{14} Jennifer S. Fan, Regulating Unicorns: Disclosure and the New Private Economy, 57 B.C. L. REV. 583, 583 (2016) (arguing “for enhanced disclosure requirements that will alleviate the risks of unicorns without restraining their innovation”); Renee M. Jones, The Unicorn Governance Trap, 166 U. PA. L. REV. ONLINE 165, 169 (2017) (arguing “recent market trends and deregulatory reforms have weakened or eliminated the principal mechanisms that imposed discipline on start-up company founders”).

\textsuperscript{15} One notable exception is work by Robert Bartlett that provides a dynamic account showing that the staged and syndicated financing that VCs use to constrain shareholder-manager agency costs can give rise to a new dimension of horizontal conflict among preferred shareholders in startups. See Bartlett, False Dichotomy, supra note 11, at 108-09. This Article builds on this insight and is the first to provide a complete dynamic account of the multiple vertical and horizontal tensions in startups and argue, in contrast to Bartlett, that startups have unique governance features and do not present the same agency problems and investment risks as all other firms. See id. at 37-40 (asserting that “all firms—public and private—often face the same agency problems” and “all firms—public and private—frequently face the same structural investment risks”).

\textsuperscript{16} See, e.g., Henry Hansmann, Worker Participation and Corporate Governance, 43 U. TORONTO L.J. 589, 591-92 (1993) (“Shareholders have highly homogeneous interests with respect to most corporate decisions: they all basically want to maximize the net present value of future distributions.”); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 1-39 (1991) (providing a contractarian theory of corporate law and characterizing employees as creditors protected by contract and external regulation); Henry Hansmann & Reimier Kraakman, The End of History for Corporate Law, 89 GEO. L.J. 439, 440-41 (2001) (“[The] emerging consensus [is] that ultimate control over the corporation should rest with the shareholder class; . . . other corporate constituencies, such as creditors, employees, suppliers, and customers, should have their interests protected by contractual and regulatory means rather than through participation in corporate governance.”); but
This approach is a poor fit for startups. Participants in startups often occupy overlapping and shifting roles. For example, a venture capital (VC) firm is a shareholder and may additionally hold a designated seat on the board. This complicates conventional applications of principal-agent theory as participants may have a dual status as both principal in one context and agent in another.

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

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

While it may seem intuitive that startups increase in governance complexity as they continue to operate, this account is missing from the existing literature. Because startups are often unprofitable for long periods while they develop innovative products or

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17 See infra Part I.B(2).

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

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

Electronic copy available at: https://ssrn.com/abstract=3352203
services, they usually raise outside investment and continue to do so to fuel growth.\textsuperscript{20} Each round of financing may bring investors with different terms and interests into the capital structure, adding to potential governance conflicts.\textsuperscript{21} Further, employees are typically hired on an ongoing and increasing basis, and become staggered in their option vesting schedules and exercise prices. Thus, as a startup company matures, it expands the participants with varied interests and claims affecting its governance structure.\textsuperscript{22}

These central contributions of the Article—which unfold in Parts I and II—help elucidate vexing issues of current debate and open future directions for corporate law that are explored in Part III. First, with scandals at companies such as Uber and Theranos making headline news, recent accounts of startups have bemoaned unaccountable companies with large social footprints and compliance failures.\textsuperscript{23} This Article’s framework helps show how a startup’s evolving governance structure pushes toward prioritizing growth and puts key participants in overlapping roles, which can result in conflicts of interest and weaken oversight. This explanation solves a puzzle left open by existing literature which assumes that VCs will serve as strong monitors. Further, it reveals cause for concern that likely cannot be solved with the standard corporate governance proposal for greater board independence. Startup governance may insufficiently constrain the social costs created by growing, innovative companies.

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

Finally, Part III suggests that corporate law should adapt in its application to startups in recognition of their distinctive features. Corporate law has largely developed to deal with the classic shareholder-manager and controlling-minority shareholder conflicts arising in public and traditional closely-held corporations. Courts have applied these conventional frames of reference in cases involving startups, treating preferred shareholders as creditors with respect to their contractual preferences and characterizing

\textsuperscript{20} See infra Part I.
\textsuperscript{21} See infra Part II.A.
\textsuperscript{22} See infra Part II.B.
\textsuperscript{23} See infra Part III.A(1).
\textsuperscript{24} See infra Part III.A(2).
common shareholders as the residual claimants of the corporation. A key example of this problematic approach arises with fiduciary duty doctrine that is at the heart of corporate law. The last section examines In re Trados,\(^{25}\) Delaware’s most notable fiduciary duty case involving a startup, and shows how the court overlooks the heightened need of heterogeneous shareholders to resolve complex governance issues by contract and a board with constituency directors that is re-negotiated over time. Further, the court ignores the differing interests even among common shareholders.\(^{26}\) A better approach recognizes the corporation itself as the beneficiary of the fiduciary duties, representing the firm value and the interests of all startup participants.

I. THE DISTINCTIVENESS OF STARTUPS AND THEIR LIFE CYCLE

To start at the beginning of understanding startup governance is to recognize that despite widespread reference to companies by the moniker of startup and recognition of their economic importance,\(^{27}\) the law does not create such a category. This Part begins with definitional background and then sets out the unique combination of business and finance features in innovative venture-backed startups, which give rise to several recurring fundamental governance issues.

A. Legal Boundaries and Definitions

The law does surprisingly little to formally define startups or mandate their governance. Federal securities law draws a line between “public” and “private” corporations.\(^{28}\) A company becomes “public” by making a public offering of securities, listing securities on a national securities exchange, or by reaching a certain asset size and number of shareholders of record.\(^{29}\) Once a company is public, it is subject to a wide variety of governance requirements provided by federal statutes and by the securities

\(^{25}\) In re Trados Inc. S’holder Litig., 73 A.3d 17, 21 (Del. Ch. 2013).

\(^{26}\) See infra Part III.B.

\(^{27}\) See, e.g., Gilson, supra note 12, at 1068 (noting that startup companies and the venture capital market are “among the crown jewels of the American economy”); Simone M. Sepe, Intruders in the Boardroom: The Case of Constituency Directors, 91 WASH. U. L. REV. 309, 315 (2013) [hereinafter Sepe, Constituency Directors] (noting that venture-backed startups “are growing exponentially in importance in the U.S. economy”).


exchange on which the company’s stock is traded.\(^{30}\) For example, a public corporation’s board must have a majority of independent directors and must give shareholders a non-binding “say-on-pay” vote on executive compensation.\(^{31}\)

If a company does not become public by one of the established paths, it is “private.”\(^{32}\) Some private corporations are referred to as “closely held” or “close,” and are generally partnership-like businesses involving family or personal ties.\(^{33}\) The Internal Revenue Service defines a closely-held corporation as having more than half of the value of its outstanding stock owned by five or fewer individuals.\(^{34}\)

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

After an initial seed stage, startups often have more than a small handful of shareholders, with the numbers increasing as the company raises capital from syndicates

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

\(^{31}\) And Now, the Independent Director? Have Congress, the NYSE, and NASDAQ Finally Figured Out How to Make the Independent Director Actually Work?, 117 HARV. L. REV. 2181, 2182-94 (2004); Jill E. Fisch, Leave It To Delaware: Why Congress Should Stay Out of Corporate Governance, 37 DEL. J. CORP. L. 731, 752-54 (2013) [hereinafter Fisch, Delaware].

\(^{32}\) To maintain this status, companies issue their securities in private placements conforming to the rules for exemptions from registration requirements. Stephen J. Choi & A.C. Pritchard, Securities Regulation: The Essentials 297-98 (2008).


\(^{35}\) See, e.g., John B. Venturella & Suzanne M. Erickson, Raising Entrepreneurial Capital 33 (2013) (distinguishing the “closely-held” corporation from the “private” corporation by the number of shareholders and stating that “[a] start-up company with high growth aspirations will typically go through a period as a private corporation”); Telecom-SNI Investors, L.L.C. v. Sorrento Networks, Inc., No. Civ.A. 19038-NC, 2001 WL 1117505, at *1 (Del. Ch. Sept. 7, 2001) (“Sorrento-California, as a startup corporation with no immediate prospects of profitability, required constant and significant cash infusions to sustain it until an initial public offering (‘IPO’) could be accomplished.”).

of investors, including VCs, and grants restricted stock and stock options to employees which vest over the course of employment.\textsuperscript{37} Like traditional closely-held corporations, startups have stock that is not publicly traded.\textsuperscript{38} But even in this regard, startups are different in that outside demand for the high-growth asset class exists and startups may facilitate partial liquidity events.\textsuperscript{39} This Article focuses on these companies—innovative, venture-backed startups and their distinctive governance features.\textsuperscript{40}

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

\section*{B. Two Dimensions of the Startup Life Cycle}

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

\subsection*{I. The Nature of the Business}

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

\textsuperscript{37} Startups typically manage the number of their holders of record to maintain private status, but the numbers may be significantly greater than the definition of closely-held provided by the IRS. See Elizabeth Pollman, Information Issues on Wall Street 2.0, 161 U. PA. L. REV. 179, 190-91 (2012); see also note 34.

\textsuperscript{38} See DOUGLAS K. MOLL & ROBERT A. RAGAZZO, THE LAW OF CLOSELY HELD CORPORATIONS 1 (2009) (“A closely held corporation can be generally defined as a corporation whose stock is not publicly traded on an established market.”).

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

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

\textsuperscript{41} State corporate law is generally enabling in nature. See Fisch, Delaware, supra note 31, at 742 (“[T]he structure of Delaware’s corporate law is largely enabling rather than mandatory.”); see also Melvin A. Eisenberg, The Structure of Corporate Law, 89 COLUM. L. REV. 1461, 1481 (1989) (“Delaware is usually taken as the apotheosis of enabling statutes”).
patterns. Startups famously fail at high rates. Those that succeed generally proceed through well-established business phases.

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

42 Mary Jo White, Keynote Address at the SEC-Rock Center on Corporate Governance Silicon Valley Initiative (Mar. 31, 2016), https://www.sec.gov/news/speech/chair-white-silicon-valley-initiative-3-31-16.html (noting that nine out of ten startups fail and 70% of failed startups die within twenty months after their last financing, having raised an average of $11 million); Deborah Gage, The Venture Capital Secret: 3 out of 4 Start-Ups Fail, WALL ST. J. (Sept. 20, 2012), https://www.wsj.com/articles/SB100008723936390443742020457800498047429190 (finding that 60% of startups survive to age three and about 35% survive to age ten).

43 Researchers have coined various terms and framed different numbers of phases, but generally track the discussion offered in this section. See, e.g., NOAM WASSERMAN, THE FOUNDER’S DILEMMA: ANTICIPATING AND AVOIDING THE PITFALLS THAT CAN SINK A STARTUP 206-07 (2012) (identifying the stages as startup, transitional, and mature, noting that “different functions within startups may go through them at different rates”); Max Marmer & Ertan Dogrultan, Startup Genome Report Extra on Premature Scaling, Mar. 2013, http://s3.amazonaws.com/startupcompass-public/StartupGenomeReport2_Why_Startups_Fail_v2.pdf (gathering data from 3,200 startups and identifying six stages: “discovery, validation, efficiency, scale, sustain, and conservation”).


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

48 SPULBER, supra note 44, at 10; see also Ibrakhm & Smith, supra note 47, at 84 (“Entrepreneurship involves new products or services, new ways of organizing, or new geographic markets.”); PETER THIEL, ZERO TO ONE: NOTES ON STARTUPS, OR HOW TO BUILD THE FUTURE 8, 10 (2014) (“Properly understood, any new and better way of doing things is technology. . . New technology tends to come from new ventures—startups”); JOSEPH SCHUMPETER, THEORY OF ECONOMIC DEVELOPMENT 74-83 (1934) (Redvers Opie trans., Transaction Pub. 2012) (describing entrepreneurs as introducing new goods or methods of production or opening new markets or supply sources).
The key early stage question is: Can we make a product or service that people want? The nature of this challenge is typically both technological and operational because of engineering or scientific challenges involved in developing innovative technology and the need to raise money to fund this work. Most founders do not have sufficient funds to bring an innovative product or service to market and the business may not be profitable for long periods of time. Founders therefore usually look to friends and family, angel investors, and VCs to finance the early and most uncertain stages of the startup. The company’s board, typically established in earnest upon the raising of a round of financing, is in a highly managerial phase—helping the company with connections, resources, strategy, and expertise to succeed in launching its innovative product or service to the market.

After the early stage, startups typically become focused on refining product development to generate revenues and grow quickly. The key mid-stage question is: Can we scale the manufacture, distribution, and sale of our innovative product or service? This question is often linked to the crucial issue of generating revenues or reaching profitability with a large market opportunity. To ultimately reach large exits,


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

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


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

54 See, e.g., Ranjay Gulati & Alicia DeSantola, Startups That Last, HARV. BUS. REV. (March 2016), https://hbr.org/2016/03/start-ups-that-last (discussing critical activities to scale a venture and transition to a mature firm).

55 See THIEL, supra note 48, at 21 (discussing product development and “viral growth”), and at 54-55 (discussing scaling); KAWASAKI, supra note 49, at 37 (explaining that the term scale “refers to the concept that there are processes in place that are fast, cheap, and repeatable” giving rise to the possibility “there will soon be millions of customers who generate billions of dollars of revenue”). Growth is often discussed as equal or greater in importance as profitability for startups. See Fred Wilson, Profits v. Growth, AVC (June 25, 2015), https://avc.com/2015/06/profits-vs-growth/.
startups need to be able to scale.\textsuperscript{56} Venture capitalists that finance startups are based on a business model that depends on having a few “home runs” in the portfolio that account for much of the fund returns.\textsuperscript{57} Sequoia Capital, for example, invested $60 million in WhatsApp, which later sold to Facebook for $16 billion—yielding a return to Sequoia of fifty times its investment.\textsuperscript{58}

As a startup evolves to late stage, its focus has typically shifted to managing a more complex organization and finding an exit to achieve liquidity for the participants holding equity stakes in the company. To have survived this long, the company has successfully developed some innovative product or service and generated customers and sales. The nature of the business may have become more complex, potentially involving global operations, new opportunities, competition, and continued challenges in terms of cash flow and growth.\textsuperscript{59} Founders that have not kept up with these needs may no longer occupy top executive positions.\textsuperscript{60} For instance, Tesla was founded by Martin Eberhard, who was later fired and replaced by Elon Musk, a large investor and chairperson of the board.\textsuperscript{61}

Indeed, by the late stage the number of participants has likely grown significantly and the needs of some have changed. Although some early employees may have left the company, others have stayed and fully vested their stock options, building pressure for an opportunity to sell.\textsuperscript{62} Different types of investors may have participated in financing

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

\textsuperscript{57} THIEL, supra note 48, at 86-87 (noting that “the best investment in a successful fund equals or outperforms the entire rest of the fund combined” and therefore “every single company in a good venture portfolio must have the potential to succeed at a vast scale”); Bob Zider, How Venture Capital Works, HARV. BUS. REV. (Nov.-Dec. 1998), https://hbr.org/1998/11/how-venture-capital-works (“Given the portfolio approach and the deal structure VCs use, however, only 10% to 20% of the companies funded need to be real winners to achieve the targeted return rate . . . In fact, VC reputations are often built on one or two good investments.”).


\textsuperscript{60} Brian J. Broughman & Jesse M. Fried, Do Founders Control Start-Up Firms That Go Public? (ECGI Working Paper No. 405, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3171237 (finding that in almost 60% of venture-backed firms that go public, the founder is no longer CEO at IPO); WASSERMAN, supra note 43, at 299 (finding that more than half of startups have replaced their founder-CEOs by the time of their Series C financing round).


\textsuperscript{62} Pollman, Information Issues, supra note 37, at 196.
the company, and the most common type of large investor—the VCs—likely need the startup to find a liquidity event so that they can return cash to their own investors and make money. VC firms typically raise capital from passive limited partners, organized in funds with ten-year terms. Not only are VC firms sensitive to liquidity within the timing of a particular fund’s term, but their business model also depends on raising successive funds and thus their ability to generate returns affects their reputation and ongoing operations. As one partner explained, VCs are the “entrepreneurs behind the entrepreneurs.”

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

2. The Complexity of the Capital Structure

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

At the founding, entrepreneurs usually split the entire ownership pie by issuing the initial common equity to themselves as founders’ stock. Founders generally pay a nominal amount for this stock because the company has minimal assets and business operations at the time of founding, and the stock is often structured to include a company repurchase right that lapses over time. In terms of initial capital, founders often “bootstrap” the business using their own funds, and those of family and friends, to finance development efforts and early operations. One study found that in 77% of

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63 See, e.g., Philippe Aghion et al., Exit Options in Corporate Finance: Liquidity Versus Incentives, 8 REV. FIN. 327, 331 (2004) (discussing the VC cycle which requires liquidating the proceeds of investment); Gilson, supra note 12, at 1071 (explaining the VC business model).
64 Gilson, supra note 12, at 1071.
65 Id.
67 See, e.g., GOMPERS & LERNER, supra note 51, at 28 (“A venture capitalist must liquidate a return in private firms to make money.”); PitchBook & Nat’l Venture Capital Ass’n, Venture Monitor 1Q 2018, at 12 [hereinafter NVCA, Venture Monitor 1Q 2018], https://nvca.org/research/venture-monitor/ (“As companies move along the venture lifecycle, exits at some point move to the forefront of discussion and business positioning.”).
70 WASSERMAN, supra note 43, at 252.
foundering teams, at least one founder contributed seed capital early in the life of the startup.\textsuperscript{71}

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

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

Thus, in the early stage of the startup, when it is highly focused on innovation, its capital structure is relatively simple: basic debt or equity granted to founders, family and friends, and angel investors. A startup will also usually adopt a stock option plan and establish a pool of options to grant employees an incentive-based ownership stake.\textsuperscript{78}

\textsuperscript{71} Id.

\textsuperscript{72} Id. at 253.


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

\textsuperscript{75} Ibrahim, Angel Investors, supra note 74, at 1408-09.

\textsuperscript{76} Id. at 1416-17; Joshua Lerner, “Angel” Financing and Public Policy: An Overview, 22 J. BANKING & FIN. 773, 778 (1998).


\textsuperscript{78} Maynard et al., supra note 69, at 338; Will Gornall & Ilya A. Streibulaev, Squaring Venture Capital Valuations with Reality, J. FIN. ECON. (forthcoming).
Stock options for startup employees have become a norm because of cash constraints for high salaries, the potential for stock options to incentivize employees, and the uncertainty that employees accept in joining the startup.\textsuperscript{79}

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

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

\textsuperscript{79} See generally Levmore, supra note 18 (discussing norms in stock option practices).

\textsuperscript{80} Not all startups seek or succeed at raising money from VCs. Wasserman, supra note 43, at 255; Darian M. Ibrahim, Should Angel-Backed Start-Ups Reject Venture Capital?, 2 Mich. J. Private Equity & Venture Cap. L. 251, 251-52 (2013) (arguing some startups should avoid venture capital to lower transaction and agency costs).


\textsuperscript{82} Gilson, supra note 12, at 1068, 1071 (explaining that VCs are “tailored to the special task of financing [the] high-risk, high-return activities” of startup companies, which are “peculiarly suited to commercializing innovation.”).

\textsuperscript{83} Id. at 1070.

\textsuperscript{84} Id. at 1071-72. Many VC funds provide for the possibility of a one or two year extension at the discretion of the general partner VC managing the fund.


\textsuperscript{86} See Strine, supra note 13, at 2037 (“Venture-backed companies are the kind of companies that can become wildly successful or fail entirely.”).
contingencies and outcomes. Further, “some information is observable by only one party (the entrepreneur) who cannot credibly communicate it to others (information asymmetry)” and “the parties cannot control post-financing behavior by contract because either the behavior itself or future states of the world cannot be verified by third party arbiters (agency problems).”

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

Consequently, the typical pattern is for a startup to engage in sequential rounds of issuing convertible preferred stock with various protective terms and designated board seats. In contrast to public companies, which generally have a single class of common equity, startups usually issue a new class of equity every 12-24 months in order to raise money to grow the company. Each round of financing varies with regard to its participants and the contract provisions associated with the new class of equity (valuation, liquidation preferences, exit rights, etc.). Each round of financing generally also brings changes to the company’s governance structure, such as the size and composition of the board.

89 See supra note 85; Smith, Exit Structure, supra note 12, at 318-55; Paul A. Gompers, Optimal Investment, Monitoring, and the Staging of Venture Capital, 50 J. Fin. 1461, 1464 (1995); Michael Klausner & Kate Litvak, What Economists Have Taught Us About Venture Capital Contracting, in Bridging the Entrepreneurial Financing Gap 54, 58-64 (Michael J. Whincop ed., 2001); Bratton & Wachter, supra note 13, at 1878-82.
90 Smith, Exit Structure, supra note 12, at 318-55.
91 Id. A liquidation preference typically entitles the holder to its original investment amount, or a multiple of this number, in certain events before payments are made to other security holders.
92 Id. at 318-19.
93 Gilon, supra note 12, at 1078.
94 Funding rounds are traditionally ordered alphabetically: Series A, B, C, and so on. Gornall & Strebulaev, supra note 78, at 3 n.4.
95 Id. at 3.
96 Multiple VCs or other investors form a syndicate to participate in each round of financing. Brad Feld & Jason Mendelson, Venture Deals 10-11 (2d ed. 2013). VCs often specialize in early, mid, or late stage financings, and other investors may participate, such as from private equity, family offices, or strategic partners. Id.; NVCA, Venture Monitor 1Q 2018, supra note 67, at 5, 12.
As the company takes on additional capital, the founders’ and other earlier investors’ ownership percentage in the company is diluted.98 According to the National Venture Capital Association using data from Capshare, the capital structure “evolve[s] in fairly predictable ways as the company grows.”99 Specifically, “employee ownership decreases from 100% at founding to approximately 70% in the seed round and starts to level off around 38% by Series C financings. Employee ownership (and by extension, investor ownership) is so predictable that it almost perfectly fits a log trend line.”100

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

Adding to this traditional venture-backed structure has been the entrance into late-stage startups of different types of investors: mutual funds, pension funds, hedge funds, corporate investors, and sovereign wealth funds.105 Startups in previous times did not generally have access to these kinds of investors until going public on a national stock exchange.

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100 Id.

101 Feld & Mendelson, supra note 96, at 95-97 (discussing startup capitalization tables); Feld & Ramsinghani, supra note 52, at 43; Gornall & Strebulaev, supra note 78, at 3.

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

103 Id.

104 Id. Square’s IPO price was $9 per share and Series E holders received extra shares per their negotiated protective terms. Leena Rao & Dan Primack, Square Prices IPO At Just $9 Per Share, Valued At $2.9 Billion, FORTUNE (Nov. 19, 2015), http://fortune.com/2015/11/18/square-prices-ipo/.

exchange. Due to a confluence of factors, including an unprecedented influx of available private capital, startups are staying private longer on average and raising larger late-stage funding rounds from this greater diversity of investors.

Late-stage rounds of investments also have various protective terms, including in some instances IPO veto rights or ratchets that can dilute other shareholders, and thus add to the “extreme complexity of these companies’ financial structures.” A notable recent study of 135 unicorn companies found that the average unicorn has eight share classes, and many have a wide mix of equity holders including founders, employees, VC funds, mutual funds, sovereign wealth funds, corporate investors, and others.

In addition to new entrants, another recent trend is for startups to use proceeds from a fundraising round to do share buybacks or to facilitate third-party buyers such as large institutional investors in making secondary tender offers. These transactions allow certain shareholders to sell some of their holdings and bring new investors into the company, but do not provide complete liquidity or involve a fundamental change, and thus the company’s private, venture-backed status remains unchanged absent an exit event. As the next Part shows, these companies can reach a size and level of governance complexity that strains continued use of the term “startup” to describe them, but they still differ in distinctive ways from traditional closely-held corporations and public corporations.

