

Common Shareholder Vulnerability in Venture-Backed Startups

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Abstract

The governance of venture-backed startups has received significant attention from economists and legal academics. Much of this literature has focused on VCs' use of preferred stock and control rights – including board control -- to reduce tax and agency costs. Scholars have failed to appreciate that these arrangements lead to a highly atypical and perhaps unique corporate governance structure: one in which preferred shareholders, rather than common shareholders, control the board and the corporation. The purpose of this paper is threefold: (1) to describe the unusual governance arrangement of startups and its origins; (2) to show that such a structure leaves common shareholders extremely vulnerable to opportunistic behavior by the preferred; and (3) to propose changes to the tax and corporate laws aimed at reducing common's vulnerability and increasing the size of the startup pie for all its investors.

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I. Introduction

Venture capital is an important contributor to economic growth in the US and elsewhere.¹ Venture capitalists (VCs) play a key role in the development of high-risk technology based business ventures, investing billions of dollars annually in emerging companies.² VCs also provide valuable management and strategic advice to these startups, many of which are founded by entrepreneurs with little business experience.³ As a result, the VCs' contribution to the economy goes far beyond the substantial amount of money they invest. Genentech, Apple Computer, Federal Express, Sun Microsystems, Cisco Systems, Yahoo, eBay, and Amazon are but a small sample of the successful companies that VCs have helped to nurture.⁴

Given the importance of venture capital to the economy, it is not surprising that VC investing has attracted considerable interest from economists and legal academics.⁵ This literature has described in rich detail

¹ See Bristow, Benjamin and Petillon, *Venture Capital Formation and Access: Lingering Impediments of the Investment Company Act of 1940*, COLUM. BUS. L. REV. 77 (2004); Joshua Lerner, *Boom and Bust in the Venture Capital Industry and the Impact on Innovation*, FEDERAL RESERVE BANK OF ATLANTA ECONOMIC REVIEW, 2002(4), 25.

² The MoneyTree Survey, a quarterly study of venture capital investment activity in the United States by PricewaterhouseCoopers, Thomson Venture Economics and the National Venture Capital Association, reports that annual venture capital investing has been approximately \$20 billion per year. <<http://www.pwcmoneytree.com>> (visited Jan 2005).

³ See David Denis, *Entrepreneurial Finance: an Overview of the Issues and Evidence*, 10 J. CORP. FIN. 301, 305 (2004); Joshua Lerner, *Venture Capitalists and the Oversight of Private Firms*, 50 J. FIN. 301(1995).

⁴ See, e.g., M. Gorman & W. Sahlman, *What do venture capitalists do?*, 4 J. BUS. VENTURING 231, 232 (1989); James T. Bartlett, *The Impact of Technological Change in the Canada/U.S. Context: the U.S. Institutional Private Capital Market: a Turbo Tour*, 25 CAN.-U.S. L.J. 183, 189 (1999).

⁵ See, e.g., Bernard Black & Ronald Gilson, *Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets*, 47 J. FIN. ECON., 243 (1998). Leslie Jeng & Philippe Wells, *The Determinants of Venture Capital Funding: Evidence Across Countries* (Working Paper, May 1998). Steven Kaplan & Per Stromberg, *Financial Contracting Theory Meets the*

the various stages of the venture capital process: the raising of capital by VCs from their funds' limited partners;⁶ the process by which VCs invest in portfolio companies;⁷ the monitoring of these portfolio companies;⁸ and exit (through an IPO, merger, or dissolution).⁹ The academic literature has also analyzed how the contracts between VCs and their limited investors and the contracts between VCs and entrepreneurs are designed to reduce agency and tax costs and thereby increase the size of the economic pie.

The focus of this paper is on the contractual arrangements between VCs and entrepreneurs. The academic literature on this subject has examined the structure of VCs' control and cash flow rights in startups. This scholarship documents that VCs contract for a variety of specific control rights, such as the right to veto changes in the certificate of incorporation and the right to veto mergers. However, by far the most important right is control of the board, which VCs acquire, either initially or over time, in the vast

Real World: An Empirical Analysis Of Venture Capital Contracts, 70 REV. ECON. STUD., 281, (2003). Thomas Hellmann & Manju Puri, *The Interaction between Product Market and Financing Strategy: The Role of Venture Capital*, 13 REV. FIN. STUD. 959 (2000). George Triantis, *Financial Contract Design in the World of Venture Capital*, 68 U. CHI. L. REV. 305 (2001); Douglas Cumming & Jeffrey Macintosh, *A Cross-Country Comparison of Full and Partial Venture Capital Exit Strategies* (working paper, 2002); Douglas Cumming, *Adverse Selection and Capital Structure: Evidence from Venture Capital* (working paper, 2004); onald Gilson & David Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 901 (2003). Michael D. Klausner, & Kate Litvak, *What Economists Have Taught Us About Venture Capital Contracting*, in *Bridging the Entrepreneurial Financing Gap: Linking Governance With Regulatory Policy*, (Michael Whincop, ed., Ashgate, 2001), D. Gordon Smith, *Control Over Exit in Venture Capital Relationships*; Fenn, Liang & Prowse, *The Economics of the Private Equity Market*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., Staff Studies Series No. 168, 1995.