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106 See Kwon et al., supra note 105, at 2-3 (tracing data on mutual fund investment into startups over the 1995-2016 period and finding that such investment has “become increasingly widespread”).
109 Gornall & Strebulaev, supra note 78, at 3.
II. A FRAMEWORK OF STARTUP GOVERNANCE

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

Most notably, one general model has dominated the discussion of corporate law and governance for decades: agency costs.\textsuperscript{112} Set out in a seminal paper by Michael Jensen and William Meckling, the agency problem arises when one party, the “principal,” relies on actions taken by another, the “agent,” which will affect the principal’s welfare.\textsuperscript{113} As a theory of corporate governance, shareholders are envisioned as the principals and managers as the agents.\textsuperscript{114} Agency costs arise in a corporation because of the separation of equity ownership and managerial control—managers may shirk or pursue their own agenda at the expense of shareholder interests.\textsuperscript{115} As set out by Jensen and Meckling, three types of agency costs exist in the principal-agent relationship: monitoring costs that principals incur in overseeing their agents, bonding costs to better align agents’ interests with those of the principals, and the residual loss that cannot be avoided.\textsuperscript{116} As other scholars have noted, the concept of reducing shareholder-manager agency costs pervades corporate law scholarship.\textsuperscript{117}

Jensen and Meckling’s framing of the agency cost problem has thus proven enormously influential, but they did not explore differences across corporations.\textsuperscript{118} They

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

\textsuperscript{113} Jensen & Meckling, supra note 9, at 308. Jensen and Meckling did not limit their theory to agency relationships under the law, but rather used the concept as a metaphor and basis for economic theory. See id. (discussing agency costs as an economic theory); see also Eugene F. Fama, Agency Problems and the Theory of the Firm, 88 J. POL. ECON. 288, 289-90 (1980); Kenneth J. Arrow, The Economics of Agency: An Overview, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS (John W. Pratt & Richard J. Zeckhauser eds., 1985).

\textsuperscript{114} Jensen & Meckling, supra note 9, at 309.

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

\textsuperscript{116} Jensen & Meckling, supra note 9, at 308.

\textsuperscript{117} Goshen & Squire, supra note 9, at 769 (describing many corporate law scholars as “agency-cost essentialists” that treat reducing agency costs as “an unalloyed good toward which all aspects of corporate law and governance should be directed”); Zohar Goshen & Assaf Hamdani, Corporate Control and Idiosyncratic Vision, 125 YALE L.J. 560, 570 (2016) ("The existing corporate-law literature focuses solely on protecting minority shareholders from agency costs.").

\textsuperscript{118} See Jensen & Meckling, supra note 9, at 309; Philippe Aghion & Richard Holden, Incomplete Contracts and the Theory of the Firm: What Have We Learned over the Past 25 Years?, 25 J. ECON. PERSP. 181, 182 (2011) (noting that Jensen and Meckling’s agency cost approach “typically did not seek to explore why such agency problems are different within and across firms”); cf. EASTERBROOK & FISCHER, supra note 16, at 228 (“We employ a dichotomous treatment [of public and closely held corporations] to illustrate the different kinds of incentives and structures in play, not to suggest that all firms were cast in one of two molds.”).
envisioned the corporation only in vertical, hierarchical terms, and they collapsed the board and executives into a single managerial agent, obscuring management conflicts.\textsuperscript{119} They assumed outside shareholders have homogeneous interests.\textsuperscript{120}

Two key scholarly contributions challenge and build on the agency cost model, bringing it closer to descriptive power for startups. First, Margaret Blair and Lynn Stout’s well-known team production model provided the critical insight that stakeholder interests conflict and are resolved within the corporation.\textsuperscript{121} Blair and Stout claimed to provide only a theory of public corporations, with an independent board unlike that found in startups, but they contributed a vision of the corporate “team” that includes “shareholders, managers, and rank and file employees” and identified that the board plays a critical role in coordinating corporate activity and mediating disputes between these team members.\textsuperscript{122}

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

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

\textsuperscript{119} See Jensen & Meckling, supra note 9, at 309; cf. Goshen & Squire, supra note 9, at 767, 784-85 (introducing a principal-cost theory positing that firms tradeoff the costs produced when investors exercise control against costs produced when managers exercise control, and treating the board and officers as “a unified agent”).

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

\textsuperscript{121} Blair & Stout, supra note 16, at 250.

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

\textsuperscript{123} Bartlett, False Dichotomy, supra note 11, at 61.

\textsuperscript{124} Id. at 63, 108-09.

\textsuperscript{125} Id. at 40.
his view, “this dichotomy obscures how all firms—public and private—often face the same agency problems.”

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

A. Fundamental Startup Governance Issues

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

1. Vertical Issues

At core, governance challenges are born when a company becomes jointly owned. If there is more than one founder, the potential exists for conflict. The governance issues in the co-founder relationship generally pale in comparison, however, to the

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126 Id. at 37, 44 (providing “groundwork for a new model... that applies to all firms, public and private.”).
127 NVCA Yearbook, supra note 1, at 8-9; Steven E. Bochner & Amy L. Simmerman, The Venture Capital Board Member’s Survival Guide: Handling Conflicts Effectively While Wearing Two Hats, 41 DEL. J. CORP. L. 1, 2 (2016).
128 Experienced startup entrepreneurs and investors recognize the potential for both inter- and intra-group governance conflicts. See FELD & RAMSINGHANI, supra note 52, at 42 (“Transactions often have conflicting interests between classes of stock, investors with different liquidity time horizons, and management versus investment interests.”).
129 See Oliver Williamson, The Economics of Governance, 95 AM. ECON. REV. 1, 4 (2005) (“Maladaptation to disturbances is where the main costs of governance reside.”); Bartlett, False Dichotomy, supra note 11, at 111-12 (discussing how governance conflicts might raise the cost of capital).
conflicts that arise when the founders take outside investment. The balance of power between founders and investors is one of the key tensions that runs through startups. This section explores those governance issues in the context of the corporate hierarchy, most notably involving the board, which is the primary governing body and locus at which founders and investors determine control.

a. Shareholders vs. Board

Startup boards are negotiated. The board is formally constituted at the first round of venture capital financing, if not before, and its agreed-upon size and composition are typically specified in the financing term sheet and then enshrined in a voting agreement or in the corporation’s certificate of incorporation. VCs seek board seats as part of their investment—for access to information, to monitor against opportunistic behavior, for voice or control on important decisions such as future financings or exit, and to add value to the company.

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

Advice to entrepreneurs regularly includes the admonition to carefully choose board members, and therefore from which VCs to take money. For example, a partner from the prestigious VC firm Andreessen Horowitz explained: “The best board members aren’t elected by default. CEOs that set themselves up with their choice of board member—which means getting more than one term sheet and doing extensive reference checking—are better off. You want to find a coach, not a lever puller.” Accordingly, the potential benefits of being backed by reputable VCs are well known—but so are

131 Feld & Ramsinghani, supra note 52, at 66, 81.
133 Smith, Team Production in VC, supra note 98, at 953; Wasserman, supra note 43, at 273.
134 Gilson, supra note 12, at 1075; Wasserman, supra note 43, at 271.
135 See Gompers & Lerner, supra note 51, at 3 (noting the “novel checks and balances” the VC industry has developed to respond to information problems).
136 Feld & Ramsinghani, supra note 52, at 68.
137 Id. at 56.
stories of entrepreneurs being fired from their own companies.\textsuperscript{138} Most famously, Steve Jobs, one of the co-founders of Apple, was ousted from the company he helped to start a few years after the company had gone public.\textsuperscript{139} Entrepreneurs generally want to maintain control of the company they have started for as long as possible and thus negotiations over board seats are critical governance points to both investors and founders.

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

Researchers have found a general trend in the evolution of a typical startup board over its life cycle—frequently starting out dominated by founders and transforming to shared or investor control at some time within the first few rounds of venture financing.\textsuperscript{143} This pattern occurs because investors typically build their voting power and seek additional board seats with each round of financing.\textsuperscript{144} Furthermore, shared control arrangements provide a solution to problems of noncontractability by deferring decisions

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


\textsuperscript{140} Wasserman, supra note 43, at 287.

\textsuperscript{141} A founder-controlled board may occur through seats allocated to a common stock vote or by founder appointment. An investor-controlled board may occur through seats allocated to different series of preferred stock. The lead investor of a financing round typically negotiates for a board seat.

\textsuperscript{142} Kaplan & Strömberg, supra note 85, at 10 (finding that board control is shared 61% of the time with an outside director holding the time-breaking vote); Brian J. Broughman, The Role of Independent Directors in Startup Firms, 2010 UTAH L. REV. 461, 462 (discussing the use of independent directors in startups); Smith, Exit Structure, supra note 12, at 326 (discussing contingent control).

\textsuperscript{143} Smith, Exit Structure, supra note 12, at 324-26 (“Because venture capitalists typically gain additional board seats with each round of investment, over time the board composition provisions of venture-backed companies tend to move from ‘entrepreneur control’ or ‘contingent control’ to ‘investor control.’”); Wasserman, supra note 43, at 285 (“In my dataset, after the A-round of financing, founders were already a minority within the average board, holding 24% of the seats, while outside directors already held 59%. After the B-round, founders were down to 21% of the seats, with 72% held by outside directors, the clear majority of whom were investors.”).

\textsuperscript{144} Smith, Exit Structure, supra note 12, at 324-26. VCs also protect themselves with regard to exits or opportunistic action by securing negative contractual covenants that require VC approval for important transactions such as acquisitions. Id. at 319-20.
until they are known. But there is a great deal of variety and some founders maintain control of the board even as the company matures to late stage.

In some instances, startups have implemented dual-class structures that give supervoting shares to founders and management, providing another mechanism by which founders and managers control the board and strategic decisions. Such structures are commonplace in the highest echelon of unicorns but are otherwise rare, suggesting that only a small portion of founders have enough leverage and investor competition to implement this feature. Key aspects of the nature of the business, discussed in Part I.B—high market potential, growth, and scalability—may impact whether or not entrepreneurs can get the founder-friendly terms they covet.

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

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145 See Bratton, supra note 12, at 896; Margaret M. Blair, Boards of Directors as Mediating Hierarchs, 38 Seattle U. L. Rev. 297, 335 (2015) (discussing how a solution to the problem of "productive activity that requires complex, difficult to measure, and difficult to contract inputs" is "[t]he delegation of key decision rights to a mediating hierarchy.").

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

147 Kaplan & Strömberg, supra note 85, at 7 ("Board rights and voting rights can be different from cash flow rights and from each other."); Alfred Lee, Inside Private Tech Voting Structures, The INFORMATION (Oct. 29, 2015), https://www.theinformation.com/articles/inside-private-tech-voting-structures?utm_medium=email&utm_source=cio (finding that as of October 2015, nine out of ten of the highest valued private tech companies had supervoting structures and the one exception had a founder with extra voting rights on the board that gave the founder control); Fenwick Unicorn Survey, supra note 108 (surveying 31 U.S.-based, venture-backed unicorns and finding 39% of their financings had dual-class supervoting common stock).


150 See Kaplan & Strömberg, supra note 85, at 1 ("We find that VC financings allow VCs to separately allocate cash flow rights, board rights, voting rights, liquidation rights, and other control rights."); Paul A.
negotiating boards, contractually separating ownership and control, and using designated seats provides a sharp contrast to public companies which typically lack negotiations, lack voting agreements, and lodge nominating power in the board itself.\(^{151}\)

In startups, the board is not only the site of value-adding managerial guidance, but also one of the key arenas in which conflicts are resolved and investments are protected.\(^{152}\) VCs and founders often diverge with respect to risk level, liquidity needs, and private benefits, which are often implicated in critical board-level decisions on financings, strategic direction, and exit.

To the extent a party in these battles did not get a decision resolved in their favor or consistent with their position, conflicts can arise between shareholders and the board. For example, shareholders might oppose a board decision regarding the timing or pricing of a round of financing that will affect their interests. These conflicts typically stem, however, from the divergence between the interests of founders and investors who are both shareholders and reflects a balance of control that was already negotiated in determining the size and composition of the board. This understanding problematizes characterizing the shareholder-board relationship as simply vertical, according to standard convention.\(^{153}\) The relationship is hierarchical in the sense that it is the shareholders who determine the board, but the relationship is not pure agency as commonly envisioned with the founder-entrepreneur as the agent and the VC as the principal.\(^{154}\)

\(b.\) Board vs. Founders or Executives

Standard models of corporate governance often collapse the board and executives into a single category of managerial agents.\(^{155}\) But startups involve participants in overlapping roles with dual status—participants with managerial control are therefore


\(^{154}\) See Smith, *Team Production in VC*, supra note 98, at 949-50 (discussing the standard convention of referring to the VC as principal and the entrepreneur as agent and arguing that the relationship is not in fact a “pure agency relationship” and instead has aspects of “team production”); cf. Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791, 795 (2002) (characterizing the board as “not a mere agent of the shareholder, but rather a sort of Platonic guardian serving as the nexus of the various contracts that make up the corporation”).

\(^{155}\) See supra note 119.
not simply agents of a monolithic body of principal-like shareholders. Conflicts can arise in startups between the board and the founders or executives that have significant governance dimensions.

The most typical scenarios involve the board firing a founder-CEO or deciding to change strategic direction over the objection of the founder or other executives. As discussed above, startups evolve through dramatically different business phases. Because the skills and experience needed to start an innovative company are often different from those needed to grow and lead a large corporation, the board might decide that it needs to put a new executive in a leadership position that had been held by a founder. In a survey of 212 startups conducted by entrepreneurship scholar Noam Wasserman, by year three only 50 percent of founders were still CEO, with the percentage of founder-CEOs declining over time. Studies that focus on companies that go public similarly find a significant rate of CEO-founder succession by the time of IPO.

The prevalence of founder departures makes sense in light of the fact that VCs attribute a large number of startup failures to problems with the CEO and management team. Monitoring the CEO is one of the key functions of the board—it should step in if a CEO is underperforming. And sometimes a board’s replacement of the CEO-founder is paradoxically a sign of the founder’s success in fundraising and getting the company to a stage at which it has outgrown the founder’s abilities.

Many instances of a board replacing a founder-CEO are thus routine, but genuine disputes can also arise regarding whether the board is properly acting in the best interest

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156 See supra Part I.B(1).
158 Kaplan et al., Should Investors Bet on the Jockey or the Horse? Evidence from the Evolution of Firms from Early Business Plans to Public Companies, 64 J. FIN. 75, 78 (2009) (finding that out of 50 venture-backed companies at IPO, a founder is CEO of only 49%); Broughman & Fried, supra note 60, at 1 (finding with a sample of over 18,000 venture-backed companies that in almost 60% of startups that go public, the founder is no longer CEO).
159 Michael Gorman & William A. Sahlman, What Do Venture Capitalists Do?, 4 J. BUS. VENTURING 231 (1989) (surveying 49 VCs about 96 of their portfolio companies and finding for 95% VCs cited problems within the management team as a top-three contributing factor to failure, and the most important contributing factor for 65%); Steven N. Kaplan & Per Strömberg, Characteristics, Contracts, and Actions: Evidence from Venture Capitalist Analyses, 59 J. FIN. 2173 (2004) (analyzing 67 internal investment memoranda from 11 VCs firms and finding that internal weaknesses that led the list for 61% of the startups concerned the CEO and management team).
161 Wasserman, supra note 43, at 303-05 (discussing “the paradox of entrepreneurial success” in product development or fundraising that can manifest in CEO-founder succession).
of the corporation. VCs and other fund managers that have designated seats on the startup board are “dual fiduciaries” in that they are a fiduciary of the startup company by virtue of serving as a director, and they also owe duties to the VC fund they manage and its limited partners. In many instances, the interests of the startup company and the VC fund will align, but in some circumstances they will not because of the liquidity needs of the fund and the terms of the preferred stock that the VC investor holds, such as regarding liquidation seniority in getting paid back before other investors.

It is therefore possible for the board to act opportunistically in ousting a founder-CEO or in other decisions affecting founders or executives. For example, in one recent case involving a startup dispute the court noted: “Venture capitalists frequently replace the founder-CEO. It is self-evident that such a decision could be appropriate. But it is also true that a founder-CEO may have greater incentive and ability to resist strategies that favor the holders of preferred stock (the venture capitalists) over the holders of common stock (the founders and employees).”

c. Shareholders vs. Founders or Executives

The preceding discussion has examined governance conflicts that involve the board of directors. Sometimes startup shareholders simply sidestep the board, however, when a conflict arises between shareholders and founders or executives. This is understandable in light of the fact that shareholders in startups generally lack one of the most commonly used mechanisms for dealing with governance problems—exit. Unlike public company shareholders, they cannot easily sell their stock when they are dissatisfied with the management.

VC contracting is designed to reduce agency costs and information asymmetry and, while board seats are a significant part of this design, mechanisms that do not rely on the formal structure of the board are also used—both contractual and structural. One of the primary examples of such a control mechanism is staged financing. VCs commit small portions of capital sequentially rather than as a full upfront investment of the amount that the startup will foreseeably need. By staging their investments, VCs have a lever to set milestones for the managers—reducing agency costs—and the option to periodically reassess and decide whether to invest in another round of financing or “abandon” the investment—reducing information asymmetry and the impact of

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164 See ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 46 (1972) (explaining that investors generally employ exit rather than voice if exit is available).
165 WASSERMAN, supra note 43, at 290.
166 Id.
uncertainty. Existing investors are an important source for continued capital and introductions to other potential investors; many startups fail before getting to profitability. Thus, staged financing can have a disciplining effect on founders, who typically fear running out of cash and having to shut down.

Mechanisms such as staged financing cannot, however, eliminate all tensions between shareholders and founders or executives. They often have different interests with respect to allocation of control and critical corporate decisions such as regarding the timing and form of exit. The disciplinary effect of staged financing is nullified when private capital is readily available to the startup. Founders and executives have greater access to information. And, while both parties are aligned in seeking a financial return, founders and executives may also receive private benefits, both pecuniary and non-pecuniary, from the continued operation of the startup or from particular exit opportunities.

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

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168 See Bratton, supra note 12, at 939-40.

169 WASSERMAN, supra note 43, at 291. This fear can be counterbalanced by founders’ desire to avoid taking on more capital than needed and to achieve as much growth as possible between rounds of financing in order to minimize the dilution of their own percentage of equity ownership.

170 Smith, Exit Structure, supra note 12, at 356; Feld & Ramsinghani, supra note 52, at 69 (“[A]t some point, usually around the fourth or fifth year of the fund, there starts to be a series of forces that drive pressure for exits, including the desire of most firms to raise another fund in that time period. As a result, some VCs start to pressure the companies they are investors in to sell earlier than entrepreneurs might otherwise desire, or accept an offer at an intermediate stage from a buyer for a successful outcome, but at a price much lower than the entrepreneurs believe the company will be worth in a few years.”).

171 See Smith, Exit Structure, supra note 12, at 341.


multi-billion dollar investment from a new major institutional investor that would restructure the company’s governance to a 17-person board and provide liquidity to the plaintiff-VC and some of the other early investors and employees.\textsuperscript{175} Notably, the solution to one conflict gave rise to a broader group of investors with different terms and a larger board, increasing complexity and the likelihood of diverging interests among board members.

2. \textit{Horizontal Issues}

The next fundamental set of governance issues are horizontal, and concern the conflicts that arise between shareholders and the costs of collective decisionmaking.\textsuperscript{176} Because shareholders may hold different types of equity interests with varied terms and preferences, they may have conflicting interests and incentives to take actions that would harm other shareholders or make inefficient decisions that fail to maximize aggregate welfare.\textsuperscript{177} In startups, these costs can reach great size as different contributors to the corporation—founders, employees, and investors—hold various equity interests.\textsuperscript{178} Furthermore, startups distinctively feature interrelated vertical and horizontal issues, as the same participants appear in both types of issues, which highlights the heterogeneity of their interests and the shifting, overlapping nature of their roles.

a. \textit{Preferred vs. Common}

The classic horizontal conflict in startups is between the holders of preferred and common stock. Both represent an equity stake and are thus aligned in desiring the startup to get as large of an exit as possible. Aside from this point of alignment, however, they often conflict in terms of how much risk they are comfortable taking on to achieve that exit, how and when to raise additional funding, when to go for an exit, and any number


\footnotesize{\textsuperscript{176} Some scholars have broadly characterized all corporate governance conflicts as agency problems. See, e.g., Simone M. Sepe, \textit{Corporate Agency Problems and Dequity Contracts}, 36 J. CORP. L. 113, 124 (2010) (describing three sets of conflicts as agency problems: vertical between shareholders and managers, horizontal between controlling and minority shareholders, and between the firm itself and the parties with whom the firm contracts such as creditors). Others have pointed out these horizontal conflicts “could also be described as team production problems—each group of participants has made some contribution to the wealth generating capacity of the corporation.” Blair, \textit{supra} note 145, at 322.

\textsuperscript{177} See \textit{Hansmann} \textit{supra} note 2, at 40. Zohar Goshen and Richard Squire have theorized these conflicts more broadly as “principal costs,” including both the conflicting interests among investors and the coordination and competence costs that arise from joint decisionmaking. Goshen & Squire, \textit{supra} note 9, at 771.

\textsuperscript{178} The possibility of a conflict between debt and equity also exists, for example between angel investors who invest using debt instruments and common stockholders such as founders. See Douglas G. Baird & M. Todd Henderson, \textit{Other People’s Money}, 60 \textit{Stan. L. Rev.} 1309, 1310-11 (2008) (“The common stockholder is merely one flavor of investor. Others, such as lenders, bondholders, and preferred stockholders, also stand to gain or lose with right or wrong decisions.”); \textit{Margaret M. Blair, Ownership and Control} 33-44 (1995) (discussing the complexity of distinguishing between debt and equity for corporate governance analyses).}
of other scenarios. In addition, founders, who typically represent a significant portion of the common equity, may receive private benefits from retaining ownership of the company that preferred shareholders do not enjoy.

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

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

Competing theories of how to interpret and apply fiduciary duties in the startup context highlight the divergence between the preferred and the common. Three views

179 See, e.g., Bochner & Simmerman, supra note 127, at 3 (explaining that down-round financings, recapitalizations, and sales of the company are transactions in which the interests of the preferred and common shareholders can conflict); Bratton, supra note 12, at 922-45 (discussing problems for preferred shareholders and contractual solutions that evolved in the VC context).

180 Smith, Exit Structure, supra note 12, at 318. Further, founders sometimes push for “early” acquisitions because they are undiversified and the payout is personally meaningful even if it does not maximize the expected value of the startup. See Matthew Wansley, Beach Money Exits (July 27, 2018) (unpublished manuscript) (on file with author).


183 See, e.g., Mills Acq. Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1989) (“[D]irectors owe fiduciary duties of care and loyalty to the corporation and its shareholders.”) (internal citation omitted); Frederick Hsu Living Trust v. ODN Holding Corp., 2017 WL 1437308, at *17 (Del. Ch. 2017) (“In the standard Delaware formulation, fiduciary duties run not only to the corporation, but rather “to the corporation and its shareholders””) (quoting In re Rural Metro Corp., 88 A.3d 54, 80 (Del. Ch. 2014)).

have emerged: common maximization, enterprise value maximization, and a contractual approach.

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

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

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

b. Preferred vs. Preferred

Despite holding the same general type of equity, preferred shareholders are not always aligned in their interests. Each round of financing that a startup raises typically results in a different series of preferred stock with different pricing and terms. In certain scenarios, these differences put the preferred shareholders in conflict. A white paper

185 In re Trados, 73 A.3d at 40-41; Frederick Hsu Living Trust, 2017 WL 1437308, at *17.
186 Strine, supra note 13, at 2028.
187 Bratton & Wachter, supra note 13, at 1885-87, 1904-06; Bartlett, Shareholder Wealth, supra note 13, at 290-95.
188 See Fried & Ganor, supra note 13, at 1021 (interpreting pre-Trados case law as a “control-contingent” approach and advocating for allowing corporations to opt into different approaches in their charters); Baird & Henderson, supra note 178, at 1333 (“The founders and common shareholders agreed that if things went well, they would all get rich, but if things went badly, the investors would come first.”); Sepe, Constituency Directors, supra note 27, at 309 (advocating for “turning a director’s obligation of undivided loyalty to the common shareholders into a default rule”).
189 Similarly, a strategic investor such as corporate venture capital that had an additional relationship with or interest in the startup might be differently positioned than other preferred shareholders. Bartlett, False Dichotomy, supra note 11, at 61-62.
written by prominent VCs acknowledged: “[D]ifferent investors even within the same round may have different exit valuations in mind; one investor may be happy selling the company for $100M while another may need $300M to even consider a deal.”

The high-profile dispute in *Benchmark Capital v. Vague* brought to light the tension among preferred shareholders. The VC firm Benchmark invested in the Series A and B Preferred Stock of Jupiter Financial, an online bank startup. Jupiter subsequently raised a Series C financing entirely from one new investor, the Canadian Imperial Bank of Commerce (CIBC), which negotiated for majority voting power, subject to existing Series A and B veto rights which could be waived if it did not “diminish or alter [their] liquidation preference or other financial or economic rights.” Additionally, CIBC bargained for a senior liquidation preference and a strong downside protective term known as a full-ratchet anti-dilution provision. The Series A and BPreferred shareholders, including Benchmark, seemingly agreed to these terms with the belief that they had veto rights and the Series C financing would be the company’s last. Shortly after, however, Juniper announced additional capital needs and plans to raise a “down round” Series D financing from CIBC. This round was structured as a merger to strategically avoid the Series A and B veto rights and it significantly diluted their interests—dropping their collective equity interests from 29% to 7% and reducing their aggregate liquidation preference from $115 million to $15 million. Benchmark sued in an attempt to enjoin Jupiter from proceeding with the financing, but ultimately lost in a court battle which narrowly construed the contractual veto rights.

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

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192 *Id.* at *2-*3.

193 *Id.* at *3.

194 *Id.* at 3-4.

195 *Id.* at *5 n.20.

196 See *id.* at *2, *10, *16.

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

198 *Id.*
shareholders respond to these potential misalignments by contracting for various protections, such as veto rights and automatic conversion provisions, but incomplete contracts are inevitable and the misalignment cannot be entirely eliminated—it will arise where the capital structure has preferred shareholders with different amounts of the company’s differently priced securities and varying terms.¹⁹⁹

c. Common vs. Common

Finally, the third type of horizontal conflict involves common shareholders. The potential for divergent interests between common shareholders in startups is remarkably undertheorized in the literature, with scholarly study of specific scenarios, but no broader identification and examination of the issue. Most accounts lump together founders, executives, and employees as the common shareholders and do not explore how their incentives become misaligned.²⁰⁰ Yet in the real world of startups, conflicts among common shareholders can arise at critical junctures for the corporation. Identifying horizontal conflicts among common shareholders in startups also spotlights another underappreciated governance feature—employees. Startup employees participate in equity arrangements and often represent part of the essential value of the company and influence its decisionmaking.

Traditional accounts of employees assume they are fungible and their inputs can be easily obtained through market contracts.²⁰¹ Corporate theory often excludes employees from analysis, treating them as “nonshareholder constituencies” that are protected by contract and labor regulation.²⁰² Scholars posit that employees will be accorded significant ownership stakes only in the rare circumstance in which they have highly homogeneous interests.²⁰³ But these assumptions about employees simply do not hold up in startups.

¹⁹⁹ Id. at 70, 75-76.

²⁰⁰ An additional source of horizontal complexity can arise in startups that raise capital through convertible debt instruments or variants such as “Park-n-Ride” instruments. See J. Brad Bernthal, The Evolution of Entrepreneurial Finance: A New Typology, 2018 BYU L. REV. 773 (2019) (discussing anticipatory and post-investment conflicts that can arise for non-shareholder investors who have bargained for rights to future equity).

²⁰¹ See, e.g., Blair & Stout, supra note 16, at 266-67 (“[T]he Alchian and Demsetz model assumed that employees were undifferentiated inputs that were hired, or at least could be hired, in atomized markets. In other words, it viewed employees as interchangeable units that brought no special skills to—and, more importantly, made no special investment in—the team.”).

²⁰² See, e.g., Hansmann & Kraakman, supra note 16, at 442-46.

²⁰³ See Hansmann, supra note 16, at 596 (“[W]orker ownership tends to arise only where there is extreme homogeneity of interest among the workers involved.”). Hansmann also observed that worker-owned firms often “give members the right of exit at will on reasonable terms.” Id. at 598. Startups notably differ in this respect as well, constrained by private company status.
Startup employees often bring special skills to the venture and make nonseparable contributions such as by collectively developing technology. The market for talent can be competitive and employees are often strongly associated with the startup itself—reflected in the fact that sometimes large corporations buy startups in “acqui-hire” deals in order to access teams of startup employees. Moreover, it is difficult for employees to protect their contributions through contract alone in light of the uncertainty that characterizes startups, particularly in their early stages, and in light of the contributions employees make that can affect firm value. Startups therefore usually grant employees stock options which vest over time and once exercised are common stock. This provides employees with the possibility of sharing in the upside of the startup, and in the aggregate can represent a significant stake of the corporate equity. For example, when Facebook went public it had employee equity grants covering more than 961.5 million shares, worth $36.5 billion at the IPO price.

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

Divergence among the common shareholders can arise when the company has an acquisition offer or is being sold, in secondary sales in which some shareholders have an opportunity to sell their shares, and even in everyday corporate decisionmaking such as regarding whether to extend the exercise period for certain optionholders. These circumstances can pit employees and angel investors against founders and executives, different types of employees such as engineers against non-engineers, and current or early-stage employees against former or late-stage employees.

204 See Yifat Aran, Note, Beyond Covenants Not to Compete: Equilibrium in High-Tech Startup Labor Markets, 70 Stan. L. Rev. 1235, 1261-63, 1273-76 (2018) (discussing how the origins of Silicon Valley employee stock option practices recognized the value and talent of startup employees as knowledge workers and how options facilitate investment in human capital and innovation); see also MARGARET M. BLAIR, WEALTH CREATION AND WEALTH SHARING 9-16, 45 (discussing the asset-specific investment of human capital); Oliver Williamson, Michael L. Wachter & Jeffrey E. Harris, Understanding the Employment Relation: The Analysis of Idiosyncratic Exchange, 6 Bell J. Econ. 250, 250 (1975) (discussing “jobs for which nontrivial job-specific skills and task-specific knowledge evolve” and describing how “[o]therwise qualified but inexperienced workers cannot be regarded as the equivalent of job incumbents under such circumstances”).


207 Facebook, Inc., Registration Statement (Form S-1/A) 8 (May 16, 2012); see also Cable, supra note 18, at 621.

208 Employees are also in a precarious position as illustrated by the Zynga “clawback” in which before going public the company demanded that certain employees give back some of their options to the company or else be fired and forfeit all unvested options. Thomas A. Smith, The Zynga Clawback: Shoring Up the Central Pillar of Innovation, 53 Santa Clara L. Rev. 577, 578 (2013).
For example, because equity arrangements for employees can vary with regard to the form of grant, exercise price, vesting schedule, and other terms such as the triggers to accelerate vesting on a change in control, employees can end up on opposite sides of a vote on whether the company should take an exit deal. Web technology firm Feedburner ended up in exactly this situation because it had made inconsistent equity arrangements with its early employees.\textsuperscript{209} When the company received an acquisition offer, employees with one equity structure wanted the company to sell while others did not.\textsuperscript{210}

In many circumstances, the issue arises because founders and executives possess information and an opportunity to extract rents that other common shareholders do not have. In a study of trade sales of venture-backed startups, Brian Broughman and Jesse Fried found that in 45\% of the deals in their data set, the VCs had given on average 9\% of the deal value to the entrepreneurial team to induce agreement.\textsuperscript{211} Their findings show that sometimes the deal sweetener was a carve-out for all common shareholders to participate in pro rata, but other times the deal sweetener was a management bonus to founders and executives that excluded other common shareholders.\textsuperscript{212} The majority of liquidity events for startups are trade sales,\textsuperscript{213} suggesting that this conflict occurs relatively frequently.

Another example arises when startups have difficulty raising financing. In this situation, startups often look for an opportunity for an “acqui-hire” rather than liquidate the company.\textsuperscript{214} But acquirors typically want engineers and may not hire the other employees.\textsuperscript{215} This can align the buyer and the engineers against the investors and other employees regarding how to distribute the aggregate deal consideration.\textsuperscript{216}

Finally, startups staying private longer has presented new conflicts among common shareholders. When startups raise late-stage rounds of financings, they often also facilitate secondary sales to give partial liquidity to certain shareholders—this means deciding between early, late, and former employees.\textsuperscript{217}

In addition, startups have been faced with deciding whether to extend the typical 90-day exercise period for departing employees who might otherwise forfeit their vested

\textsuperscript{209} Wasserman, \textit{supra} note 43, at 240-43.
\textsuperscript{210} Id.
\textsuperscript{211} Broughman \& Fried, \textit{supra} note 132, at 1319.
\textsuperscript{212} Id. at 1335-39.
\textsuperscript{213} See VC Director Guide, \textit{supra} note 59, at 3.
\textsuperscript{214} Coyle \& Polsky, \textit{supra} note 205, at 295.
\textsuperscript{215} Id. at 300.
\textsuperscript{216} Id. at 299.
options because they lack the cash necessary to pay the exercise price and taxes. Yet doing so effectively transfers wealth from employees who choose to stay at the company, because the options would otherwise return to the pool and be available for new hires or refresh grants, and increasing the pool dilutes the ownership of all existing shareholders. Providing an extended exercise period can also misalign the employee and company interests as it can incentivize employees to quit and join a new company to diversify their risk once they have vested some of their options. Despite these concerns, Pinterest and Quora recently extended their exercise periods to seven and ten years post-departure, allowing former employees to potentially enjoy the liquidity of a later IPO or sale of the company. These issues pose difficult tradeoffs and potentially magnify tensions between the holders of common stock and options.

B. Increasing Governance Issues Over Time

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

At the founding stage, ownership and control are fully aligned in the founder. Governance is not an issue because there are no relationships or conflicts to manage within the corporation, as Figure 1 depicts. The amoeba-like simplicity of governance is readily apparent.

![Figure 1. Founding Stage](image)

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219 Id.


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

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

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222 THIEL, supra note 48, at 109.
223 See Kupor, supra note 130.
When the startup raises a second round of venture financing, it yet again increases potential governance issues. Unless the second round is exactly pro rata with precisely the same investors, the potential for conflicts between the preferred shareholders arises ($P_1$ and $P_2$), as represented in Figure 4 with an additional layer of horizontal conflict among shareholders and additional diversity of interests represented on the board. With each additional round, the pattern continues ($P_3$, $P_4$, $P_5$, etc.).

Further, the startup may hire additional executives and employees with varied types of incentive-based equity and associated terms, adding to potential divergences between the interests of common shareholders ($C_1$ and $C_2$), also represented in Figure 4.
Additional complexity may arise from other capital sources such as corporate venture capital or debt.\textsuperscript{224}

In sum, startup governance typically evolves from relatively simple to very complex sets of tensions between and among participants—it is not static and yet on the whole it changes in predictable ways. Venture-backed startups share this feature because of the way that VC financing adds to the different type of participants and equity in sequential rounds. Even an individual participant’s interest may shift as liquidity needs ripen and other affiliations with the corporation change.\textsuperscript{225} The emergence of a greater diversity of investors in startups and the trend of startups staying private longer on average might aggravate these issues. Investors represent a larger universe of interests, not all investors have board representation, and the separation of ownership and control grows.

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

### III. IMPLICATIONS AND FUTURE PATHS

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

#### A. Understanding Challenges

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

##### 1. Monitoring Failures

Scholars have generally assumed that VCs have strong incentives to monitor startups in their portfolios based on their substantial investments and the prevalence of VCs negotiating for designated board seats.\textsuperscript{226} This traditional framing reflects the

\textsuperscript{224} See supra notes 73, 80 & 189.

\textsuperscript{225} See William J. Carney, The Theory of the Firm: Investor Coordination Costs, Control Premiums and Capital Structure, 65 WASH. U. L.Q. 1, 7 (1987) (“Complex capital structures and other costly contracts arise because the preferences of the investor group can change over time.”).

\textsuperscript{226} See, e.g., Gilson, supra note 50, at 901 (“Very powerful incentives for all participants—investors in venture capital funds, general partners of the funds and entrepreneurs—are coupled with very intense monitoring of entrepreneurs by venture capitalists, and monitoring of venture capitalists by the capital market.”); Ibrahim,
standard agency-cost model, which applied in the startup context has narrowly focused on the vertical relationship between VCs and entrepreneurs.\(^\text{227}\) Recent scandals have put a spotlight on monitoring failures by startup boards, however, that raise a puzzle not explained by the existing literature.

If VCs are strong monitors, why are examples of oversight failures in startups so plentiful and varied? A series of scandals emerged at Uber in the years before it went public involving regulatory evasion, sexual harassment, and alleged theft of a competitor’s trade secrets.\(^\text{228}\) Investigative reporting revealed Theranos to be a fraud started by a founder who claimed to have developed blood testing technology that in fact did not exist—the company raised $700 million and reached a $9 billion dollar valuation before its undoing.\(^\text{229}\) At SoFi, a consumer finance startup valued at over $4 billion, it took several years before the board stepped in and fired the CEO-founder despite reports of rampant misconduct and misrepresentations to customers.\(^\text{230}\) Human-resources startup Zenefits paid millions in fines to regulators after it came to light that the company created software to enable its employees to cheat on state-required licensing courses.\(^\text{231}\) And the list of examples goes on.\(^\text{232}\)

This Article’s framework sheds light on why monitoring failures may occur.\(^\text{233}\) Two main explanations emerge once we take into account that the VC-entrepreneur

\footnotesize{\textit{Venture Debt, supra} note 73, at 1194 (“In the startup context, VCs are strong monitors, thereby reducing the need for lender monitoring to curtail managerial slack.”).}

\(^\text{227}\) See Bartlett, False Dichotomy, supra note 11, at 48 (“VC scholarship has been concerned with primarily one question: How do VC investors respond to the extreme uncertainty, information asymmetry, and agency problems inherent in VC investment?”). Studies of VC oversight include: Josh Lerner, Venture Capitalists and the Oversight of Private Firms, 50 J. FIN. 301, 309-12 (1995) (finding that VC representation on the board increases around the time of a CEO replacement and that geographic distance is an important determinant of the board membership of VCs); Shai Bernstein et al., The Impact of Venture Capital Monitoring, 71 J. FIN. 1591 (2016) (finding that VC on-site involvement with portfolio companies leads to an increase in innovation and the likelihood of successful exit).

\(^\text{228}\) See supra note 174.


\(^\text{233}\) This discussion is not intended to suggest that VCs or other investors routinely fail to monitor startups, but rather to posit explanations of how monitoring weaknesses might arise. It is difficult to know the full extent
relationship is not simply a vertical principal-agent relationship, but instead part of a system of startup governance that puts heterogeneous participants in overlapping roles that creates both vertical and horizontal tensions that tend to increase over time.

First, early-stage startups need a managerial board to add resources and guidance—this value-add is what VCs are known for and aim to provide.\textsuperscript{234} In light of the great uncertainty at this stage regarding whether any value will be created, the board typically invests little in compliance and internal controls.\textsuperscript{235} This makes sense as Part I.B explains, the company is usually still figuring out if it can even make an innovative product or service that people want and develop a strategy to bring it to market.\textsuperscript{236}

But the key point is what comes next—as a startup moves beyond its early stages, board members have incentives to prioritize cash flow and growth. As the framework in Part II demonstrates, governance conflicts typically increase across time.\textsuperscript{237} Board members—whether investors or founders—need the company’s valuation to keep going up in order to raise another round of financing and not get significantly diluted and eventually to reach an exit that generates returns.\textsuperscript{238} Startups must grow fast to achieve an exit that benefits all participants without putting them at odds with each other. To the extent that company culture or lack of compliance imperils the company’s ability to achieve a successful exit, board members have an incentive to monitor and invest in controls; otherwise, they will likely prioritize growth.\textsuperscript{239}

\textsuperscript{234} To the extent VCs have exit control rights or redemption protections, this may also weaken incentives to monitor. Smith, Exit Structure, supra note 12, at 344 (“The primary benefit of exit options is the venture capitalist’s interest in liquidity, while the primary cost of exit options is the venture capitalist’s reduced incentive to monitor.”).

\textsuperscript{235} See Jeff Jordan, 16 Things CEOs Should Do Before an IPO, ANDREESEN HOROWITZ (Aug. 23, 2017), https://a16z.com/2017/08/23/ipo-process-prep/ (“Early-stage companies allocate scarce product resources to the projects that will move the needle on revenue and profits. As a result, much-needed improvements in administrative systems are almost always deferred… and deferred… and deferred… sometimes until right before they IPO.”).

\textsuperscript{236} See supra Part I.B(1) (discussing early-stage focus on innovation, high failure rate, and VC business model focused on achieving returns with a small number of high-potential companies).

\textsuperscript{237} See supra Part II.B.

\textsuperscript{238} On this point, one prominent venture capitalist remarked, “I’m a bit sick and tired of the objective of every operating plan I see is to get the business to a point where it can raise money at a much higher price. That’s nice and it’s how the VC/startup game is played. But at some point I’d prefer to see an operating plan that has the objective of getting to sustainable profitability.” Wilson, supra note 55.

\textsuperscript{239} In some of the startups where oversight failures have recently come to light, it was employees rather than the board that prompted the investigations—an engineer’s public blog post catalyzed the sexual harassment investigation at Uber and an employee at Theranos exposed the misconduct by alerting regulators and the Wall Street Journal. Maureen Dowd, She’s 26, and Brought Down Uber’s C.E.O. What’s Next?, N.Y. TIMES (Oct. 21, 2017), https://www.nytimes.com/2017/10/21/style/susan-fowler-uber.html; John Carreyrou, Theranos Whistleblower Shook the Company—and His Family, WALL ST. J. (Nov. 18, 2016), https://www.wsj.com/articles/theranos-whistleblower-shook-the-company-and-his-family-1479335963.
Second, whereas the VC literature often adopts the standard framing of the VC as principal and the entrepreneur as agent, in fact these key participants frequently serve in overlapping roles. Startup directors are both the monitor and the subject—a dual status which may engender conflicts of interest and weaken oversight.

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

The Uber litigation between VC firm Benchmark Capital and the previous founder-CEO Travis Kalanick, discussed in Part II.A, demonstrates this dynamic that arises from participants holding overlapping roles. Benchmark was one of Uber’s early VC investors that held a large equity stake in the company and a designated board seat. The firm sued Kalanick, claiming that he “intentionally concealed and failed to disclose his gross mismanagement and other misconduct at Uber.” The complaint notably takes the perspective of Benchmark as an investor—but the firm also held a board seat. It was that director’s duty to take an active role in monitoring the corporation’s management and putting in place information reporting systems and controls that would bring to light...

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240 See supra Part II.A(1).
241 See, e.g., Feld & Ramasinhani, supra note 52, at 70 (“Recognize that a VC is taking a board seat as a fiduciary responsible to his own investors (his LPs). While he also has a legal duty to the company as a board member, his duty as a fiduciary to his investors will often take precedence.”); Bochner & Simmerman, supra note 127, at 4–5 (“[F]iduciary duties tend to run primarily to the common stockholders, as the relevant case law views preferred stockholder rights as a function of, and protected primarily by, contract law.”).
242 See Alfred Lee, How Many Board Seats Is Too Many?, The Information (Jan. 17, 2018), https://www.theinformation.com/articles/how-many-board-seats-is-too-many (identifying twenty-four VCs who hold nine or more directorships at tech startups, including one VC who sits on eighteen boards); Zider, supra note 57 (“The popular image of venture capitalists as sage advisors is at odds with the reality of their schedules. The financial incentive for partners in the VC firm is to manage as much money as possible. The more money they manage, the less time they have to nurture and advise entrepreneurs.”).
243 Compl. at ¶¶ 19-20, Benchmark Capital Partners VII, L.P. v. Kalanick, 2017 WL 3437765 (Del. Ch. Aug. 10, 2017) (No. 2017-0575) (noting that at the time of the lawsuit Benchmark held “approximately 13% of Uber’s stock, including approximately 20% of Uber’s voting power, approximately 36% of the preferred stock voting power and approximately 0.5% of Uber’s Class B common stock” and a board seat “designated by Benchmark”).
244 Id. at ¶ 4-5. According to the complaint, this failure induced Benchmark to execute a stockholder consent and amended voting agreement that created three new board seats to be designated by Kalanick.
misconduct occurring at the company. The complaint highlighted the concealment of information from investors rather than the monitoring role of directors.

The other aspect of overlapping roles that might affect board monitoring arises from the relational nature of startup governance. VCs and other startup investors are repeat institutional players in a reputation-based market for investments. As investors they could be characterized as principals in the startup, but in a very real sense they get hired or chosen by founders—the agents in traditional models. Recent work has traced the changing market pressures that began in the early 2000s, explaining that “[w]hereas once too many start-ups chased limited amounts of capital from a relatively small number of VC firms, today, some would argue, too much capital is chasing too few quality start-ups.”

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

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247 See note 137 and accompanying text; Pollman, Private Company Boards, supra note 122, at 635-39.

248 Blank, supra note 232.

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

250 See, e.g., Blank, supra note 232 (discussing the emergence of “founder friendly VCs” with a marketing competitive advantage). VCs may also recognize that an exit through a sale of the company is far likelier than an IPO and having a founder retain a leadership role can make a deal more attractive to acquirors. Id.

251 Id.
managerial to monitoring. Some of the hottest startups have their choice of investors and bargaining leverage to demand favorable terms.252

Entrepreneurs and VCs alike have noted the weak oversight that can arise from the overlapping roles in the governance structure. For example, the longtime CEO of online real-estate brokerage Redfin that went public in 2017 remarked, “There is a new world of VCs who really can’t perform their governance functions on boards because they want to preserve their relationship with you.”253 Similarly, Benchmark general partner Bill Gurley stated, “There’s a systematic problem in Silicon Valley, the venture capitalist board members are finding it harder and harder to speak up and hold entrepreneurs responsible for financial performance.”254 He explained, “Our business has gotten super competitive. What the venture capitalist is afraid of is losing the next big one...[Y]ears ago [some of the best venture capitalists] were known for storming into board rooms [to demand accountability]—if you get a reputation like that you won’t win the next deal.”255 He lamented that Silicon Valley board rooms have mostly become an applauding audience of clapping hands.256

Although some observers may have little sympathy for VCs who lose money due to oversight failure, it is not only VCs who bear the cost of weak startup boards and compliance failures. Particularly egregious examples such as the fraudulent activity at Theranos, which harmed not only investors and employees but also innocent third-party patients, puts the concern into sharp relief.257

Yet, the potential for oversight weakness stems from the underlying governance structure and is not easily resolved. Founder-friendly terms exacerbate the issue, and unicorn size raises the stakes, but the structure and dynamics that contribute to the oversight weakness are commonplace in venture-backed startups.258

252 See supra notes 147-149 and accompanying text; see also Lessin, supra note 249 (”As long as demand for great companies outstrips supply, some investors will back any company with growth potential, regardless of its governance standards.”).
253 Winkler & Farrell, supra note 148.
255 Id.
256 Id.
257 Another issue is that companies and regulators may not fully appreciate the social risks and costs of new technology until some time after deployment. John Armour et al., Putting Technology to Good Use for Society: the Role of Corporate, Competition and Tax Law 8-9 (ECGI, Working Paper No. 427, 2018).
258 This point reflects that while worthy of attention, the governance issues that unicorns manifest do not spring into existence only when these companies cross the line of a billion-dollar valuation, and notably the valuations may be unreliable markers. See Robert P. Bartlett III, A Founder’s Guide to Unicorn Creation: How Liquidation Preferences in M&A Transactions Affect Start-Up Valuation, in RESEARCH HANDBOOK ON MERGERS AND ACQUISITIONS (Hill & Davidoff Solomon eds., 2016) (explaining that the stated valuations of unicorns may be unreliable measures of firm value because they reflect preferred stock terms); Gornall & Strebulaev, supra
Independent directors who do not hold overlapping roles have the potential to improve the monitoring function of startup boards. Recent reports and advice from former SEC chair Mary Jo White and former attorney general Eric Holder indeed call on mature startups to enhance board oversight by adding independent directors and installing an independent board chair. In previous periods when startups went public earlier on average, much of the company’s growth phase could have been funded by public capital markets and overseen by a public company board with greater independence. Proposals concerning independence, particularly for late-stage startups, can thus be understood as efforts to move startup boards to a model closer to that of public company boards and previous expectations about the publicness of companies with a sizeable footprint.

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

Further, not only may the independent director be envisioned more as a tie-breaker than a monitor, the meaning of independence in the startup context is in many ways narrower than public company norms—it often refers simply to an individual who is not an inside manager such as a founder or executive and not a major outside investor such as a VC. Independent directors in the startup context may still have significant social and professional ties with the VCs, founders, or executives. These connections can add enormous value to the startup and establish the trust necessary to have a voice on the board, but could at the same time influence their ability to provide oversight. In

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note 78 (modeling the valuation of unicorns and finding that after adjusting for valuation-inflating terms, almost half of unicorns lose their status).

259 Empirical studies have not, however, definitively established a link between board independence and corporate profitability or stock price performance. Fisch, Boards, supra note 53, at 276-77; Langevoort, supra note 160, at 798.


261 For discussions of the concept of “publicness,” see Hillary A. Sale, The New “Public” Corporation, 74 LAW & CONTEMP. PROBS. 137 (2011); Langevoort & Thompson, supra note 29.

262 See supra Part II.A(1); Broughman, supra note 142, at 461-64; see also Lessin, supra note 249 (criticizing notable unicorns for failing to appoint independent directors).

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

264 See Mark S. Granovetter, The Strength of Weak Ties, 78 AM. J. SOC. 1360 (1973) (examining the importance of weak social ties in diffusion of influence, information, and talent); Scott Shane & Daniel Cable, Network Ties, Reputation, and the Financing of New Ventures, 48 MGMT. SCI. 313 (2002) (finding that social ties influence venture financing); Emilio J. Castilla et al., Social Networks in Silicon Valley, in THE SILICON VALLEY
addition, not only does independence have a narrower meaning in the startup context, the information generally available to these directors in carrying out their board service is also limited by the lack of public reporting and stock exchange price.

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

In sum, this Article’s analysis highlights that VCs may not always be the strong monitors they are assumed to be and adding some measure of greater independence may improve the oversight function of startup boards. This proposal is unlikely to be a panacea, however, because the system of startup governance is not oriented around such a goal—rather, insiders’ vision, shared control, and social ties provide value for growing, innovative companies. Accountability mechanisms other than board oversight may take on greater importance as the social costs of startups are increasingly felt in communities around the world.

2. Extreme Late-Stage Governance and Liquidity Pressure

While startup scandals and monitoring failures have captured headlines, another issue has attracted considerable academic attention. In just two decades, the number of publicly listed U.S. companies has plummeted by nearly half and the number of

EDGE: A HABITAT FOR INNOVATION AND ENTREPRENEURSHIP 245 (Chong-Moon Lee et al. eds., 2000) (describing the “crucial importance of social networks” in the flow of people, resources, and information in Silicon Valley startups).

265 See Goshen & Hamdani, supra note 117, at 565-66, 577-79 (describing the entrepreneur’s idiosyncratic vision and the value of controlling management decisions to pursue such vision under conditions of information asymmetry or differences of opinion); SCHUMPESTER, supra note 48, at 95-127 (describing the role of entrepreneur as innovator); Blank, supra note 232 (“The decline of IPOs and less focus on management credentials have reduced the need for ‘adult supervision, and VCs have come to respect founders’ ability to maintain a fast-moving, innovative culture.”).

companies going public through an IPO has decreased to roughly one-third. Scholars and commentators have debated the role that regulatory costs, securities law changes, technology, and public market dynamics may have played in these developments, and whether companies still have incentives to go public.

Drawing on the framework of startup governance set out in Part II, this section contributes a novel, supplementary explanation of why some companies might choose to go public even when they do not need to raise money: increasing governance costs and liquidity pressure from heterogeneous shareholders. Staying private for long periods while growing and adding participants with diverging interests involves significant governance complexity. Going public offers a chance to unwind a complicated and largely contractual governance structure in favor of a more traditional allocation of rights and responsibilities. Even dual-class stock can represent a considerable simplification over the complex multi-class structures and contracts of late-stage startup companies.

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

Liquidity is also commonly listed as a reason to go public, but its importance is usually explained as increasing the value of equity and lowering the cost of capital for.


268 See Kahle & Stulz, supra note 267; De Fontenay, supra note 267, at 447, 453-58; see also Brian R. Cheffins, Rumours of the Death of the American Public Company are Greatly Exaggerated, COMPANY LAWYER (forthcoming) (arguing that based “on the ratio of aggregate market capitalization to gross domestic product, the public company is currently as important relative to the U.S. economy as it ever has been, if not more so”).

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


271 Id. at 447; STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS (2002); JEAN TIROLE, THE THEORY OF CORPORATE FINANCE (2006).
companies to make acquisitions and hire and retain managers and employees.272 Some scholars have additionally recognized that going public is an important form of exit for venture-backed companies, serving as a “mechanism for founders, employees, and early investors to cash out their relatively illiquid stakes in the firm.”273 What remains underappreciated, however, are the governance dynamics occurring in these late-stage companies that can be difficult to navigate and make liquidity pressure particularly problematic, especially for employees.274

Recall from Part I the late-stage mature startup’s financial and governance structure that is characterized by extreme complexity—these companies are increasingly raising financing rounds of previously unheard-of size, bringing new public-style investors into the capital structure.275 Part II observes that these startups can be plagued by tensions between and among all participants and in a pattern that increases. This raises the question of what is the ultimate endpoint. Most startups fail or reach an exit through a sale of the company.276 But what happens to the companies that have not taken this path?

We are currently witnessing the answer to this question play out. To date, the structure of venture-backed companies has been premised on the notion that there must ultimately be an exit.277 Key participants rely on the assumption that exit is an essential goal. VC funds have a fixed life, usually ten years and sometimes with an option for a short extension.278 Incentive-based equity compensation for employees usually vests over four years and typically has a term of ten years from the date of grant.279

272 See Jeff Schwartz, The Twilight of Equity Liquidity, 34 CARDOZO L. REV. 531, 536-37 (2012); De Fontenay, supra note 267, at 46.
274 When Facebook went public in 2012, it listed employee liquidity as one of the principal purposes of its IPO. Facebook, Inc., Registration Statement (Form S-1), at 7 (Feb. 1, 2012) (“The principal purposes of our initial public offering are to create a public market for our Class A common stock and thereby enable future access to the public equity markets by us and our employees, obtain additional capital, and facilitate an orderly distribution of shares for the selling stockholders.”).
275 See supra Parts I.B(2), II.B.
276 See VC Director Guide, supra note 59, at 3.
277 Smith, Exit Structure, supra note 12, at 345 (“Exit is not merely optional for venture capitalists.”); Zider, supra note 57 (“Venture money is not long-term money. The idea is to invest in a company’s balance sheet and infrastructure until it reaches a sufficient size and credibility so it can be sold to a corporation or so that the institutional public-equity market can step in and provide liquidity.”).
278 Smith, Exit Structure, supra note 12, at 345.
279 MAYNARD ET AL., supra note 69, at 340. Another type of stock-based compensation, restricted stock units, usually expire after five to seven years. Lee, supra note 5.
Extended periods of staying private has strained these timelines and prompted new mechanisms to give partial liquidity: secondary markets for private company stock, third-party tender offers, and company-sponsored share buybacks. These are important developments that provide a release valve for participants’ liquidity needs and governance conflicts. For example, Benchmark’s lawsuit against Uber’s former CEO-founder ultimately settled as part of a deal to bring in a new institutional investor, give partial liquidity to Benchmark, and restructure the board. Palantir, a data analytics startup, did a $225 million buyback, offering to repurchase up to 12.5% of certain employees’ shares. But these transactions also create new risk and challenges that must be managed and it is an open question whether it will be sustainable for startups to remain private forever—whether, for example, companies can find new investors large enough to satisfy all liquidity needs on a continual basis and that do not demand assurances of a timeline to go public.

Staying private in the extreme late stage involves significant governance difficulty and cost. Raising new rounds of financing requires complex renegotiations among an increasingly diverse group of shareholders. It often raises the bar for a potential exit down the road, for example, by giving protective terms to the newest investors regarding the price and timing of an IPO that guarantees them a return, potentially at the expense of founders, employees, and earlier investors. Taking on additional capital can also reduce the number of potential acquirors that would have the means and interest to buy the company in a trade sale. Faced with these governance complexities, co-working space startup WeWork turned to the junk-bond market for a $500 million bond sale, putting the company that is “burning through its cash” in a potentially precarious position.

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

280 See supra note 110.
281 See supra notes 172-175 and accompanying text.
283 See supra note 108 and accompanying text; see also KOPP & GANZ, supra note 66, at 25 (quoting venture capitalist John Doerr of Kleiner Perkins: “Having a $1 billion dollar valuation can be a real problem . . . being a unicorn is really an albatross.”).
Managing information within the private governance structure also becomes increasingly challenging. State corporate law provides shareholders with the right to inspect the corporate books and records. This right provides startup employees and other shareholders with an important protection and means of seeking information to value their stock, but it is potentially costly and time-consuming for companies to respond to these requests. In addition, federal securities law requires companies that grant more than $10 million of options or other employee equity awards in a twelve-month period to provide detailed financial statements and risk disclosures to their employees. The SEC levied a civil penalty on Credit Karma, a personal finance startup, for failing to comply—the company had the information available, but did not want to provide it to employees due to confidentiality concerns. Companies are in a bind: employees are making investment decisions and are entitled to the information, but the company suffers when sensitive financial information is leaked. As companies get bigger and stay private longer, avoiding leaks becomes harder.

Partial liquidity events are often problematic. Secondary trading can be time-consuming and distracting for managers and employees—key resources for company performance and value. Because unrestricted secondary trading poses problems for startups in managing their shareholder base and valuation, startup lawyers added trading restrictions that prevent employees and other shareholders from selling without...
company consent.292 Although this alleviates certain concerns, it puts directors, founders, and executives in further tension with other startup participants as they are deciding which shareholders are allowed to sell, and when they do it often necessitates information disclosures in addition to company consent.293

Similar concerns about distractions, fairness, and disclosures arise when a company does a buyback or facilitates a third-party tender offer.294 Palantir’s share buyback put the company in the position of picking and choosing among current and former employees to offer partial liquidity at a price above the valuation that one of its institutional shareholders, Morgan Stanley, had determined in a mark down.295 Different pricing and terms for investors and employees are commonplace in private tender offers.296 Company-facilitated transactions expose corporate decisionmakers and the corporation itself to litigation and regulatory risk from potential pricing and information asymmetry issues.297

In addition, a lengthy list of problems for startup employees in particular can arise from the extended pre-liquidity period. The discussion in Part II.A explained problems arising from expiring exercise periods and how it can put common shareholders in tension with each other. Some companies have turned to giving cash bonuses instead of options and loaning employees money to exercise their options,298 but these solutions are costly, complicated, and only underscore the need for a better system that aligns company and employee interests.

In the meanwhile, employees risk getting hurt in the process. In startups, option exercise requires out-of-pocket money to cover the exercise price and taxes. The more

292 See Schwartz, supra note 272, at 559-60; see also Kupor, supra note 220 (discussing transfer restrictions on startup stock); Henry v. Phixios Holdings, Inc., 2017 WL 2928034 (Del. Ch. July 10, 2017) (discussing the enforceability of transfer restrictions).

293 See supra note 217; Pollman, Information Issues, supra note 37, at 213-14 (discussing company disclosures in secondary transactions).


295 Davidoff Solomon, supra note 282.


297 See Pollman, Information Issues, supra note 37, at 238.

valuable the options, the more expensive it is to exercise them, and coming up with the cash can be difficult for employees—it can sometimes run in the hundreds of thousands of dollars.\textsuperscript{299} Once the options are exercised they become shares of (semi) illiquid common stock and it remains to be seen what they will be worth. Some companies fail or ultimately exit at an unfavorable valuation.

For example, when Good Technology sold to BlackBerry after a cancelled IPO and having turned down a much higher acquisition offer, employees discovered their stock was valued at 44 cents per share, down from $4.32 a year earlier.\textsuperscript{300} Although Good Technology had at one time been labeled a unicorn valued at more than $1 billion, its final sale price was just $425 million and most of the proceeds went to the preferred shareholders.\textsuperscript{301} Many employees were stuck with large losses and tax bills, and they subsequently sued the directors for breach of fiduciary duty.\textsuperscript{302} This example reflects the classic principle that equity comes with risk, but it also shows something more particular to startups—the governance cost of exposing large numbers of employees to personal financial harm and, consequently, key managers to litigation.

Nothing in this discussion suggests that there is only one reason to go public or that the impetus will be the same for all companies. Instead, this discussion adds depth to understanding the governance costs and liquidity pressure that develop in the extreme late stage of startups. The framework offered here suggests that we can expect increasing complexity to remaining private and an ownership structure of different types of participants with vesting and investing timelines that can be delayed, but will eventually push toward an exit.\textsuperscript{303}


\textsuperscript{301} Id.

\textsuperscript{302} Id.; Matt Levine, \textit{Good Technology Wasn’t So Good For Employees}, BLOOMBERG (Dec. 23, 2015), http://www.bloombergview.com/articles/2015-12-23/good-technology-wasn-t-so-good-for-employees; Helaine Olen, \textit{These Startup Workers Thought Their Company Stock Would Make Them Rich. Instead They Got Worthless Shares and Massive Tax Bills}, SLATE (Dec. 23, 2015), http://www.slate.com/blogs/moneybox/2015/12/23/good_technology_workers_thought_their_stock_would_makeThem_rich_nope.html (noting that “even as corporate honchos were aware that an ‘outside appraisal firm’ had priced the firm’s common stock at 88 cents a share in June, employees were still purchasing company stock at $3.34 a share in August.”).

\textsuperscript{303} The recent batch of IPOs and direct listings, including companies that reached late-stage maturity such as Uber, Lyft, Zoom, Pinterest, and Spotify evidence this possibility of governance complexity and liquidity pressure pushing toward going public. For example, the digital music service company Spotify went public without selling a single new share and prioritized giving immediate liquidity to all existing shareholders, without lock-up provisions that normally delay employees in accessing the market. Slack has announced plans to do the same. Alexander F. Cohen et al., \textit{Spotify Case Study: Structuring and Executing a Direct Listing}, LATHAM & WATKINS (June 21, 2018), https://www.lw.com/spotify-case-study; Maureen Farrell, \textit{Slack Plans to Follow Spotify on Unconventional IPO Route}, WALL ST. J. (Jan. 11, 2019), https://www.wsj.com/articles/slack-planning-to-pursue-direct-listing-11547202723.
**B. Applying Corporate Law**

In addition to illuminating current issues of debate such as monitoring failures and late-stage startups, the Article’s framework also sheds light on how corporate law might adapt in the future to account for startups. Foundational doctrines have been shaped in the context of classic closely-held problems of majority-minority disputes and the public corporation context of shareholder-manager agency costs.\(^{304}\) High-growth, innovative startups funded by venture capital call for a different approach.

This final section aims to start a conversation about how to apply traditional corporate law doctrine to startups. It takes as a key example *In re Trados*, discussed above in Part II.A, regarding the conflict that can arise between the common and preferred shareholders.\(^{305}\) The court took a formalistic approach to applying fiduciary duties without sensitivity to startup dynamics.

The case involved a startup that faced dim prospects for growth after several years of operation in which it had taken on seven rounds of preferred stock having an aggregate liquidation preference of approximately $58 million.\(^{306}\) As is typical for a startup by this stage of its life cycle, the board had been re-negotiated such that the preferred shareholders and company executives composed the board, together with one independent industry expert.\(^{307}\) The legal dispute concerned the board’s decision to sell the company to a strategic buyer for $60 million—an amount that just covered the preferred shareholders’ liquidation preference and a management incentive plan that gave select executives a bonus to find and carry out the deal.\(^{308}\) The question was whether, in negotiating a sale that gave the common shareholders nothing, the directors breached their fiduciary duty.\(^{309}\)

The court held that the directors owed a fiduciary duty to the common shareholders as the residual claimants.\(^{310}\) It characterized the preferred shareholders as having rights and preferences that are only contractual in nature like creditors rather than residual claimants—“the ultimate beneficiaries of the firm’s value.”\(^{311}\) As a majority of the

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\(^{304}\) See, e.g., D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 279 (1998) (tracing to the closely-held corporation context the development of the fiduciary duty to act in the best interest of the corporation and its shareholders); Revlon, Inc. v. MacAndrews & Forbes Holdings Inc., 506 A.2d 173 (1986) (ruling in the public corporation context that when a sale of the company becomes inevitable, the duty of the board is to maximize the corporation’s value by getting the best price available for the shareholders).

\(^{305}\) *In re Trados Inc. S’holder Litig.*, 73 A.3d 17 (Del. Ch. 2013).

\(^{306}\) Id. at 21-25.

\(^{307}\) Id. at 45.

\(^{308}\) Id. at 26-33.

\(^{309}\) Id. at 33.

\(^{310}\) Id. at 40-41.

\(^{311}\) Id. at 39-41.
directors were VCs and executives whom the court deemed not disinterested and independent, the court applied the entire fairness standard, “Delaware’s most onerous standard.” It found the process lacking because the board members “did not understand their job was to maximize the value of the corporation for the benefit of the common shareholders” and failed to form an independent committee that would represent the common shareholders. It further found, however, that the common stock had no economic value due to the corporation’s weak prospects, and thus the common shareholders had received their fair value. Fortunately for the defendants, they had no liability in the case, but many commentators pointed out that common stock functions like an option and the results could easily be otherwise in a case in which the plaintiffs provide a better expert valuation.

Most critically, Trados sets out a vision of fiduciary principles that imagines that all directors have an immutable obligation to maximize value for common shareholders. This does not accord with the reality of most startups, which do not have homogeneous shareholders, even among the common stock class. The common shareholders do not represent the firm value or an undifferentiated residual as imagined—instead, they are only a segment of the shareholders and they often stand in tension with each other and have other forms of affiliation with the corporation in addition to their shareholding.

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

312 Id. at 44-45.
313 Id. at 62, 64-65.
314 Id. at 76.
315 See, e.g., Adam M. Katz, Comment, Addressing the Harm To Common Stockholders in Trados and Nine Systems, 118 Colum. L. Rev. Online 234 (2018) (arguing that courts should recognize “the value of the option to continue operating the firm in the hopes of performance improving”).
316 See supra Part II.A(2).
317 See Bratton & Wachtler, supra note 13, at 1815 (arguing that “preferred stock is both corporate and contractual—not all one nor all the other”).
318 See Bratton, supra note 12, at 894 (explaining that preferred shareholders in startups typically have “incomplete protection from issuer opportunism”); supra Part II.A (describing governance conflicts involving preferred shareholders).
319 See supra Part II.A(1) (discussing shared control in startups).
The special features of startup governance suggest that courts should be willing to apply fiduciary doctrine more flexibly in this context to recognize the different types of contributions represented in the corporation and that the board is repeatedly renegotiated on the path to an eventual exit. The value of the corporation itself, the site of these investments and bargains, best reflects the sum of the participants’ interests and it is to the corporation that the fiduciary duty should be owed.

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

In addition, when fiduciary litigation does end up in the courts, they should recognize that corporate law’s standard approach to conflicts, such as giving judicial deference to decisions made by a disinterested majority or committee of the board or with disinterested shareholder approval, is often not possible in the startup context. Most participants in the startup lack independence by design. Directors will unavoidably be conflicted in many cases. “Independent” directors typically have social ties in the entrepreneurship community. Instead of being a cause for concern, these social ties and networks are a valuable resource for startups to mobilize the talent, information, and investments needed to grow an innovative company. Social and professional connections also often create the trust necessary for VCs and entrepreneurs to invite an independent director to the board, a practice that should be encouraged as discussed in

320 See Sepe, Constituency Directors, supra note 27, at 309 ("[T]he liability that constituency directors face under current fiduciary rules may reduce a corporation’s access to important sources of capital.").

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

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

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

324 See Sandys v. Pincus, 152 A.3d 124 (Del. 2016) (ruling in the context of public company Zynga, previously a venture-backed startup, that independence was lacking for one director because of social tie of co-owning a private airplane and for two VC directors with network of ongoing business relations).

325 See supra note 264.
Part III.A(1) concerning oversight. Further, courts should recognize that startups often have only one independent director, if any, available to serve on a special committee.326

Therefore, the potential for bias and self interest are significant, but the lack of independence or a special committee does not indicate a lack of good faith efforts to act in the best interest of the corporation. Shareholders have bargained for a different style of board governance. Without other red flags, the absence of independence should not constitute cause to engage in judicial second-guessing of business decisions that would otherwise be granted deference in the public company context. Traditional notions of “fair process” or “fair dealing” should adjust to calibrate expectations to the startup environment, while still maintaining the essential role that fiduciary duties can serve to police bad faith, opportunistic conduct that harms corporate value.

CONCLUSION

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

This Article has provided a comprehensive, novel account of startup governance. It is a positive, descriptive framework, built from the ground up with an understanding of the evolving nature of the startup business and capital structure, driving the interrelated set of vertical and horizontal governance issues between all participants. Setting out this framework shows that startups are characterized by having heterogeneous shareholders, overlapping governance roles, and dynamic change.

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

326 Delaware courts have applied a higher level of scrutiny to one-member special committees. Gesoff v. IIC Industries, Inc., 902 A.2d 1130 (Del. Ch. 2006).
Private equity fund agreements have been heavily criticized for failing to protect investors from exploitation by managers. To defend itself, the industry has frequently invoked what I call the private equity negotiation myth, which claims that because fund agreements are highly negotiated, substantive concerns about their terms are unwarranted. This myth assumes that large investors use their bargaining power to demand strong fund agreement protections.

This Article challenges the private equity negotiation myth. First, I show that large investors’ incentive to negotiate fund agreements is actually much weaker than the myth suggests. Because large private equity fund investors can commonly negotiate for individualized benefits outside of fund agreements, they have strong incentives to use their bargaining power to maximize individualized benefits before negotiating for better fund-wide protections. Individualized benefits thus dampen the extent to which fund agreements are actually negotiated. Second, I show that large investors cannot always be expected to “vote with their feet,” either, by avoiding funds with weak protections. When large investors have bargaining power, it makes them less sensitive to the quality of fund agreement terms because it enables them to negotiate for individualized benefits that offset the harm caused by weak protections. As a result, the marginal investors in private equity funds—those that have the greatest influence on the quality of fund terms—may sometimes be ones that lack bargaining power, not the ones that have it.

The private equity negotiation myth thus directs policymakers to look in the wrong places when assessing whether investors are adequately fending for themselves in this $5 trillion industry. By debunking the myth and showing the true incentives associated with bargaining power in private equity funds, this Article contributes to important and timely policy discussions at both the state and federal levels on the regulation of private investments.

1 Associate Professor, BYU Law School. I am thankful to Robert Daines, Elisabeth de Fontenay, Jessica Erickson, Jill Fisch, Michael Gutentag, Christine Hurt, Cathy Hwang, John Morley, Roberta Romano, Megan Shaner, Andrew Tuch, and participants in the 2019 Association of American Law Schools Business Associations Workshop and the 2019 BYU Law Winter Deals Conference in Park City not recognized above for helpful discussions and comments on earlier versions of this Article. All errors are my own.
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INTRODUCTION

Harsh criticisms have been levied against private equity fund agreements in recent years. Fund agreements have been accused of enabling managers to charge exorbitant fees, encouraging managers to engage in excessive risk-taking, allowing managers to operate behind a veil of secrecy, and eliminating negative consequences for bad behavior by managers, among various other critiques. One commentator has accused fund agreements of being so deficient that they create an “incubator for agency costs.” Given the vast size of the private equity market, and the heavy investment by public institutions in private equity funds, these criticisms have raised alarm.

To defend itself, the private equity industry has frequently invoked what I call the private equity negotiation myth. The myth is simple. It claims that large investors in private equity funds can—and do—use their bargaining power to negotiate for the protections that they need in fund agreements. Because fund agreements are highly-negotiated, so the myth goes, concerns about the substantive quality of their terms are unwarranted.

This defense has strong surface-level appeal. If fund agreements really are heavily negotiated by investors, it would create a presumption that the terms in them must not be deficient, despite what critics say. Classical contract theory holds that unrestricted freedom of contract between parties that possess equal

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2 See infra notes 74-75 and accompanying text.
3 See infra note 69 and accompanying text.
4 See infra notes 73-76 and accompanying text.
5 See infra notes 84-87 and accompanying text.
6 James C. Spindler, How Private is Private Equity, and at What Cost?, 76 U. Chi. L. Rev. 309, 331 (2009) [hereinafter, Spindler, How Private is Private Equity?] (“One could view the typical private-equity setup as creating almost an incubator for agency costs, an incredibly hospitable environment for opportunistic managerial behavior.”).
8 Public pension plans are by far the largest investor type in private equity funds, representing 35% of all investment. See 2018 PREQIN GLOBAL PRIVATE EQUITY & VENTURE CAPITAL REPORT at 73 [hereinafter 2018 PREQIN GLOBAL REPORT]. See also Andrew J. Bowden, Dir., Office of Compliance Inspections & Examinations, U.S. Sec. & Exch. Comm’n, Address at the Private Equity International Private Fund Compliance Forum: Spreading Sunshine in Private Equity (May 6, 2014) [hereinafter Bowden, Spreading Sunshine in Private Equity] (noting that misconduct in the private equity industry “adversely affects the retirements savings of teachers, firemen, police officers, and other workers across the U.S.”).
9 See infra note 88.
10 See infra Part II.
bargaining power, skill, and knowledge of relevant market conditions enhances individual welfare and promotes an efficient allocation of resources.11

Closer examination, however, reveals that this myth is unpersuasive. Unlike in a corporate setting,12 large investors in private equity funds can commonly use their bargaining power to negotiate for individualized benefits outside of fund agreements, where the benefit of the bargain is not shared with other investors in the fund. These individualized benefits, which include fee discounts and rights to participate in co-investments alongside the fund (among others),13 fundamentally alter large investors’ incentives. When individualized benefits are common, it makes large investors less likely to demand strong protections in fund agreements, in two ways.

First, because of individualized benefits, large investors have much weaker incentives to negotiate fund agreements than the myth suggests. In general, the more that an investor can use its bargaining power to negotiate for individualized benefits instead of things that will benefit all investors in the fund (like fund agreement protections), the better off that investor will be.14 This does not eliminate the negotiation of fund agreements, but, when individualized benefits are common, it will significantly dampen the extent to which fund agreements are negotiated.

Second, individualized benefits also make large investors less likely to “vote with their feet” by refusing to invest in funds that have weak protections. In the absence of negotiation, the quality of a fund agreement’s terms will be shaped by the preferences of the “marginal” investors in that market,15 which are the investors that will stop investing when the quality of the fund agreement terms starts to decline.16 This Article shows that bargaining power can actually make

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11 See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 72 cmt. b (1981) (“Bargains are widely believed to be beneficial to the community in the provision of opportunities for freedom of individual action and exercise of judgment and as a means by which productive energy and product are apportioned in the economy. The enforcement of bargains rests in part on the common belief that enforcement enhances that utility.”).
12 One of the core principles of corporate law is that shareholders holding the same class of shares should be treated similarly. See REINIER H. KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 96 (2d ed. 2009) (stating that the equal treatment of shareholders in the same class is a fundamental norm of corporate law); Victor Brudney, Equal Treatment of Shareholders in Corporate Distributions and Reorganizations, 71 CAL. L. REV. 1072, 1074 (1983) (stating that all shares of common stock are to be treated as “homogeneous claims on enterprise wealth” in a public corporation).
13 See infra Section III.D for a discussion of the various forms that these individualized benefits can take.
14 Negotiating fund agreement terms is thus only a secondary priority—after the negotiation of individualized benefits—for rational investors with bargaining power. See infra Section III.A.2.
15 This assumes a competitive market where buyers have alternative options. See G. Marcus Cole, Rational Consumer Ignorance, 11 J.L. ECON & POL’y 413 (2015) [hereinafter Cole, Rational Consumer Ignorance] (“[N]on-price terms, like price terms, are ‘policed’ in competitive markets by the marginal consumer for each term.”).
16 See id. (“[T]he marginal consumer, by definition, is the party for whom a particular term means the most. . . . The marginal consumer is someone who cares so much about that particular term, that she has educated herself, researched the product terms, and its closest substitutes along the margin of that all-important dimension—whatever it happens to be.”).
large investors less sensitive to the quality of fund agreement terms because it enables them to negotiate for individualized benefits that offset the harm caused by weak protections. This means that large investors will sometimes be willing to invest in funds that they would otherwise find unacceptable if they lacked bargaining power. As a result, large investors with bargaining power may not be the marginal investors—those that have the greatest influence on the quality of fund terms—in many of the private equity funds that they invest in.

Debunking the private equity negotiation myth is important for a few reasons. Most fundamentally, it shows that the criticisms of fund agreements raised in recent years cannot be dismissed as easily as industry commentary suggests. At its core, the private equity negotiation myth is a process-based response to substantive criticisms. It argues that because the process by which fund agreement terms are created is sound, substantive scrutiny of those terms is unwarranted and unnecessary. This Article shows that policymakers and theorists should not be lulled into a false sense of security by this logic. Without a stronger process-based defense, concerns about the substantive critiques of fund agreements should not simply be set aside and dismissed, particularly since so many of the investors that would bear the cost of sub-optimal terms are entities that invest on behalf of the public.

Also, by debunking the private equity negotiation myth and showing the true incentives associated with bargaining power in private equity funds, this Article contributes to broader policy discussions at both the state and federal levels. At the state level, this analysis advances the growing literature on the controversial practice of waiving fiduciary duties in non-corporate entities like limited partnerships and limited liability companies. It builds on recent commentary by Leo Strine, Chief Justice of the Delaware Supreme Court, and Travis Laster, Vice Chancellor of the Delaware Chancery Court, questioning the waiver of fiduciary duties in private investment funds, and also fills important gaps in that analysis. At the federal level, this analysis lends important insights to inform ongoing policy initiatives updating the rules governing who can and cannot invest in private investments under the federal securities laws.

These contributions are timely, particularly in light of the unprecedented rise of private market investments in recent years, which has prompted a broad reexamination of traditional approaches to regulating private markets. The

17 See infra Section III.B.2 for an illustrative example.
18 See infra Section III.B.2.
19 To be clear, I am not saying that a legitimate process-based defense does not exist for private equity fund agreements. For example, if all investors in the private equity market are sufficiently sophisticated to analyze fund agreements and search the market for alternatives, then lack of negotiation may not be problematic at all. This Article focuses on the negotiation-based defense raised by the industry in recent years, and does not examine the legitimacy of alternative defenses.
20 See infra note 8.
22 See infra Section IV.B.
23 See infra notes 153 and 154 and accompanying text.
private equity industry represents a particularly large and influential sector of this private universe.24

This Article proceeds as follows. Part I discusses the conflicts of interest that commonly arise in private equity funds and the various forms of protection against these conflicts commonly used in private equity funds. Part II summarizes some of the most pointed criticism of private equity fund agreements in recent years, and shows how the industry has responded by raising the private equity negotiation myth in its defense. Part III challenges the myth by arguing that large investors cannot be counted on to demand strong protections in fund agreements through negotiation or by “voting with their feet.” It also provides a concise description of the various forms of individualized benefits that investors can seek to negotiate for in private equity funds. Part IV concludes with a discussion of policy implications.

I. CONFLICTS OF INTEREST IN PRIVATE EQUITY FUNDS

A. Basic Conflicts of Interest

Private equity managers25 invest other people’s money for a fee. They raise money by pooling the capital of their various investors into a single vehicle called a fund. Fund investors generally commit different levels of capital to the fund—some commit very large amounts while others commit much smaller amounts. These “pooled” funds are typically organized as limited partnerships26 and governed by a limited partnership agreement (an “LPA”), a document that is collectively negotiated between the manager and the fund’s investors and sets forth the terms of the fund. Private equity LPAs are long and complicated

24 Private equity has played an important role in the decline of public—and the rise of private—markets. See Maureen Farrell, America’s Roster of Public Companies is Shrinking Before Our Eyes, WALL ST. J. (Jan. 6, 2017) (“Since the financial crisis, the equity market has become bifurcated, with a private option available to select investors and a public one that is more of a last resort for companies.”); Jonathan Macey, As IPOs Decline, the Market is Becoming More Elitist, L.A. TIMES (Jan. 10, 2017) (“It’s not an exaggeration to say that the IPO market is in the beginning of a death spiral as observers assume that any company that resorts to raising money in an IPO must already have been rejected by the more sophisticated investors in the private capital markets.”).

25 To avoid unnecessary complexity, I will use the term “manager” through most of this Article, even in cases where other terms (like “sponsor” or “adviser” or “general partner”) may be more technically correct. Any technical distinctions will not be important for purposes of this Article. I will also generally use the term “investor” throughout this Article, even in cases where the term “limited partner” might be more technically correct, for similar reasons.

26 Because funds are usually structured as limited partnerships, the limited partnership architecture applies to these vehicles. Accordingly, investors are passive “limited partners,” and the manager acts through a “general partner” that has broad authority to control the fund. The details of the limited partnership form are not important for purposes of this Article, so I avoid using terms like “limited partner” and “general partner” to spare the reader unnecessary jargon.
agreements, typically over 100 pages long.27 By and large, the industry is very lightly-regulated.28

ILLUSTRATIVE PRIVATE EQUITY FUND

Once a fund is formed, a manager has an “investment period”—typically three to five years in duration29—during which the fund is free to make investments. These investments are known as “portfolio companies,” and a manager’s objective is to buy companies that are undervalued or that would benefit from changes to strategy or management. During the investment period, investors are contractually obligated to contribute capital to the fund each time the manager makes a “capital call” so the fund can make investments and pay the fund’s fees and other expenses. Managers typically have extremely broad discretion to select investments, and investors generally have very few rights to influence the fund’s activities.30

27 See Marco Da Rin and Ludovic Phalippou, The Importance of Size in Private Equity: Evidence from a Survey of Limited Partners, 31 J. FIN. INTERMEDIATION 64 (2016) [hereinafter Da Rin and Phalippou, Size in Private Equity] (“LPAs are technical and lengthy documents, typically over 100 pages.”).
28 See Douglas Cumming & Sofia Johan, Regulatory Harmonization and the Development of Private Equity Markets, 31 J. BANKING & FIN. 3218, 3219 (2007) (“The dearth or lack of regulations in private equity to which we refer is related to the fact that investors in private equity funds are institutional investors and high net worth individuals (not the so-called unsophisticated retail investors) and therefore these funds do not receive the same degree of scrutiny as other types of retail based funds, such as mutual funds.”).
29 See Stephanie Breslow & Phyllis Schwartz, Private Equity Funds: Formation and Operation § 2:4.2 [hereinafter Breslow & Schwartz, Private Equity Funds] (“The appropriate length of the commitment period will vary depending on the investment strategy of the fund, with a time period of three to five years being typical for many strategies.”).
30 For this reason, traditional private equity funds are commonly called “blind pools” because investors are signing up to invest in them without any knowledge of, or control over, the investments that will be made by the manager. See Spindler, How Private is Private Equity?, supra note 6 (“While the [LPA] will usually impose strict obligations upon the limited partner to provide capital to the partnership, the limited partner has very little control over what the capital is used for.”).
After a number of years, the manager seeks to sell the fund’s portfolio companies or take them public through an initial public offering, hoping to make profits upon the disposition. Each fund has a stipulated end date (typically around ten years after the date of the fund’s closing31) by which the manager must dispose of any remaining assets and distribute the proceeds to the fund’s investors.32

Conflicts of interest in private equity funds stem from the separation of ownership and control in the private equity fund structure.33 For example, private equity managers may be incentivized to invest less time and effort than they would if they were managing their own money, or seek to enrich themselves at the expense of their investors. Manager self-dealing could take the form of secretly charging excessive fees and expenses, or keeping the best investment opportunities for personal investment rather than allocating them to the fund, among any number of others.34

B. Protections Against Conflicts

Legal scholars and financial economists have theorized about the ways in which private equity investors can defend against agency conflicts in the absence of mandatory legal protections.35 The combination of contractual protections,

31 See Ronald W. Masulis & Randall S. Thomas, Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance, 76 U. Chi. L. Rev. 219, 222 (2009) [hereinafter Masulis & Thomas, Does Private Equity Create Wealth?] (noting that private equity funds are typically established for ten year terms).
32 Often, the life of a fund can be extended for successive one- or two-year periods to liquidate and wind up investments.
33 See Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property (1933); Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305, 308 (1976) (describing the relationship between investor and manager as one “under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.”).
34 See infra Sec. II.A for a discussion of some of the conflicts that have been criticized in private equity funds.
paired with a manager’s reputational incentives, are generally seen as the most important tools. Each will be considered below.

Before committing to invest in a fund, investors have an opportunity to review the LPA governing the terms of the fund. LPAs contain a number of provisions that are designed to protect investors from conflicts with the fund manager.36 One way that LPAs seek to limit these conflicts is through the manager’s compensation arrangements. In addition to “management fees,” which are calculated as an annual percentage of the investor’s total investment in the fund,37 private equity managers typically receive a percentage interest in the profits of the fund called a “carried interest,”38 which generally results in them receiving higher compensation as the profitability of the fund increases. Managers are also generally required to invest a certain amount of their own money directly in the fund itself alongside the pooled fund investors. Depending on how the manager’s carried interest and commitment are structured in the LPA, they can shape the manager’s incentives in various ways and afford greater or lesser protection to investors.

LPAs also contain various non-economic provisions designed to address agency conflicts. For example, investors are sometimes granted the right to consent to certain transactions when the manager’s interest is conflicted, or to dissolve the fund if the manager engages in certain forms of misconduct.39 LPAs also sometimes include requirements that the manager’s key employees dedicate a certain percentage of their time to working for the fund. Terms designed to limit risk-taking by the manager—such as restrictions on borrowing and requirements for diversification of investments—can also be included.40 Funds also commonly establish “advisory boards” consisting of the fund’s largest investors, which are

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36 See David T. Robinson & Berk A. Sensoy, Do Private Equity Fund Managers Earn Their Fees?, 26 REV. FIN. STUDIES 2760 (2013) [hereinafter Robinson & Sensoy, Do Private Equity Managers Earn Fees?] (“In private equity, the agency relationship between fund managers (the general partners, or GPs) and investors (the limited partners, or LPs) is governed by a management contract signed at the inception of the fund.”).

37 See BRESLOW & SCHWARTZ, PRIVATE EQUITY FUNDS, supra note 29 § 2:8.2[B][1] (Carol Benedicto ed., Practising Law Inst. 2015) (“The market rate for management fees of private equity funds is approximately 1.5%-2% of the fund’s aggregate capital commitments during the fund’s investment period.”).

38 Historically, the conventional carried interest percentage has been between 15-20% of the fund’s profits over a “hurdle” rate of 5-12%. See JAMES M. SCHELL ET AL., PRIVATE EQUITY FUNDS: BUSINESS STRUCTURE AND OPERATIONS § 2.03[2] [hereinafter SCHELL, ET AL., PRIVATE EQUITY FUNDS] (“Fixed rate preferred returns commonly range from 5% to 12%.”).

39 See id., § 11.04.

40 See id., § 11.07(2)(b) (“In the case of most private equity funds, a policy concerning diversification is imposed as a contractual requirement. In many cases, a private equity fund will generally not be allowed to invest more than 20% to 25% of its total capital commitments in the securities of any single portfolio company.”).
sometimes given limited rights to consult with the manager or consent to certain types of transactions.41

In addition to contractual protections, agency conflicts in funds are also limited by managers’ incentive to maintain a good reputation. Because private equity funds have limited lives,42 private equity managers must raise funds on a serial basis if they desire to remain in business. Managers commonly start raising a new fund for a given strategy every three to five years, launching a new fund each time the investment period of a prior fund draws to a close.

If a manager wants to raise funds in the future, it has an incentive to achieve a successful “track record” of investment returns in its current fund because investors want to see evidence of the manager’s capabilities before they commit their money.43 A manager’s history of past performance is typically provided to investors in the marketing materials that they distribute to prospective investors when they raise a fund.

Managers are also subject to fiduciary duties under state limited partnership law44 and under the federal Investment Advisers Act of 1940 (the “Advisers Act”). However, both of these duties generally show great deference to the contents of the LPA and its accompanying disclosures.45 In most states, fiduciary duties can be modified, and sometimes waived entirely, by an LPA’s terms,46 and under the Advisers Act, fiduciary duties can largely be satisfied by

41 See Schell, et al., Private Equity Funds § 11.07[8] (“From the Limited Partners’ perspective, an Advisory Board represents a mechanism for a limited degree of oversight in areas where the interests of the General Partner may not be fully aligned with those of the Limited Partners.”).
42 See Masulis & Thomas, Does Private Equity Create Wealth?, supra note 31 at 222 (noting that private equity funds are typically established for ten year terms).
44 These include a duty of loyalty, which, among other things, requires that the general partner refrain from dealing with the partnership on behalf of a party that has an adverse interest and from competing with the partnership, and a duty of care. See, e.g., Revised Uniform Limited Partnership Act § 403(b); Uniform Limited Partnership Act § 408; Del. Code Ann. tit. 6, § 15-404(b) and (c).
45 See, e.g., Del. Code Ann. tit. 6, § 17.1101(c) (“It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements.”).
46 See, e.g., Del. Code Ann. tit. 6, § 17.1101(d) (“To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, the
The world of private equity funds is thus highly contractual, and neither state nor federal law provide investors with meaningful back-up protection if the combination of LPA-based protections and reputation-based protections is deficient.

II. THE PRIVATE EQUITY NEGOTIATION MYTH

LPAs are held up as one of the primary sources of investor protection against managerial exploitation in private equity funds, but they have been widely criticized as deficient in recent years. In response to criticism, the industry has frequently invoked what I call the private equity negotiation myth as a form of self-defense. If LPAs are heavily negotiated and private equity investors are sophisticated, so the argument goes, there is no basis for outside observers to criticize the substance of these agreements.

A. Critiques of Private Equity LPAs

1. Scholarly Critiques

Scholars have accused LPAs of being deficient in a number of ways. One line of criticism argues that the compensation arrangements set forth in LPAs, which are supposed to align managers’ interests with their investors’ interests, actually create serious conflicts of interest. Scholars have criticized carried interest compensation for encouraging excessive risk-taking by managers.

partner's or other person's duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.”). Note, however, that the more limited implied contractual covenant of good faith and fair dealing cannot be waived under Section 18-1101(c) of the Delaware Limited Liability Company Act.

47 See SEC v. Capital Gains Research Bureau, 375 U.S. 180, 196 (1963) (citing United States v. Miss. Valley Generating Co., 364 U.S. 520 (1961)) (holding that investors must “be permitted to evaluate overlapping motivations, through appropriate disclosure, in deciding whether an adviser is serving ‘two masters’ or only one, ‘especially . . . if one of the masters happens to be economic self-interest.”); Andrew Ceresney, Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm’n, Securities Enforcement Forum West 2016 Keynote Address: Private Equity Enforcement (Mar. 12, 2016) (transcript available at https://www.sec.gov/news/speech/private-equity-enforcement.html) (indicating that managers must “disclose sufficiently specific facts such that the client is able to understand the [manager’s] conflicts of interest and business practices, and can give informed consent to such conflicts or practices.”). As a result, if a manager has disclosed certain risks and investors have not negotiated for contractual protections against those risks, the investors will be exposed to those risks without any protection from federal fiduciary duties.

45 See infra note 88.

49 See, e.g., Robinson & Sensoy, Do Private Equity Managers Earn Fees?, supra note 36 (“[T]he typical private equity contract allows GPs to earn excessive compensation and does too little to discipline GPs or to provide them with incentives to maximize LP returns.”); 50 See supra note 38 and accompanying text.
in their investment decisions, creating a moral hazard problem because managers enjoy the upside of strong performance without downside risk. Carried interest has also been criticized for distorting managers’ decision-making in other ways, including giving them an incentive to shorten their investment horizons and time cash flows in ways that will increase incentive fees. Separately, scholars have also argued that the carried interest formulations in LPAs are simply too complex, and unnecessarily so, making it harder for investors to understand exactly how much they are obligated to pay.

One of the most controversial critiques of LPAs in recent years has to do with portfolio company fees charged by private equity fund managers. These fees are not paid directly by investors. Instead, they are paid by the portfolio companies owned by the fund, as illustrated in Figure B below, which shows an arrangement where two portfolio companies are paying fees to a manager. These fees sometimes take the form of “monitoring” fees or “consulting” fees—the idea is that the portfolio companies pay managers for “services” that the managers provide to the portfolio companies. However, because portfolio companies are ultimately controlled by a fund’s manager (because the manager controls the fund that owns the portfolio company), the timing and amount of these payments have historically been controlled by the manager. Skeptical of the value actually provided by these services, some scholars have called these fees “money for

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51 See, e.g., Gilson, Engineering a Venture Capital Market, supra note 43 (“While aligning the interests of the GP and the investors, the intensity of the GP’s compensation incentive in turn creates a different agency cost. The GP’s carried interest has option-like characteristics, which may cause it to prefer investments of greater risk than the investors. This is especially true with respect to the fund’s later investments if the early ones have done poorly. In that circumstance, the GP actually may be best served by making negative net present value investments if the investments are sufficiently risky.”); Harris, Critical Theory, supra note 35 (“One of the problems of incentive compensation provisions . . . is that the compensation structure may encourage a manager to make overly risky investment decisions.”).

52 See, e.g., William Magnuson, The Public Cost of Private Equity, 102 MINN. L. REV. 1847, 1904 (2018) [hereinafter Magnuson, Public Cost of Private Equity] (“The carried interest element of private equity compensation creates a moral hazard problem in the private equity industry that in many ways mirrors the critiques levied against the banking industry after the financial crisis of 2008-2009.”).

53 See Ludovic Phalippou, Beware of Venturing into Private Equity, 23 J. ECON. PERSPECTIVES 147 (2009) (“To further isolate potential conflicts between the managers of private equity buyout funds and their outside investors, I discuss a few features of buyout contracts that exacerbate conflicts of interest, rather than mitigate them. First, managers have an incentive to time cash flows in a way that will increase incentive fees. Second, certain contracts provide steep incentives for shortening investment horizons. Third, transaction fees may distort choices of buyout firms in terms of leverage, size of investment, and number of changes in capital structure.”).

54 See, e.g., Peter Morris and Ludovic Phalippou, A New Approach to Regulating Private Equity, 12 J. CORP. L. STUDIES 59 (2012) [hereinafter Morris & Phalippou, New Approach to Private Equity] (positing that complexity in an LPA’s carried interest provision can benefit managers by making it harder for investors to understand it).
Because the fees paid by a fund’s portfolio companies decrease the profitability of the fund, they effectively come out of investors’ pockets.

PORTFOLIO COMPANY FEES

The payment of portfolio company fees has historically been authorized by language in LPAs that authorizes managers to charge them in a general sense but otherwise provides little specificity about the timing and nature of these fees. Scholars have raised concern that LPAs thus effectively give managers freedom to charge an unspecified amount in fees in the future without obtaining investors’ specific consent to those fees. While many LPAs stipulate that a portion of these portfolio company fees will eventually be reimbursed to investors or offset fees that would otherwise be paid by investors, critics have argued that vague language in LPAs often leads to those rebates and offsets never being realized.

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56 See id. (“[V]ague and misleading wording allows PE firms to take advantage of their asymmetric position of power vis-à-vis investors and the lack of transparency in their activities.”).

57 See, e.g., Ludovic Phalippou, Christian Rauch, and Marc Umber, *Private Equity Portfolio Company Fees*, 129 J. FIN. ECON. 559 (2018) [hereinafter Phalippou, Rauch & Umber, *Portfolio Company Fees*] (Investors “do not agree on all fees ex ante and leave ex post discretion to [managers]. . . . The amount of fees charged to portfolio companies is not specified in the LPA; they are contracted upon in the Management Services Agreements which are signed by the [manager] and representatives of the company at the time of the transaction.”).

58 See Appelbaum & Batt, *How Private Equity Abuses Its Limited Partners*, supra note 55 (“Many current Limited Partnership Agreements stipulate that a portion of the transaction and monitoring fees charged to portfolio companies will be rebated to the PE fund’s limited partners. But vague and confusing wording in the LPAs has meant that too often . . . these investors have not received the fee income that is owed them; instead, it has been pocketed by the PE firm. Even when LPs are reimbursed out of these fees, the LP can only receive the amount it has paid in management fees. Monitoring fees in excess of those payments are retained solely by the PE firm.”).
Scholars have also criticized LPAs for failing to require that managers provide robust information disclosure to their investors.\(^\text{59}\) Compared to shareholders in publicly-traded companies, private equity funds have been accused of giving investors only “barebones” information about the fund, and of subjecting investors’ information rights to numerous caveats and conditions that benefit managers and keep investors in the dark.\(^\text{60}\) Weak LPAs have thus, according to critics, led to private equity fund managers being among the most non-transparent actors in the financial marketplace.\(^\text{61}\)

When LPAs do not require robust disclosure, it can have compounding effects.\(^\text{62}\) Scholars have argued that weak disclosure diminishes the effectiveness of reputation\(^\text{63}\) as a source of protection against exploitation.\(^\text{64}\) In order for investors to make an assessment of a manager’s reputation, they need information about the manager’s history and past performance in prior funds. However, if information about a manager’s bad acts is never disclosed, the manager will never be held accountable for those acts, and they will never become part of the manager’s reputation. The effectiveness of reputation will be particularly diminished if, as some scholars have argued, weak disclosure obligations enable managers to overstate the performance of their current and prior funds.\(^\text{65}\)

The critiques described above, if valid, are exacerbated by the fact that LPAs typically grant private equity fund investors very weak control rights and exit rights. Accordingly, if incentive compensation and reputation really do provide insufficient protection, investors do not have any meaningful alternative protections to fall back on. Some scholars have advocated for stronger control

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\(^\text{59}\) See Spindler, *How Private is Private Equity?*, supra note 6 (“[O]nce the investment decision has been made, limited partners are largely in the dark. . . . [T]he information that limited partners receive is somewhat useful in terms of keeping in check gross malfeasance by the general partners but not useful in terms of knowing what their investments are likely to be worth at any point in time or whether the general partners are doing a good job.”); Appelbaum & Batt, *How Private Equity Abuses Its Limited Partners*, supra note 55 (“The reporting requirements for private equity [managers] under Dodd Frank are modest compared with what publicly traded companies, mutual funds, and other investment funds must disclose to the SEC.”).

\(^\text{60}\) See, Magnuson, *Public Cost of Private Equity*, supra note 52 at 1882 (“[E]ven the limited information disclosures that private equity investors are entitled to come saddled with myriad caveats and carve outs.”).

\(^\text{61}\) See Appelbaum & Batt, *How Private Equity Abuses Its Limited Partners*, supra note 55 (“Private equity is among the least transparent financial actors in the economy.”).

\(^\text{62}\) For example, it could mean that investors may never find out, even after the fact, how much a manager was paid in the form of portfolio company fees.

\(^\text{63}\) See supra note 43 and accompanying text.

\(^\text{64}\) See, e.g., Spindler, *How Private is Private Equity?*, supra note 6 (“There is a tendency to overstate the salutary effect of reputation; from a theoretical perspective, the gradual learning that takes place through reputation is inefficient compared to more immediate revelation through greater transparency.”); Magnuson, *Public Cost of Private Equity*, supra note 52 at 1900 (“Reputation can only constrain a party’s behavior if the party believes that others will receive information about the party’s past behavior and base their decision making on that past behavior. In other words, reputation is only as good as the information that underlies it.”).

\(^\text{65}\) See id. (“In this atmosphere of extreme confidentiality, it is unsurprising that a number of studies have found that private equity firm disclosures systematically tend to overstate fund performance.”).
rights. But lack of investor control has long been an embedded characteristic of the private equity fund governance model, and seems unlikely to change.

This leads to the last scholarly criticism of private equity fund LPAs that I will summarize here—the elimination of fiduciary duties under state limited partnership law. If all of the criticism described above is true and investors cannot rely on LPAs or reputation for meaningful protection, then their protection of last resort would be the fiduciary duties that managers owe to their investors. Because funds are typically formed as limited partnerships, managers act as general partners of their funds, and are therefore subject to default fiduciary duties under state limited partnership law. However, as noted above, private equity fund LPAs commonly include provisions that explicitly modify, or even eliminate, these fiduciary duties altogether. Many scholars strongly oppose this highly contractarian approach to fiduciary duties and argue that fiduciary duties are necessary in light of other weaknesses in the private equity fund governance model.

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66 See, e.g., Magnuson, Public Cost of Private Equity, supra note 52 at 1905 (“[P]rivate equity structures could be reformed to grant limited-partner investors greater governance rights, including voting, transfer, and information rights. Investors would not necessarily need broad governance rights in all of these areas in order to ensure that they are protected from misbehavior or shirking by private equity firms. Instead, greater governance rights in one area might obviate the need for greater governance rights in another.”); Spindler, How Private is Private Equity?, supra note 6 (“[O]ne need not take a Bebchukian view of firm agency costs to believe that something more than zero shareholder empowerment is optimal. Some degree of privately negotiated disclosure and control would seem intuitively best.”). From a practical perspective, stronger exit rights would be difficult for managers to grant given the long-term holdings of private equity funds.

67 Some scholars have argued that the limits on investor control are actually a source of value for investors. See, e.g., Morley, Separation of Funds and Managers, supra note 35 at 1232.

68 As previously noted, managers also have fiduciary duties pursuant to the Advisers Act. A manager’s fiduciary duties under the Advisers Act cannot be waived entirely by contract, but they can be satisfied when the manager simply discloses the existence of the relevant conflicts of interest and risks. See supra note 47 and accompanying text.


70 See supra note 46 and accompanying text.

71 See, e.g., Appelbaum & Batt, How Private Equity Abuses Its Limited Partners, supra note 55 (“Analyses of Limited Partnership Agreements (LPAs) have also uncovered clauses that specifically allow private equity firms to waive their fiduciary responsibility towards their limited partners — leading to serious conflicts of interest and negative spillover effects for the beneficiaries of pension funds that invest in private equity.”); Magnuson, Public Cost of Private Equity, supra note 52 at 1877 (“The inability of private equity investors to participate in governance decisions might be less worrisome if they were protected by strong fiduciary duties. . . . But many limited partnership agreements require investors to waive any fiduciary duties that the private equity firm might otherwise have, thus depriving private equity investors of this judicial check on misbehavior.”). But see Larry E. Ribstein, Fiduciary Duties and Limited Partnership Agreements, 37 Suffolk U. L. Rev. 927, 930-31 (2004) [hereinafter Ribstein, Fiduciary Duties and LPAs] (arguing against the restriction of fiduciary duty waivers in limited partnerships).
The above criticism does not reflect the full universe of critical academic commentary on private equity fund LPAs, but it gives the reader a sense of some of the most important and frequently-cited issues in this area.

2. Journalistic Critiques

The news media has also raised strong criticisms of private equity LPAs. Journalists have taken private equity LPAs to task for, among other things, failing to protect against managers engaging in conflicted investment activities, allowing managers to engage in practices that overstate their returns and enable them to receive inflated incentive compensation, and failing to provide adequate disclosure of portfolio company fees and other fees.

One particularly controversial practice drawing media scrutiny in recent years has been the common custom of requiring investors to sign non-disclosure provisions prohibiting them from sharing LPAs with any third parties. Commentators have argued that these provisions are included by managers primarily to prevent the public from evaluating LPAs and exposing the unfair provisions in them, and to make it difficult for investors to benchmark and

72 See, e.g., Anupreeta Das and Juliet Chung, Wall Street’s New Problem: When Fund Titans Invest on the Side, WALL ST. J. (Apr. 26, 2017) (“Wall Street billionaires, their fortunes build by investing other people’s money, increasingly are putting some of their own in sideline investment ventures, while continuing to operate their hedge funds or private-equity funds for clients. The side businesses . . . are a growing concern to the pension funds, university endowments and other institutional investors that make up the clientele of hedge funds and private-equity funds.”).

73 See, e.g., Chris Flood, Private Equity’s Dirty Finance Secret, FIN. TIMES (July 26, 2017) (“Money promised by investors is increasingly being used by private equity managers as security for bank loans that are then used to pay for deals in place of a client’s capital. This little-discussed technique, known as subscription-line financing, helps private equity managers earn performance fees because one of their funds’ key assessment metrics, the internal rate of return, is based on the date an investor’s cash is put to work.”).

74 See, e.g., Gretchen Morgenson, Challenging Private Equity Fees Tucked in Footnotes, N.Y. TIMES (Oct. 17, 2015) (“How much do private equity investors pay to the firms overseeing their portfolios? You might think such a question would be a no-brainer. But in the supersecret world of private equity, it is anything but.”); Dan Primack, Private Equity’s New Fee Trick, FORTUNE (July 1, 2013) (“Most limited partnership agreements allow for additional fees to be charged if the fund is required to hire outside help, such as in the case of a serious legal issue. But . . . some general partners are hiring others for tasks that should reasonably be expected to fall under the management fee, in order to juice the bottom line.”); Gretchen Morgenson, Private Equity Funds Balk at Disclosure, and Public Risk Grows, N.Y. TIMES (July 1, 2016)

75 See, e.g., Gretchen Morgenson, Behind Private Equity’s Curtain, N.Y. TIMES (Oct. 18, 2014) (“[I]n exchange for what they hope will be hefty returns, many pension funds have signed onto a kind of omerta, or code of silence, about the terms of the funds’ investments.”); Madison Marriage and Chris Newlands, Pension Funds Forced to Sign Non-Disclosure Agreements, Fin. Times (Oct. 26, 2014) [hereinafter Marriage and Newlands, Pension Funds Forced to Sign NDAs] (“Anger has erupted over the practice of asset managers coercing pension funds into signing non-disclosure agreements.”).

76 See, e.g., Marriage and Newlands, Pension Funds Forced to Sign NDAs, supra note 75 (“Critics believe the non-disclosure agreements allow fund managers to overcharge some of their pension clients significantly.”); Gretchen Morgenson, The Deal’s Done, But Not the Fees, N.Y. TIMES
compare LPAs against each other. Concerns in this area even led one commentator to create a publicly-available collection of “leaked” private equity fund LPAs, including LPAs from many of the largest private equity managers in the industry. These criticisms of LPAs are part of a long list of journalistic critiques brought against the private equity industry, relating to various controversial practices in the industry.

3. The SEC’s Critique

The scholarly and journalistic criticism described above has helped to draw attention to the controversial elements of private equity fund LPAs. But the most impactful critique—one that has done the most to draw attention to concerns about LPAs—came from the SEC. In the years following the financial crisis, the SEC launched an industry-wide “sweep” of the private equity industry. The goal was for the SEC to establish a presence within the private equity industry following the Dodd-Frank Act, which gave SEC authority to perform examinations on a much wider universe of fund managers. Because private equity LPAs and other fund documentation are almost never publicly-filed, the SEC’s newly-expanded authority gave it an opportunity to become more familiar with the unique issues surrounding the private equity business model.

(May 24, 2014) [hereinafter Morgenson, Not the Fees] (quoting SEC official Andrew Bowden as saying in an exclusive interview that “in some instances, investors’ pockets are being picked.”).


78 See, e.g., Josh Kosman, Why Private Equity Firms Like Bain Really Are the Worst of Capitalism, ROLLING STONE (May 23, 2012) (describing private equity as “a predatory system created and perpetuated by Wall Street solely to pump its own profits”); James Surowiecki, Private Inequity, THE NEW YORKER (Jan. 30, 2012 (describing the wealth created by private equity as being derived “not from management or investing skills but, rather, from the way the U.S. tax system works”); Pat Garofalo, The Real Scandal in Private Equity? It’s the Taxes, THE ATLANTIC (Jan. 17, 2012) (“[T]here’s no value added by letting private equity managers treat the paycheck they receive as capital gains: that particular tax loophole just lets very wealthy money managers avoid paying the top tax rate, for no real reason.”); Steven Pearlstein, The $786 Million Question: Does Steve Schwarzman—Or Anyone—Deserve to Make That Much?, Wash. Post (Jan. 4, 2019) (“[I]f we, as a society, decide that we find the current distribution of income unacceptable—if it offends our moral intuitions that a single financier earns as much in a year as 15,000 elementary school teachers—then it violates no great moral or economic principle to alter that distribution.”).

79 See Andrew J. Bowden, Dir., Office of Compliance Inspections & Examinations, U.S. Sec. & Exch. Comm’n, Address at the Private Equity International Private Fund Compliance Forum: Spreading Sunshine in Private Equity (May 6, 2014) [hereinafter Bowden, Spreading Sunshine in Private Equity] (stating that the exam initiative was designed to “establish a presence with the private equity industry and to better assess the issues and risks presented by its unique business model”).

80 See Title IV, Dodd-Frank Wall Street Reform and Consumer Protection Act (eliminating the “private adviser” exemption to registration requirements under the Investment Advisers Act of 1940, which had the effect of requiring all but a small minority of private fund managers to register with the SEC and become subject to the SEC’s examination authority).
Following this initiative, the SEC publicly announced strongly-worded criticisms of what examiners found in the LPAs that they examined, along with other findings stemming from the examinations.\textsuperscript{81} Specifically, the SEC raised the issue of portfolio company fees, noting that broad language in LPAs enabled managers to charge fees and expenses at the portfolio company level that “were not reasonably contemplated by investors.”\textsuperscript{82} This helped create an environment where, according to the SEC, “violations of law or material weaknesses in controls” related to fees and expenses were observed in more than half of the funds that were examined.\textsuperscript{83} The SEC also indicated other areas where lack of clarity in the LPA gave managers too much discretion in their interactions with investors, including with respect to asset valuation, fund investment strategies, and protocols for mitigating conflicts of interest.\textsuperscript{84}

The SEC also criticized the light disclosure requirements set forth in LPAs. SEC examiners found that LPAs did not provide investors with sufficient information rights to be able to monitor their investments adequately, and that they had broad, imprecise language which enabled managers to be opaque in areas where investors would benefit from transparency.\textsuperscript{85} This was, from the SEC’s perspective, the most important finding of the examination initiative, reinforcing the view of academics that poor disclosure has compounding effects that weaken other forms of investor protection in private equity funds.\textsuperscript{86}

All in all, the SEC’s comments were a sweeping rebuke of common practices throughout the private equity industry, and they pointedly questioned the adequacy of the LPA as a source of investor protection.

\textsuperscript{81} In this Article, I focus on the SEC’s claim that private equity fund LPAs are deficient. To be sure, the SEC’s remarks also condemned a number of activities that clearly breached LPA terms. In those cases, the problem had to do with the manager’s conduct, not with shortcomings in the LPA that permitted managers to engage in harmful conduct. This Article is interested in the latter.

\textsuperscript{82} Bowden, \textit{Spreading Sunshine in Private Equity}, supra note 79 (“Many limited partnership agreements are broad in their characterization of the types of fees and expenses that can be charged to portfolio companies (as opposed to being borne by the adviser). This has created an enormous grey area, allowing advisers to charge fees and pass along expenses that are not reasonably contemplated by investors.”).

\textsuperscript{83} \textit{Id.} (“When we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of law or material weaknesses in controls over 50% of the time.”).

\textsuperscript{84} \textit{Id.} (“We’ve also seen limited partnership agreements lacking clearly defined valuation procedures, investment strategies, and protocols for mitigating certain conflicts of interest, including investment and co-investment allocation.”).

\textsuperscript{85} \textit{Id.} (“[M]ost importantly, we see that most limited partnership agreements do not provide limited partners with sufficient information rights to be able to adequately monitor not only their investments, but also the operations of their manager. Of course, many managers voluntarily provide important information and disclosures to their investors, but we find that broad, imprecise language in limited partnership agreements often leads to opaqueness when transparency is most needed.”).

\textsuperscript{86} See supra notes 64-65.
B. The Industry’s Negotiation-Based Defense

In response to the various critiques levied against LPAs, the private equity industry\(^87\) has frequently defended itself by arguing that these agreements are highly-negotiated documents.\(^88\) This claim, which I call the “private equity:

\(^{87}\) References to the “private equity industry” in this Article refer primarily to private equity industry trade groups, including the American Investment Council (formerly known as the Private Equity Growth Capital Council), a national trade association, and the Association for Corporate Growth, a trade association focused on middle-market private equity. See https://www.investmentcouncil.org/ and https://www.acg.org/, respectively.

\(^{88}\) See, e.g., Chris Flood, SEC Issues Fresh Warning to Private Equity, FIN. TIMES (May 31, 2015) (“Steve Judge, chief executive of the Private Equity Growth Capital Council, a trade body, said agreements between private equity managers and institutional investors were ‘the result of highly negotiated terms between sophisticated parties.’”); Neil Weinberg and Darrell Preston, Look Who’s Coming to Private Equity’s Defense on Fee Secrecy, BLOOMBERG BUSINESSWEEK (Aug. 25, 2016) (“The terms of industry contracts are negotiated over months between sophisticated parties,’ says James Maloney, a spokesman for the American Investment Council, a private equity trade group in Washington.”); Steve Judge (CEO of the Private Equity Growth Capital Council), Confidentiality of Limited Partnership Agreements is Paramount, PE HUB NETWORK (Nov. 3, 2014), https://www.pehub.com/2014/11/confidentiality-of-limited-partnership-agreements-is-paramount/ (“LPAs are highly negotiated agreements between sophisticated parties and, in the case of public pensions, are entered into by individuals who have a fiduciary duty to act in the best interests of beneficiaries. So it goes beyond reason to believe that they would enter into any agreement that would violate that duty.”); Morgenson, Not the Fees supra note 76 (“Asked about the SEC’s criticisms, Steve Judge, chief executive of the Private Equity Growth Capital Council, the industry’s lobbying group, said in a statement: ‘Every private equity fund agreement is negotiated by professional investment managers on both sides, creating an alignment of interests that consistently delivers the best returns — net of fees — of any asset class over the long-term.’”); Jason Mulvihill (General Counsel of the American Investment Council), Standardization in PE: Needed Trend or Impractical Solution in Search of a Problem?, American Investment Council’s “State of the Industry” (Fall 2017) (“Calls for greater standardization of private equity documents frequently derive from a misunderstanding about the inherent transparency and long-standing success of funds vis-à-vis their investors. As a general proposition, bespoke partnership agreements reflect extensive negotiations between fund sponsors and their sophisticated investors and have served investors and managers well.”); Steve Judge (CEO of the Private Equity Growth Capital Council), Private Equity and Pensions: A Strong Partnership, PE HUB NETWORK, https://www.pehub.com/2015/06/private-equity-and-pensions-a-strong-partnership/ (“[Pension plans] understand very well the investments they are making: They receive extensive disclosure, conduct due diligence, heavily negotiate essentially every aspect of a fund’s terms before investing, and pension funds take very seriously their responsibilities to the pensioners they represent.”); Analysis: New York AG’s Private Equity Probe May Have Little Bite, REUTERS (Sept. 6, 2012), https://www.reuters.com/article/us-private-equity-tax-idUSBRE88606E20120907 (“‘Management fee waivers are legal, widely recognized, and often part of negotiated agreements between the alternative investment community and investors, including pension funds and endowments,’ said Steve Judge, president of Private Equity Growth Capital Council, the industry’s lobby group.”’); Association for Corporate Growth (private equity trade group), Private Equity Regulatory & Compliance Principles (2017) (“Terms relating to disclosures and reporting in fund LPAs and side letters are highly negotiated, and reflect the mutually-agreed upon terms between the manager and the limited partners. . . . Firms enter into a highly-negotiated LPA with their investors, which may describe the valuation process to be used for that particular fund.”); Stephen Beale, Firms Paid Millions to Manage Rhode Island Pension Money They Didn’t Have, GOLocal PROVIDENCE NEWS (July 9, 2015), https://www.golocalprov.com/news/firms-paid-millions-to-manage-ri-pension-money-they-didnt-have (quoting James Maloney, spokesman for
negotiation myth,” draws on common perceptions about the way that LPAs are created. In effect, this is a process-based response to the substantive criticisms that have been brought against private equity fund LPAs. Rather than seek to establish that the terms of LPAs themselves are substantively fair, by invoking the private equity negotiation myth, private equity industry representatives are arguing that the process by which the terms were generated is fair. In other words, the industry has sought to use a process-based argument to tell critics that there is “nothing to see” in private equity fund LPAs.

While negotiation is not the only process by which fair terms can be created in a contract, evidence of robust negotiation between knowledgeable and properly incentivized parties would certainly create a strong presumption that neither party is taking advantage of the other. Classical contract theory holds that unrestricted freedom of contract between parties that possess equal bargaining power, skill, and knowledge of relevant market conditions maximizes individual welfare and promotes the most efficient allocation of resources in the marketplace.

the Private Equity Growth Capital Council, as saying, “Limited partners, such as pension funds, incentivize private equity managers to locate the best returns for them. . . . All of this is negotiated and explicitly agreed upon in the limited partner agreement.”); Association for Corporate Growth (private equity trade group), SEC Task Force Survey (2014) (“The allocation of fees and expenses between the general partner of a fund and the limited partners is highly negotiated and memorialized in a formal limited partnership agreement, or LPA.”); American Investment Council Comment Letter re: Adviser Business Continuity and Transition Plans, SEC Release No. IA-4439, File No. S7-13-16 (Sept. 6, 2016) (“[T]he limited partnership agreements governing fund operations contain specific, negotiated provisions concerning changes in management and ownership and the liquidation of the fund, which we believe accurately reflect what investors expect to happen in times of stress or transition.”); See Comment Letter from the American Investment Council to the SEC, Feb. 25, 2019, https://www.sec.gov/comments/s7-09-18/s70918-4970860-182100.pdf (“[T]he terms of the LPA are determined after a robust negotiation process that results in the private equity fund sponsor and the fund’s limited partners agreeing on the terms of an investment fund in advance of their admission to the fund.”).

89 See, e.g., Dan Primack, Why the SEC is Investigating Private Equity, FORTUNE (Apr. 8, 2014) (“When private equity firms raise a fund, they sign ‘limited partnership agreements’ (‘LPAs’) with each of their investors. . . . LPAs differ from firm to firm, and almost always are highly negotiated.”); Samuel Nadler, Note: Federal Fiduciary Duties and Private Equity: The Search for Workable Standards, 2018 COLUM. BUS. L. REV. 254 (2018) (“The “one-size-fits-all” approach embodied by the SEC’s enforcement of federal fiduciary standards fails to take into account the intricate and heavily negotiated legal relationships found in LPAs.”).

90 See infra Section III.B.1.


92 See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 72 cmt. b (1981) (“Bargains are widely believed to be beneficial to the community in the provision of opportunities for freedom of individual action and exercise of judgment and as a means by which productive energy and product are apportioned in the economy. The enforcement of bargains rests in part on the common belief that enforcement enhances that utility.”).
If private equity fund LPA terms are the product of a fair process, it would suggest that the criticisms of LPAs by scholars and policymakers might be overblown. How could this be the case? One explanation could be that the vague and open-ended terms in LPAs are that way simply because private equity funds typically last a long time and are therefore necessarily incomplete contracts. Trying to foresee all of the many contingencies that can arise over a fund’s ten-year life-span, let alone crafting contractual arrangements for each of those contingencies, can be very difficult and costly. In the case of portfolio fees, for example, it could be the case that at the time of contracting, investors and managers lack the information necessary to fully determine the appropriate amount of compensation, and that some amount of flexibility and discretion is needed. This would be consistent with findings in the procurement literature, which highlights the importance of allowing agents to charge ex-post adaptation costs. Another explanation for vague terms could be grounded in measurement and verification challenges. It could be the case that the level of performance which the investors and manager jointly deem satisfactory is more complex and/or nuanced than courts will be able to discern. Rather than run the risk of courts misinterpreting the parties’ intentions, parties may prefer to put vague standards in the LPA and rely on reputational incentives instead of terms that can be litigated.

93 To be clear, this Article is focusing on criticisms of LPAs themselves, not on criticisms of other activities by managers that could be viewed as breaches of LPA terms.
95 For early work discussing the relationship between transaction costs and incomplete contracts, see e.g., Oliver Williamson, Transaction-Cost Economics: The Governance of Contractual Relations, 22 J.L. & ECON. 233 (1979); R.A. Dye, Costly Contract Contingencies, 26 INTL. ECON. REV. 233 (1985).
96 See, e.g., Phalippou, Rauch & Uember, Portfolio Company Fees, supra note 57 (“For example, five years after the LPA is signed, there may be an unexpected hike in the cost of executing or monitoring LBOs.”).
98 In certain kinds of arrangements, it will be difficult for the parties to specify their respective duties in the contract such that they can be verified by a third party like a court. In these cases, rather than leave enforcement of the parties’ obligations to a court whose decisions may be unpredictable or incorrect, parties may prefer to rely on their own methods of recourse, including the parties’ incentive to maintain a good reputation and ability to walk away from doing further business with the counter-party. See Douglas Bernheim & Michael D. Whinston, Incomplete Contracts and Strategic Ambiguity, 88 AMER. ECON. REV. 902 (1998).
Plausible explanations for some of the other controversial elements of private equity LPAs can also be imagined. Accordingly, evaluating process rather than substance in this area may not actually be a bad idea. Judging the substantive quality of LPA terms as an outside observer is inherently difficult, and no outside critic can claim to know what the optimal substantive terms for every LPA should be (though many, as shown above, have certainly weighed in\(^99\)). Having an accurate understanding of the process by which LPA terms are generated is critically important when making these kinds of process-based assessments.

III. **DEBUNKING THE MYTH**

The private equity industry’s frequent invocation of the negotiation myth\(^100\) demands a closer look at the role of bargaining power and negotiation in private equity funds. The myth assumes that investors with bargaining power in private equity funds use their bargaining power to demand robust and adequate LPA protections. This Part challenges that assumption.\(^101\)

A. Large Investors Cannot Be Counted on to Negotiate LPAs

1. Why Large Investors Have Bargaining Power

Before we can assess how investors use bargaining power, we first need to identify which investors have bargaining power. Because the securities laws establish minimum net worth requirements for investing in a private equity fund,\(^102\) “ordinary” people typically do not invest in private equity funds. The

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\(^99\) See Sec. II.A.1.

\(^100\) See supra note 88 and accompanying text.

\(^101\) A description of various forms of individualized benefits that can be negotiated for in private equity funds can be found in Section III.D.

\(^102\) The current minimum standards for investing in private equity funds are rooted in private equity managers’ desire to avoid registering under the federal securities laws, as registration imposes obligations on managers that are costly and incompatible with the business plan and management structure of a typical private equity fund. See Schell, et al., *Private Equity Funds*, supra note 38 at § 8.03 (“[T]he substantive requirements imposed on registered investment companies are not compatible with the business plan and management structure of a typical private equity fund.”). To avoid registration under the Securities Act of 1933, all of a fund’s investors typically must be “accredited investors” meeting certain net worth thresholds ($5 million for most entities and $1 million for individuals). See 17 CFR 320.501(a) for the formal definition of “accredited investor.” Registration under the Investment Company Act of 1940 (the “Investment Company Act”) can be avoided if a fund has fewer than 100 investors or, alternatively, if a fund’s investors are all “qualified purchasers”\(^103\) who satisfy a different set of net worth thresholds (generally $25 million for entities and $5 million for individuals). See Section 3(c)(1) of the Investment Company Act (which imposes no sophistication requirements as long as the fund has fewer than 100 investors) and Section 3(c)(7) of the Investment Company Act (which allows a fund to raise an unlimited amount of money from an unlimited number of investors if they are all “qualified purchasers”). Various other exemptions to the Investment Company Act exist, but these are the most commonly used. Furthermore, if managers want to charge carried
securities laws do, however, allow for an extremely wide range of investors. On one hand, private equity fund investors can include individuals like entrepreneurs, doctors, and lawyers, and small institutions like modestly-sized pension plans, endowments, and foundations (as long as they have at least $5 million in assets). By contrast, the ten institutions with the greatest exposure to private equity in 2017 each had between $21 billion and $52 billion allocated to the private equity asset class and total assets in the hundreds of billions. When compared with the largest investors, investors that would seem quite substantial in any other context will be relatively small in many private equity funds.

Large investors generally have greater bargaining power when they make investments in a private equity fund. When managers know that an investor has a large amount of capital that could be invested in the manager’s future funds or other product offerings, they will be more inclined to accommodate its requests in order to keep that investor happy. In addition, larger institutions that make a higher volume of private equity investments are more likely to have a larger investment team available to negotiate their private equity fund investments.

Large investors are also more likely to make large investments in each individual fund that they invest in. The size of an investment has two important...

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footnotes:


104 Available evidence suggests that small institutional investors, which often invest on behalf of middle class workers, universities, and charitable institutions, are regular investors in today’s private equity funds. See, e.g., “Endowment Plans’ Private Equity Allocation by Assets Under Management,” Prequin (Jan. 2016), available at https://www.prequin.com/blog/0/13413/endowments-in-private-equity (reporting the results of a survey showing that small endowments with less than $500 million in assets represented 60% of the number of all endowment plans investing in private equity funds, but only 6% of the total capital invested by endowments in private equity).

105 See 2017 PREQIN GLOBAL PRIVATE EQUITY & VENTURE CAPITAL REPORT at 93 [hereinafter 2017 PREQIN GLOBAL REPORT].

106 See Andonoy, Bauer & Cremers, Can Large Pension Funds Beat the Market?, supra note 103 (finding that “larger funds can assert more negotiation power in alternative asset classes”).

107 Many private equity managers offer different funds focusing on a wide range of strategies and industries. See Andrew Tuch, The Remaking of Wall Street, 7 HARV. BUS. L. REV. 315 (2017) (noting the expansion and diversification of private equity firm activities); Helen Thomas, Carlyle Buys 55% in Credit Investor Claren Road, FIN. TIMES (Dec. 6, 2010) (quoting a commentator as saying, “Many of the world’s biggest private equity groups are diversifying geographically and pushing into different asset classes as they seek to enlarge the range of products they can offer investors.”).

108 See Morris & Phalippou, New Approach to Private Equity, supra note 54 (“Many private equity investors are small. They may have just one person allocating capital to private equity, who may also be responsible for other alternative investments. These institutions may simply lack the resources to benchmark complex contracts, performance data and the like.”).
effects. First, it increases an investor’s bargaining power with a fund manager because that manager will have more to lose if the investor chooses not to make the investment. Second, when an investor makes a larger investment in a fund, that investor will find it easier to justify spending on legal and other advisory expenses necessary to negotiate the terms of that investment. For example, if an investor makes a $100 million investment in a fund, spending $50,000 in legal fees to negotiate the terms of that investment will repay itself if it leads to a 0.05% increase in the value of the investor’s overall investment. But if an investor is making a $100,000 investment in a fund, spending $50,000 in legal fees will only make sense if it generates at least a 50% increase in the value of the investor’s overall investment—which is clearly far less likely to happen.

2. **Large Investors Have Weak Incentives to Negotiate LPA Terms**

A closer look at how investors use their bargaining power reveals a fundamental flaw in the private equity negotiation myth: private equity LPAs, it turns out, are unlikely to be highly-negotiated after all. This is because large investors have strong incentives to use their bargaining power to negotiate for personal benefits—benefits that they do not need to share with other investors in the funds—before they exhaust their bargaining power on the terms in the LPA.

Why is this? Unlike large investors in a corporation, it is common for large private equity fund investors to be able to negotiate for various forms of individualized benefits in private equity funds, where the benefit of the negotiated bargain is not shared with other investors in the fund. These benefits are typically documented in a “side letter” to the LPA, which modifies the terms of the LPA as they apply to the investor that is the recipient of the side letter.

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109 This assessment is consistent with anecdotal observations by Leo Strine (Chief Justice of the Delaware Supreme Court) and Travis Laster (Vice Chancellor of the Delaware Chancery Court). See Strine and Laster, *Siren Song of Contractual Freedom*, supra note 21 (“Based on the cases we have decided and our reading of many other cases decided by our judicial colleagues, we do not discern evidence of arms-length bargaining between the sponsors of the alternative entities and the investors in the governing instruments of alternative entities that raise capital from diverse investors. . . . [B]argaining, at best, occurs only sometimes.”).

110 To be clear, I am not saying that LPAs are *never* negotiated. Rather, I am saying that LPA terms are unlikely to be a very high priority when large investors are deciding how to use their bargaining power.

111 See *supra* note 12.

112 Part III.D provides a short summary of many of the individualized benefits that large investors can negotiate for in private equity funds.

113 See Schell, et al., *Private Equity Funds*, *supra* note 38 at § 11.14 (“A side letter is an agreement between a Fund and one of its investors, which establishes a series of investment terms that supplement or modify the terms of the partnership agreement with respect to that investor.”). Because separately managed accounts are distinct entities from any pooled funds, they typically have their own LPAs and therefore are not provided for in side letters.
If we assume that large private equity fund investors have a finite amount of bargaining power, and that they want to use their bargaining power in a manner that maximizes their personal benefit, negotiating for strong fund-wide protections will usually be an inefficient use of that bargaining power. Instead, a large investor will generally be better off using its bargaining power to obtain as many individualized benefits as possible before it “spends” its bargaining power on benefits that other investors will also enjoy. In this context, an “efficient” use of bargaining power refers to one that achieves as much personal benefit as possible in return for the investor’s bargaining power.

This claim is grounded in the idea that whenever an investor seeks a term in an LPA that would benefit all investors in the fund, it will generate what I call “asymmetric benefits and losses” between the large investor and the manager. Asymmetric benefits and losses happen anytime the negotiating investor would enjoy only a fraction of the benefit provided by a requested LPA protection (because that investor holds only a partial ownership interest in the fund), while the manager would bear the whole corresponding cost of that protection. Even though an investor may be able to persuade a manager to grant concessions that have asymmetric benefits and losses, more of that investor’s bargaining power will be exhausted in the process. In other words, the greater the loss that a requested protection will inflict on a manager, the more bargaining power a large investor will have to spend to obtain that protection.

For example, consider a case where a large investor wants to insert a term into the LPA stating that the manager’s fiduciary duties to investors under state law have not been waived or modified by any provisions in the LPA. Let’s assume that this term will restrict the manager’s activities in a manner that will result in a $1 million loss for the manager over the life of the fund and a $1 million gain for the overall fund. However, because the requesting investor only owns a portion of the pooled fund, that investor will only enjoy a fraction of the benefit generated by this affirmation of the manager’s fiduciary duties. For example, if the negotiating investor owns a 20% interest in the fund, bargaining for this affirmation will generate a $200,000 benefit for the negotiating investor and will impose a $1 million loss on the manager, as illustrated in Figure C below.

114 The validity of this premise seems self-evident. When a manager negotiates with a large investor, it will be willing to make certain concessions to that investor due to its size and influence. However, at the point when the requested concessions outweigh the expected benefit that the manager expects to receive from the large investor’s investment, the manager will push back on the request and/or reject the investor’s investment.

115 See supra notes 69-71 and accompanying text for a discussion of the common practicing of modifying and waiving fiduciary duties under state law.
If, however, instead of requesting an LPA provision that affirms the manager’s fiduciary duties, the large investor were to ask the manager to give it the expected value of the affirmation ($200,000) in the form of an individualized deal that is not shared with other investors, the picture looks different. In such a scenario, none of the value created by that negotiation would benefit free riders, and the large investor would be equally well off, as illustrated in Figure D below. This is clearly a more efficient use of the large investor’s bargaining power.

The same logic applies when there are multiple investors that request an LPA affirming the manager’s fiduciary duties. For example, in Figure E below, in addition to the 20% investor, there are also three investors who each own 10% of the interests in the fund who request an affirmation of the manager’s fiduciary duties in the LPA. Even though multiple investors are requesting the affirmation in this example, free riders still consume half of the benefit that is generated by the term. As a result, none of these investors will receive the full benefit of the bargaining power that they “spend” by negotiating for the affirmation of the manager’s fiduciary duties. Each of them thus has a strong incentive to use their bargaining power to negotiate for individualized benefits rather than for an affirmation of the manager’s fiduciary duties.

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116 A large investor could, for example, negotiate to pay less in management fees by an amount that “offsets” the expected harm from the manager breaching its fiduciary duties. If this provision only benefits the large investor, it would consume less of the investor’s bargaining power than an LPA term that affirms the manager’s fiduciary duties.
At this point, readers familiar with the private equity fund contracting process might insist that the benefits conveyed in side letters often are not truly “individualized” because other investors in the fund will sometimes have “most favored nation” rights. A most favored nation (“MFN”) right is typically granted in an investor’s side letter, and it gives that investor the right to see side letters granted to other investors in the fund and to receive the same rights and privileges given in those side letters. However, MFN provisions usually only entitle an investor to receive the rights and privileges given to investors who have made investments in the fund of equal or lesser value.117 Because of this, the logic above still applies even when investors have MFN rights—investors will still strongly prefer to use their bargaining power to negotiate for side letter benefits before they negotiate for LPA terms.

Let’s see how the incentives of the investors in our hypothetical fund—with one 20% investor, three 10% investors, and an assortment of smaller investors—change when all investors in the fund have MFN rights that entitle them to receive the rights given to other investors making similarly-sized investments. The 20% investor is the simplest case. This investor’s incentives are completely unaffected because no other investors in the fund will be entitled to receive the side letter terms that it negotiates for. As a result, any benefits that the 20% investor receives in a side letter are truly “individualized” because no free riders will get the benefit of them.

However, if one of the 10% investors negotiates for a side letter benefit, the MFN right will kick in for investors that have made investments in the fund of the same or greater size. In this case, both of the other 10% investors and the 20% investor will have a right to receive the same benefit. In this case, if the negotiating 10% investor bargains for a side letter benefit worth $100,000 in value, it will result in $100,000 in value also going to the 20% investor and to each of the 10% investors, who get to free ride on the negotiation thanks to their

117 See Schell, et al., Private Equity Funds, supra note 38 at § 11.14 (“An MFN provision usually requires the sponsor to provide similarly-situated investors (i.e., those with equivalent capital commitments or regulatory circumstances) the opportunity to elect to receive the rights and benefits provided via side letter to other investors in the same fund.”).
PRIVATE EQUITY NEGOTIATION MYTH

MFN rights. Effectively, the negotiating investor will “spend” $400,000 of bargaining power to obtain a $100,000 benefit, with $300,000 going to free riders with MFN rights. This is illustrated in Figure F below.

Accordingly, if the negotiating 10% investor is deciding between negotiating for a fiduciary duty affirmation in the LPA worth $1 million for the fund and a side letter benefit worth $100,000, the side letter benefit will still be a far better use of that investor’s bargaining power. Whereas the side letter benefit will result in $300,000 in value going to free riders, the affirmation in the LPA will result in $900,000 in value going to free riders. This is illustrated in Figure G below.

The analysis above does not suggest that large investors do not review the protections in LPAs or that they are indifferent to them. What it does show is that if a large investor can quantify the expected cost of a weak LPA protection, it has strong incentives to use its bargaining power to recover that expected lost value through individualized benefits before it seeks to negotiate for a more robust protection in the LPA. Only after the universe of potential individualized benefits has been exhausted will it make sense for a large investor to seek to negotiate for improved protections in the LPA.

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118 This assumes that no other investors are demanding the same LPA term.
Of course, the strength of this incentive will differ from fund to fund, depending on the size of the fund and the availability of individualized benefits. In general, the larger a fund, the greater the disincentive to negotiate the terms in that fund’s LPA. As an individual investor’s percentage interest in a fund goes down, the more free riders there will be who benefit when that investor negotiates for an improved LPA term. For example, consider a fund with only two investors (let’s call them Investor 1 and Investor 2) that each have a 50% interest in the fund. In this fund, the disincentive to negotiate will be relatively weak. If Investor 1 negotiates for an LPA term affirming the manager’s fiduciary duties, for example, 50% of the value from Investor 1’s negotiation will go to Investor 2, who did not negotiate for that term. By contrast, if the fund is much larger and Investor 1 only holds a 5% interest in it, 95% of the value from Investor 1’s negotiation will go to the fund’s other investors. This will be a much less efficient use of Investor 1’s bargaining power, and Investor 1 will have even stronger incentives to negotiate for individualized benefits before it seeks to negotiate LPA terms.\textsuperscript{119}

3. *Most Important Protections Are Least Likely to Be Negotiated When There Is Information Asymmetry*

Of course, notwithstanding the incentives described above, it is true that some large investors will sometimes seek to negotiate certain LPA terms.\textsuperscript{120} However, due to managers’ incentives, we can expect that the *most important* protections in LPAs will be the ones that are *least likely* to be negotiated when the manager has better information about the true value of an LPA’s various protections.

For example, in the fiduciary duty affirmation scenarios discussed above, we assumed that the bargaining investors and the manager knew the relative costs and benefits of the protection—such that all bargaining parties knew that the fiduciary duty affirmation would impose an expected cost on the manager of $1 million and would bring an expected benefit of $1 million to the fund investors collectively. But this assumption might not always be true. Consider an example where the manager expects to breach its fiduciary duties in a manner that would result in a $5 million loss to the fund (and a $5 million gain for the manager), but the bargaining investors think it will only result in a $1 million loss.\textsuperscript{121} Under these circumstances, the manager will have strong incentives to respond to any requests for a fiduciary duty affirmation in the LPA with an individualized counter-offer. In this case, if the manager were to offer the requesting investor an individualized benefit worth $1 million instead of adding a fiduciary duty

\textsuperscript{119} This is a form of collective action problem in private equity funds that gets worse as the fund gets bigger.
\textsuperscript{120} Even when negotiation does occur, the extent and intensity of negotiation is likely to be significantly diminished for the reasons discussed in Section III.A.2.
\textsuperscript{121} This could be related to potential conflicts of interest or other issues implicating fiduciary duties that the manager anticipates facing in the future, but which are not apparent to investors now.
affirmation to the LPA, the manager would be $4 million better off than if it had granted the fiduciary duty affirmation in the LPA.

The general idea here is that when a protection would restrict an activity that the manager actually expects to engage in, the manager will be more reluctant to agree to provide that protection in the LPA, and more likely to counter-offer with an individualized benefit. With these protections, the manager has more to lose from granting the robust LPA protection, and the fund investors as a whole have more to gain from including the LPA protection (even though they do not know it). As a result, it is precisely the most important terms in the LPA—the ones that protect against activities that are most likely to extract value from the fund—that are the least likely to be negotiated.

B. Large Investors Cannot Be Counted on to “Vote with Their Feet”

The private equity negotiation myth assumes that large investors will use their influence to ensure that LPAs have high-quality protections. Above, I challenged the idea that large investors actually negotiate very hard for better fund protections. But more analysis is needed. Even if large investors are unlikely to negotiate LPAs, they could still be wielding influence by choosing to walk away from funds that have weak terms. Because large investors make large investments, managers might still be sensitive to their preferences even if they are not actively negotiating for their demands.

Below, I show why large investors cannot be counted on to wield this kind of non-bargaining influence either. In private equity funds, when large investors have bargaining power, it makes them less sensitive to the quality of LPA protections because it enables them to negotiate for individualized benefits that offset the harm caused by weak protections. This will make them more willing to invest in funds with sub-optimal protections. As a result, the marginal investors in private equity funds may often be ones that lack bargaining power, not the ones that have it.

1. How Contract Terms Are Shaped in the Absence of Negotiation

The vast majority of commercial contracts in the modern economy are not negotiated. But this does not necessarily mean that they have unfair terms. Throughout the marketplace, parties frequently sign contracts without negotiating their terms, opting instead to make take-it-or-leave-it decisions based on the quality of the offered terms and the seller’s reputation.

In contracting settings where the parties do not negotiate, the quality of a contract’s protections are shaped by the preferences of that market’s “marginal”

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122 See John J.A. Burke, Contract as Commodity: A Nonfiction Approach, 24 SETON HALL LEGIS. J. 285, 290 (2000) (“[I]n an advanced economy the standard form contract accounts for more than 99% of all contracts used in commercial and consumer transactions for the transfer of goods, services and software.”).
buyers.\textsuperscript{123} Marginal buyers are those that care most about the contractual protections and are most likely to stop buying a product when the quality of the contractual protections go down.\textsuperscript{124} Accordingly, when the protections in a private equity fund LPA are not negotiated, the quality of those protections will be determined by how sensitive the industry’s marginal investors are to LPA protections.\textsuperscript{125}

If the marginal investors in private equity funds are informed and rational, it means that less informed and less rational investors can also invest in private equity funds without upsetting the quality of the contract’s terms. These infra-marginal investors can effectively “free ride” on the marginal investors, enjoying the benefit of high-quality LPA protections even if they would have been willing to buy the product with lower-quality terms.\textsuperscript{126} Identifying the marginal investors in private equity funds thus has important policy ramifications.

2. \textit{Large Investors Won’t Always Be the Marginal Investors}

For the reasons mentioned above, even if large investors are not actively negotiating the terms of LPAs, they could still be regulating the quality of LPA protections by consistently choosing to “vote with their feet” by walking away from funds with weak protections. If this is true, then the private equity negotiation myth may not be so misleading after all. The myth might get the details wrong by focusing on the act of negotiation, but lead to the right conclusion by saying that large investors are demanding (in one way or another) high-quality LPA protections.

Unfortunately, this is too generous. In reality, large investors cannot be relied on to serve as the marginal investors with respect to LPA protections in

\textsuperscript{123} This assumes that the market is competitive. See Cole, \textit{Rational Consumer Ignorance}, supra note 15 (“[N]on-price terms, like price terms, are ‘policed’ in competitive markets by the marginal consumer for each term. Competitors failing to capture the marginal consumer for such terms under competitive market conditions suffer the same fate as sellers who fail to compete on price.”).

\textsuperscript{124} See supra note 16 and accompanying text.

\textsuperscript{125} See Richard Craswell, \textit{Passing on the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships}, 43 STAN. L. REV. 361 (1991) (“In markets where different consumers attach different values to a warranty, the size of the accompanying price increase will be determined largely by the valuations held by those consumers who are on the margin between buying or not buying the product/warranty package. These consumers, the marginal consumers, will stop buying the package if its price rises; consequently, the willingness to pay of marginal consumers will determine how high the price of the combined package will rise.”).

\textsuperscript{126} See Michael J. Trebilcock, \textit{The Limits of Freedom of Contract} 120 (1993) (“To the extent that there is a margin of informed, sophisticated, and aggressive consumers in any given market, who understand the terms of the standard form contracts on offer and who either negotiate over those terms or switch their business readily to competing suppliers offering more favourable terms, they may in effect discipline the entire market, so that inframarginal (less well informed, sophisticated, or mobile) consumers can effectively free-ride on the discipline brought to the market by the marginal consumers . . . .”); Alan Schwartz, \textit{How Much Irrationality Does the Market Permit?}, 37 J. LEG. STUDIES 131 (2008) (finding that “when enough consumers are sophisticated and the naïve have a relatively low willingness to pay for their preferred contract, exploitative contracts decline in frequency and may actually vanish”).
private equity funds. A close evaluation reveals that when large investors have bargaining power, it makes them more likely to tolerate funds with weak terms than if they had no bargaining power at all. To illustrate, imagine an investor called Investor A. Investor A requires a total expected net present value ("NPV") of $100,000 from investing in Fund Z or it will walk away from making the investment. Before considering the effect of sub-optimal LPA protections, an investment in Fund Z has an expected NPV of $200,000, as illustrated in Figure H below.

However, Fund Z has sub-optimal LPA protections which bring down the expected NPV of an investment in Fund Z by $175,000. These sub-optimal protections could include, for example, an open-ended provision allowing Fund Z’s manager to charge unlimited portfolio company fees and an explicit waiver of the Fund Z manager’s fiduciary duties. This brings the expected NPV of an investment in Fund Z down to $25,000, which is well below Investor A’s walk-away point. This is illustrated in Figure I below, with the red rectangle representing the lost expected value resulting from sub-optimal terms.

Because the concept of a marginal investor is theoretical, it is impossible to determine with certainty who the “true” marginal investors are in any particular market. See Cole, *Rational Consumer Ignorance*, supra note 15 (The marginal consumer—that one consumer for whom all of the suppliers compete—is unknown to the suppliers. All they know is that the marginal consumer is out there.”).
If Investor A does not have any bargaining power, the sub-optimal protections in Fund Z’s LPA will certainly cause Investor A to walk away from an investment in Fund Z. The harm from the sub-optimal protections in Fund Z’s LPA bring the expected NPV of Fund Z far below Investor A’s walk-away point.

This conclusion can change, however, if Investor A has bargaining power. As discussed above, if Investor A has bargaining power, she will have strong incentives to use it to negotiate for individualized benefits before she directly negotiates to improve the LPA protections in Fund Z. If Investor A can negotiate for individualized benefits—in the form of fee discounts, rights to co-investment opportunities, or otherwise—of at least $75,000, she will go ahead and invest in Fund Z despite its weak LPA protections. When her individualized benefits exceed $75,000, Investor A’s expected NPV from investing in Fund Z will exceed her break-even point of $100,000. Thus, even though Investor A would have walked away from Fund Z if she lacked bargaining power, there is a good chance that she will proceed with the investment if Fund Z’s manager is willing to grant individualized benefits when Investor A requests them.

Now consider Investor B. Investor B is smaller than Investor A. She has no bargaining power to negotiate for individualized benefits. She also has fewer attractive outside investment opportunities than Investor A, so she is willing to accept a lower expected NPV for her investment in Fund Z—$50,000—before she will walk away from making the investment. This is illustrated in Figure J below.

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Figure I

Expected NPV of Fund Investment
(Harm from Weak Terms Subtracted)

$200K

$100K

$25K

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128 See supra Section III.B.
129 See supra Section III.D.
However, after the harm caused by the sub-optimal terms in Fund Z’s LPA is taken into consideration, the expected NPV of investing in Fund Z of $25,000, which is lower than Investor B’s walk-away point of $50,000. This is illustrated in Figure K below.

Since Investor B does not have bargaining power to negotiate for any individualized benefits that would offset the harm caused by the sub-optimal terms, Investor B really will walk away from Fund Z, unlike Investor A.

The examples above show how bargaining power can cause investors to tolerate weaknesses in LPAs that they otherwise would not tolerate. In this case, without bargaining power, Investor A would have been more sensitive than Investor B to weaknesses in Fund Z’s LPA because her walk-away threshold was much higher than Investor B’s. But because she can negotiate for individualized benefits, Investor A can get comfortable with investing in Fund Z if the manager is willing to grant her a relatively modest amount of individualized benefits.  

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130 This assumes that Investor A can obtain at least $75,000 in individualized benefits, as the example shows.
Investor B, by contrast, will definitely walk away from Fund Z, despite the fact that Investor B’s walk-away point is so much lower than Investor A’s.

Because of this, it cannot be assumed that the largest investors in private equity funds are the ones that always shape the quality of LPA protections. Not only are large investors unlikely to use their bargaining power to negotiate for strong LPA protections, but their bargaining power can also make them less sensitive to the quality of LPA protections and less likely to walk away from funds with weak terms. This means that the marginal investors in private equity funds may often be investors that lack bargaining power, rather than those that have it. 131 Thus, by focusing attention on large investors, the private equity negotiation myth directs us to look in the wrong places when evaluating whether investors are likely to demand adequate protections in LPAs.

C. Forms of Individualized Benefits in Private Equity

The incentives described in Sections III.A and III.B above will only exist when large investors can negotiate for individualized benefits. To the extent that a fund’s manager refuses to grant or otherwise limits individualized benefits, large investors will be more likely to demand strong LPA protections. However, available data suggests that individualized benefits are quite common in the private equity fund industry and are therefore likely to play a significant role in shaping large investors’ incentives. These individualized benefits can take various forms. Below, I briefly describe some of the individualized benefits that managers commonly grant to investors in side letters. 132

1. Fee Discounts

Fee discounts are a standard practice in the private equity marketplace. 133 Fee terms are commonly viewed as the most heavily-negotiated terms when investors make investments. 134 Large investors most commonly negotiate for discounts to management fees, but discounts to carried interest are sometimes
granted as well. Fee discounts are entirely legal as long as managers disclose the possibility of differential fee treatment to the fund’s investors. Unlike contractual protections that benefit all investors in a fund, a large investor will internalize the full benefit of a fee discount that is not shared with other investors.

2. Co-Investments

“Co-investing” describes arrangements where a manager invites large investors to invest alongside the pooled fund in portfolio companies that the pooled fund is investing in. Co-investments are commonly structured through co-investment vehicles that aggregate the capital of multiple co-investors for one or more deals. Co-investment rights are commonly granted to investors that are already participating in a manager’s fund through those investors’ side letters. In such cases, the investor gains exposure to portfolio companies in two ways—first, through its interest in the fund (which invests in the portfolio company), and second, through its “co-investment” directly in the portfolio company.

Co-investments are attractive to investors because managers typically charge much lower fees on co-investments than they charge for investments in their pooled funds, with many co-investments offered on a fee-free basis. As a result, co-investments commonly outperform pooled funds on a net-of-fees basis. In addition, when a manager offers a co-investment opportunity, it typically gives the investor a chance to consider the opportunity and decide whether to accept or reject it. Co-investments thus provide investors with a level of control that goes far beyond their rights as investors in a pooled fund.

Managers feel competitive pressure to grant co-investment opportunities because it is something that large investors frequently demand. Co-investment rights are commonly considered an important part of the overall package when investors decide whether to make an investment in a fund, and they have

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135 Though fee discounts can come in various forms, for purposes of this Article, a basic understanding of the fact that fee discounts are commonly requested and granted is sufficient. See Kaal, Private Fund Fee Structure, supra note 133 (“Alternative fee arrangements include but are not limited to modified highwater marks, incentive hurdles, and triggers, as well as clawbacks.”).

136 See Preqin Special Report: Private Equity Co-Investment Outlook (Nov. 2015) (survey showing that co-investment rights are most commonly granted during the fundraising process (see Appendix A for full results)).

137 See Appendix B for a graphic showing an illustrative co-investment arrangement.

138 See PRICEWATERHOUSECOOPERS, PRIVATE EQUITY CO-INVESTMENT. BEST PRACTICES EMERGING (2015), (“Co-investors often benefit from lower (or no) management fees and carried interest, as well as greater deal selectivity and transparency.”).

139 See 2018 PREQIN GLOBAL REPORT, supra note 8 at 55 (survey results showing that (i) 98% of investors saw similar or better returns from their co-investments compared to fund returns in 2017 and (ii) investors’ two most commonly cited reason for pursuing co-investments is the expectation of lower fees and better returns than pooled fund investments).

140 Antoine Drean, The Growing Promise and Pitfalls of Private Equity Co-Investment, FORBES (July 13, 2016) (“Competitive pressure is why the number of managers offering co-investment has grown so much.”).

141 Marc Wyatt, Acting Dir., Office of Compliance Inspections & Examinations, U.S. Sec. & Exch. Comm’n, Address at the Private Equity International Private Fund Compliance Forum:
become a key part of the overall private equity marketplace. Just like fee discounts, when a large investor negotiates to receive a greater allocation of co-investment opportunities on better terms, it will enjoy the full benefit of that negotiation.

3. Other Rights in Side Letters

Fee discounts and co-investment rights are not the only individualized terms granted to investors in side letters. For example, as noted above, investors can negotiate for MFN rights in side letters, which effectively give an investor the benefit of any bargains made by other investors that have made similarly-sized (or smaller) investments in the fund. This can be an extremely valuable individualized benefit. Investors can also seek to obtain seats on the fund’s advisory board. With a seat on the advisory board, an investor gains increased exposure to the fund manager and its operations, and it will have a right to vote if the manager seeks the advisory board’s consent to certain conflicted transactions. Importantly, when advisory board members participate in such votes, they typically have no duties to other investors in the fund and are free to vote in a manner that promotes their self-interest.

Side letters also commonly grant rights to address investors’ specialized disclosure or tax needs due to their structural and/or regulatory requirements (such as laws applicable to pension plans or sovereign wealth funds, among various others), and grant opt-out rights for investments in certain restricted industries. Investors also sometimes negotiate for things like customized disclosure and special access to the manager in the form of informational meetings.

Private Equity: A Look Back and a Glimpse Ahead (May 13, 2015) (observing that the allocation of co-investment rights “was becoming a key part of an investor’s thesis in allocating to a particular private equity fund”).

142 See Bain 2017 Global Report (“Bain estimates that co-investment (the largest form of shadow capital) represents 10% to 12% of traditional fund-raising . . . ”); 2018 PreQin Global Report, supra note 8 at 54 (reporting survey results showing that 64% of fund managers offered co-investments in 2017, up from 45% in 2014 and 52% in 2015, and that 42% of all surveyed private equity investors are actively co-investing, with 12% considering co-investing in the future).

143 See supra note 117 and accompanying text.

144 See Claire Wilson, The Power of the LPAC, Private Funds CFO (Dec. 15, 2017), https://www.privatefundsco.com/print-editions/december-2017-january-2018-issue/the-power-of-the-lpac/ (“For the investor, membership [in an advisory board] is a way of gaining greater visibility into the fund’s operations and access to information that is not otherwise disclosed to investors.”)

145 See Claudia Zeisberger, Michael Prahl & Bowen White, Mastering Private Equity: Transformation via Venture Capital, Minority Investments & Buyouts 215 (2017) (“A fund’s limited partner advisory committee generally does not owe a fiduciary duty to the fund or its limited partners.”).

These other rights can also have the effect of diluting a large investor’s incentive to negotiate LPA terms.

4. Separately Managed Accounts

An even more extreme type of individualized benefit occurs when a large investor negotiates for a “separately managed account” that exists entirely outside of a manager’s pooled funds. Unlike a co-investment opportunity, which is tied to a specific deal, separately managed accounts are vehicles that are set up to make many investments over longer periods of time. The terms of a separately managed account are independently negotiated between the investor and manager.\

Separately managed accounts commonly have their own customized investment mandates and governance and liquidity terms. Because the vehicle is not shared with other investors, it is easier for the investor to customize and exercise control over a separately managed account. Managers face competitive pressure to grant separately managed accounts to large investors who desire them, and, like co-investments, they are a large and growing part of the private equity marketplace, with no signs of slowing down.

Unlike fee discounts and co-investments, which merely diminish large investors’ incentive to negotiate for pooled fund contractual protections, separately managed accounts remove large investors from pooled funds altogether. This eliminates the possibility of that investor negotiating the terms of the pooled fund’s LPA because the separately managed account will be entirely separate from the pooled fund.

IV. Policy Implications

147 Separately managed accounts can be used by investors to gain exposure to the various investment strategies offered by a manager—including, for example, hedge fund, real estate, and credit products—without having to invest directly in the various funds managed by the manager.

148 See Damodaran, Matthew Judd & James Board, Combining Managed Accounts with Traditional Fundraising: The Key Issues, PRIVATE EQUITY INT’L, Apr. 2013, at 26, https://www.ropesgray.com/~/media/Files/articles/2013/03/20130326_PELashx (“Recently, several sophisticated large-ticket investors, ranging from sovereign wealth funds to pension funds, have developed enhanced requirements for the terms under which they are willing to commit their sizable capital.”).

149 See BAIN 2017 GLOBAL REPORT, supra note 142 (“[S]eparately managed accounts now comprise almost 6% of private capital raised, up from 2.5% in 2006); Bowden, Spreading Sunshine in Private Equity, supra note 79 (“[M]uch of the growth in private equity is not coming from the traditional vehicles but from separate accounts and side-by-side co-investments.”).

150 See Preqin Investor Outlook: Private Equity H1 2016 (reporting the results of a survey showing that, among investors who had previously awarded a separate account mandate, 47% viewed separate account mandates as a permanent part of their investment strategy and 37% were considering making separate account mandates an ongoing part of their strategies going forward).
The private equity negotiation myth reflects an ongoing effort by the industry to use a process-based argument to avoid substantive scrutiny. This Article, at its most basic level, aims to discourage policymakers and other industry observers from believing the myth. It argues that invoking the private equity negotiation myth as a defense against the recent critiques of LPAs is both unpersuasive and misleading, and that it directs attention to the wrong places when evaluating how well investors are fending for themselves.

This Article also makes important contributions to broader current policy debates at both the state and federal levels. Scholars and policymakers have been re-evaluating conventional approaches to regulating private markets in recent years, driven in large part by the ongoing decline of the public corporation and the unprecedented rise of private markets. But policy is only as good as the theory that informs it. Below, I discuss how a more accurate understanding of the effects of bargaining power in private equity funds refines and advances these ongoing policy discussions.

A. State Law: Waiving Fiduciary Duties in Limited Partnerships

As noted above, private equity funds typically operate as limited partnerships. General partners have default fiduciary duties to the limited partners in a limited partnership, but in most states these duties can be modified by written agreement in the partnership agreement. In some states, including Delaware, it can be eliminated entirely. This contractarian approach has been

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151 See supra Section II.B.
152 This does not reflect a judgment about whether the substantive terms of LPAs are actually fair or not. See supra Sec. II.A for a summary of various critiques of the substance of LPA terms. Nor does it rule out the possibility that there might be other process-based arguments to support the idea that private equity LPAs are built on effective processes that lead to sound terms.
153 See Xiaohui Gao et al., Where Have All the IPOs Gone? 48 J. FIN. & QUANTITATIVE ANALYSIS 1663, 1663 (2013) (showing that from 2001-2012, there were an average of less than 100 IPOs each year in the United States, compared to over 300 IPOs per year during the 1980s and 1990s); Anne VanderMey, IPOs Are Dwindling, So Is the Number of Public Companies, FORTUNE (Jan. 20, 2017) (reporting a 65% decline in the number of U.S. initial public offerings since 2014); See Why the Decline in the Number of Listed American Firms Matters, ECONOMIST (Apr. 22, 2017) (“A big trend in American business is the collapse in the number of listed companies. There were 7,322 in 1996; today there are 3,671.”); Andrew Ross Sorkin, C.E.O.s Meet in Secret over the Sorry State of Public Companies, N.Y. TIMES (July 21, 2016) (reporting the findings of the National Bureau of Research that the number of publicly listed companies dropped from 8,025 to 4,101 over approximately the last twenty years).
154 See supra note 24 and accompanying text.
155 Most state law views limited partnerships as highly contractual in nature and defers to the terms and conditions set forth in limited partnership agreements. See, e.g., DEL. CODE ANN. tit. 6, § 17.1101(c) (“It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements.”).
156 See supra note 44 and accompanying text.
157 See supra note 46 and accompanying text.
the subject of much controversy, and a robust literature has developed on the desirability of fiduciary duty waivers in non-corporate entities.\textsuperscript{158}

One of the most important recent commentaries in this area was published by Leo Strine, Chief Justice of the Delaware Supreme Court, and Travis Laster, Vice Chancellor of the Delaware Chancery Court. Strine and Laster focused their analysis specifically on the waiver of fiduciary duties in private investment funds, including private equity funds and hedge funds.\textsuperscript{159} Consistent with this Article’s analysis, they expressed the view that, based on the cases they have observed over the years in Delaware, private fund LPAs are more like standard form contracts than highly-negotiated agreements.\textsuperscript{160} They argued that private equity fund LPAs are usually offered to investors by managers on a take-it-or-leave-it basis, and that this approach usually leads to LPAs having one-sided terms, including provisions that waive the fiduciary duties of the fund’s manager.\textsuperscript{161} This commentary, which struck at the heart of Delaware long-time commitment to complete freedom of contract in limited partnerships, was remarkable, particularly given the authoritativeness of the authors.

By sharing their perspective from the Delaware bench, Strine’s and Laster’s article offered an extremely valuable view\textsuperscript{162} into what is usually a secret


\textsuperscript{159} Strine and Laster, \textit{Siren Song of Contractual Freedom}, supra note 21. As previously discussed, private equity LPAs commonly contain provisions waiving the fiduciary duties of the fund’s general partner (which is usually an affiliate of the manager).

\textsuperscript{160} See id. (“The record in actual cases rarely, if ever, reflects that any bargaining at all occurred over the governing instrument. Instead, it is almost always the case that the manager or general partner’s counsel drafted the governing instrument and investors were only given the choice to sign up or not, but not to bargain over its terms.”).

\textsuperscript{161} See id. (“The cases . . . cast doubt on the idea that the liability standards in alternative entity governing instruments reflect a high-minded, careful consideration of the unusual role of the human beings who serve as fiduciaries of general partners and managing members. Nor do the cases suggest that these standards are the result of bargaining between entity managers who wish to limit their own liability and investors who want to be able to hold them and their human fiduciaries accountable.”). Some would argue that LPAs have become even more manager-friendly since Strine and Laster’s article. \textit{See} Elizabeth Weindruch & Brian Pope, \textit{Views from the LPAC, “Barings Insights” client memorandum} (July 2019) (“As partnerships have become progressively sophisticated over time, the LPA terms have gotten more granular and nuanced—and there’s been a noticeable shift toward agreements that incorporate more favorable terms for the general partner.”).

\textsuperscript{162} Strine’s and Laster’s analysis, of course, is limited by the fact that is was based on anecdotal observations. \textit{Id.} (“Based on the cases we have decided and our reading of many other cases decided by our judicial colleagues, we do not discern evidence of arms-length bargaining between sponsors and investors in the governing instruments of alternative entities.”). It has nevertheless
PRIVATE EQUITY NEGOTIATION MYTH

and opaque world.\textsuperscript{163} However, it leaves open two critical questions. First, Strine’s and Laster’s account suggests that the reason investors fail to negotiate the terms of LPAs is because managers have superior bargaining power. According to Strine and Laster, managers simply demand that investors sign the LPA on a take-it-or-leave-it basis, and investors never get a chance to negotiate the terms, even if they want to.\textsuperscript{164} But this cannot always be true. Managers—particularly those with low-performing track records—will not always have such superior bargaining power vis-à-vis their investors, and there will certainly be cycles when investor demand for private equity funds is on the wane. Why, then, do Strine and Laster indicate that the Delaware courts almost never see evidence that private equity LPAs are negotiated by investors?\textsuperscript{165}

This Article helps to explain this puzzle. It shows why private equity LPAs are unlikely to be heavily negotiated even when managers have relatively weak bargaining power. When individualized benefits are available, investors will almost always receive more value by negotiating for individualized benefits before they negotiate for better LPA terms.\textsuperscript{166} Hence, regardless of how much bargaining power managers have, negotiating the LPA will be a secondary priority when large investors can negotiate for individualized benefits. This is an important distinction. It shows that the absence of negotiation is not just a temporary condition that persists only during cycles when managers have strong bargaining power, but something that can exist in all cycles.

This insight fundamentally alters our understanding of the extent of the problem that Strine and Laster identify, as well as the range of policy responses that could address the problem. If we assume that the absence of negotiation in private equity funds is a consequence of managers’ bargaining power, then it would be logical to conclude that the concerns raised by Strine and Laster will simply be resolved when market conditions change and investors have more bargaining power relative to managers. This would give policymakers an easy excuse to respond conservatively to these concerns, but it would be based on an incorrect assumption.

Second, while Strine and Laster are clear about the fact that private equity LPAs are not highly-negotiated, they fail to explain why the absence of negotiation is a problem. As discussed above, optimal contracts can be created without any negotiation in a competitive market.\textsuperscript{167} Without negotiation,

\begin{itemize}
  \item See supra notes 75, 76, and 85 and accompanying text.
  \item Strine and Laster, \textit{Siren Song of Contractual Freedom}, supra note 21 (“The record in actual cases rarely, if ever, reflects that any bargaining at all occurred over the governing instrument. Instead, it is almost always the case that the manager or general partner’s counsel drafted the governing instrument and investors were only given the choice to sign up or not, but not to bargain over its terms. . . . [T]he practical alternatives for a skeptical investor are often stark: invest without adequate protection against self-dealing or avoid the asset class altogether.”).
  \item Id.
  \item See supra Sections III.A.2 and III.A.3.
  \item See supra Section III.B.1.
\end{itemize}

been quite valuable given how notoriously difficult it is to obtain data on private funds, which are exempted from filing public disclosures.
investors could choose to “vote with their feet” by avoiding funds that waive fiduciary duties, thereby putting competitive pressure on managers not to do so.

In this Article, I show why large investors cannot be counted on to exert this kind of non-bargaining pressure on managers. I show that large investors will sometimes be willing to look the other way and invest in funds that have weak protections when they can negotiate for individualized benefits. If large investors are generally more sophisticated and/or willing to invest time and resources in reviewing LPA terms than smaller investors, this could lead to LPAs systematically providing investors with sub-optimal protections.

Another way of stating this idea is simply to say that large investors with bargaining power often may not be the marginal investors in the funds they invest in. This question of who the marginal investors are is a critical one. If the marginal investors are capable of evaluating LPA terms and searching the market for alternatives, then concerns in the literature about sub-optimal LPA terms may be overstated. But if they are not, then the logic for restricting the ability to waive fiduciary standards in private equity funds would be stronger.

Strine’s and Laster’s article made important contributions to the current dialogue on the waiver of fiduciary duties in non-corporate entities. But their commentary both misdiagnosed the cause of the phenomenon (by assuming it is caused by imbalances in bargaining power) and also failed to explain why it is truly harmful (by ignoring the fact that standard form contracts can be optimal under the right conditions). By filling in these gaps, this Article clarifies both the nature and scope of the problem, and lends additional credibility to Strine’s and Laster’s skepticism of the long-time status quo of granting unlimited freedom of contract to Delaware private funds.

B. Federal Law: Regulating Access to Private Funds

Federal law regulates who can and cannot invest in private entities. In an ongoing effort to strike an appropriate balance between investor protection and access to capital markets, policymakers have engaged in various initiatives to update the rules regulating who can and cannot invest in private entities in recent years—sometimes in contradictory ways. On one hand, in the interest of promoting investor protection the SEC has increased various net worth requirements for participating in private markets. Yet, in the interest of making

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168 See supra note 131 and accompanying text.
169 See supra note 123 and accompanying text.
170 See supra note 102.
it easier to raise capital, Congress has also made it easier for private entities to solicit capital from a broader range of investors and authorized new channels for private investment that impose no investor sophistication standards. Most recently, policy momentum is in favor of making it easier for individuals to invest in private markets, as announced in the summer of 2018 by Jay Clayton, the SEC chairman appointed by President Trump.

The academic literature in this area is also mixed. Some scholars have argued that expanding private fund access to a broader universe of investors would be socially beneficial because, among other reasons, it would give ordinary investors the tax advantages of investing in a private fund and because lower regulatory restrictions could generate better expected returns. Others have criticized the existing standards, arguing that they leave room for opportunism against unsophisticated investors.
In the area of private equity funds, until we know which investors are shaping the quality of the protections in LPAs, having policy discussions like the ones above are putting the cart before the horse. This Article helps to identify which investors do—and do not—move the needle when it comes to the quality of private equity fund LPA. Contrary to the private equity negotiation myth, policymakers should not assume that the large investors with bargaining power are the ones shaping the quality of LPA terms.177

V. Conclusion

Critics have condemned private equity LPAs in recent years, and the industry has repeatedly invoked the private equity negotiation myth to insist that nothing is amiss. This Article challenges that myth. It shows how the private equity negotiation myth directs policymakers to look in the wrong places when evaluating the quality of private equity fund governance, and it offers a more realistic portrayal of the role that bargaining power plays in private equity funds. In light of the private equity industry’s massive size and influence, and the heavy investment by public pension plans in private equity funds, the need for policy built on sound theory—and not mythologies promulgated by the industry—in this area is clear. This Article offers an important step in that direction.

unsophisticated investors unprotected”); Howard M. Friedman, On Being Rich, Accredited, and Undiversified, 47 OKLA. L. REV. 291, 299 (1994) (suggesting that the accredited-investor standard leaves wealthy but unsophisticated investors vulnerable); William K. Sjostrom, Jr., Rebalancing Private Placement Regulation, 36 SEATTLE UNIV. L. REV. 1143 (2013) (arguing that recent updates to the securities laws “has tilted the balance too far in favor of capital formation and away from investor protection”).

177 See supra Section III.B.2.
Appendix A

Typical Stage in Investment Cycle at Which GPs Offer Co-Investment Rights to LPs

Source: Preqin Fund Manager Survey, August 2015

Reprinted from Preqin Special Report: Private Equity Co-Investment Outlook (Nov. 2015)
Appendix B

Illustrative Co-Investment Arrangement
(red arrows denote co-investments)
THE NEW UNICORN INVESTORS - DISRUPTORS OR DISTRactors?

SUMMARY

Anat Alon-Beck*
Jacobson Fellow in Law & Business, NYU School of Law
Soon to be Assistant Professor, Case Western Reserve University School of Law

There is a rise in late-stage private placements, mega deals, where unicorn firms are raising large amounts of capital from VCs and a mix of nontraditional investors. There is a concern that not only these fund-raisings are an alternative to going public, but also that the contractual provisions in these deals depart greatly from traditional VC investments, and have an effect on unicorn founders’ incentives and behavior.

VCs are specialized market players, which developed unique arrangements of successful private ordering, i.e., contractual arrangements that can deal with “extreme uncertainty, information asymmetry, and agency costs” that plague investments in startup firms. In light of new regulatory and market developments, there is a concern that the new suppliers of capital are not adequately adopting corporate governance arrangements and hence not monitoring unicorn managers.

This Article explores a puzzle: how do the new nontraditional investors affect unicorn’s corporate governance arrangements (such as voting rights, board composition and ownership structure)? Unicorns are private companies that experience a transition from early-stage to late-stage mega deals, and their new investors are accordingly affecting private ordering in the venture capital financing context.

The hypothesis is that there are new market conditions, specifically, new market actors, that change the traditional investment patterns in unicorns, and affect private ordering. New VC investment rounds are now structured as “friendly” financing rounds. The contractual mechanism that VC investors traditionally used to avoid opportunism by founders changed as a result of the intervention of these new market players. These changes give unicorn founders greater power vis-à-vis preferred shareholders and minority common shareholders to oppose a sale and keep the company private longer.

Unicorn founders and managers’ actions can have serious effects on economic activity. Monitoring them is extremely important, because misbehavior, such as rent-seeking, corruption or other illegal activities, can not only hamper the manager’s decision-making process, but may also reduce the incentives and opportunities to invest in innovation in the future.

The developments of new investor groups, contractual rights and fiduciary duties are extremely important because courts are now asked to decide on disputes between startup stockholders, common and preferred. Delaware courts grapple with determining which strategic or powerful contractual rights (such as consent or blocking powers) deem
an investor (or debtor) in a startup to be a “controlling stockholder,” who also owes a fiduciary duty to the company.

There are many different types of investors with different incentives, contractual rights and characteristics, including pooled investment vehicles, who owe fiduciary duties to their own investors. The decision to deem an investor as a controlling stockholder imposes fiduciary duties on a third party that has powerful contractual rights and obligates her to act in the best interests of the other stockholders (especially minority). The court needs to decide on whether to enforce the parties’ rights according to contract law or fiduciary doctrine (where preferred stock is required to maximize firm value and is subordinate to the rights of common). The court’s decision on these matters is important for the future of strategic investments in startup firms.

There is a need for policy reform and implementation of new corporate governance principles and practices for unicorn firms, in order to address the concentration of power in the hands of founders. This Article will also address the new UK Wates Corporate Governance Principles for Large Private Companies.