⁶ For theoretical work, see, e.g.,____ For empirical work, see, e.g., [xx for both theoretical and empiracla move appropriate papers from fn. 5, xx]

⁷ For theoretical work, see, e.g.,____ For empirical work, see, e.g., [xx for both theoretical and empiracla move appropriate papers from fn. 5, xx]

⁸ For theoretical work, see, e.g.,____ For empirical work, see, e.g., [xx for both theoretical and empiracla move appropriate papers from fn. 5, xx]

⁹ For theoretical work, see, e.g.,____ For empirical work, see, e.g., [xx for both theoretical and empiracla move appropriate papers from fn. 5, xx]

majority of startups. Because of the board's key role in overseeing the corporation and initiating major transactions, control of the board gives VCs substantial power over and above what any specific contractual provisions could give them.

The control rights negotiated by VCs are designed to reduce the agency costs associated with financing entrepreneurs.¹⁰ For example, at least initially, the entrepreneurs serve as managers of the company and thus are able to extract private benefits.¹¹ Absent VC control, entrepreneurs might make decisions aimed at maximizing their private benefits rather than maximizing the value of the startup as a whole.

In addition to control rights, VCs negotiate for certain cash flow rights. In the U.S., VC investment in startups almost always takes the form of preferred stock.¹² This preferred stock is convertible into common at the VCs' option. If the VCs don't convert, their preferred stock carries a liquidation preference entitling them to be paid a specified amount ahead of common stockholders in the event the company is sold or dissolved. Accordingly, the preferred stock held by VCs has characteristics of both debt and common stock.

The academic literature has offered two types of explanations for the use of preferred stock with liquidation preferences: an agency cost explanation

¹⁰ See, e.g., Paul Gompers, *Optimal Investment, Monitoring, and the Staging of Venture Capital*, 50 J. FIN. 1461 (1995); William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473, 510 (1990)

¹¹ See, e.g., William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891(2002); George G. Triantis, *Financial Contract Design in the World of Venture Capital*, 68 U. CHI. L. REV. 305 (2001). In addition, there is an asymmetric-information problem. The entrepreneurs, who have founded the company, tend to have superior knowledge about its prospects. See, e.g., Michael D. Klausner, & Kate Litvak, *What Economists Have Taught Us About Venture Capital Contracting*, in *Bridging the Entrepreneurial Financing Gap: Linking Governance With Regulatory Policy*, (Michael Whincop, ed., Ashgate, 2001).

¹² See *Infra* Part ____.

and a tax explanation. According to the agency cost explanation, the liquidation preference on distribution forces the entrepreneur, who holds common stock, to bear a greater fraction of the cost of failure. This, in turn, may provide the entrepreneur with greater incentive to generate value.

The tax explanation for the use of preferred stock is that the U.S. tax system implicitly subsidizes VCs' use of preferred stock or, equivalently, penalizes the use of common stock. As Ronald Gilson and David Schizer have shown (and as has been long understood in Silicon Valley), the sale of preferred stock to VCs rather than common stock allows firms to avoid establishing an indisputable arm's-length value for the common. As a result, firms are able to assign, for tax-purposes, a below-market valuation to the common stock given to employees. This below-market valuation in turn, reduces the joint tax burden of the startup and its employees, who receive much of their compensation in the form of stock or stock options.

Whether preferred stock is used to reduce agency costs, to reduce tax costs, or for both purposes, academics appear to have missed an important point: that the combination of VCs' control rights and their use of preferred stock gives rise to an unusual and apparently unique corporate governance structure. Consider a typical corporation that has issued both preferred and common stock. The board is elected solely by common shareholders and is expected to serve their interests exclusively. Preferred shareholders are not owed a fiduciary duty by the board. However, they typically negotiate elaborate contractual arrangements with the corporation to protect themselves from opportunistic behavior by a board seeking to serve common shareholders' interests. Academics claim this arrangement is efficient because the common shareholders, as residual claimants, have the greatest incentive to increase corporate value.

Now consider the typical startup. Like the preferred shareholders in a typical corporation, the preferred shareholders in the startup have elaborate contractual arrangements. But, unlike the preferred shareholders in a typical corporation, the preferred shareholders in the startup usually control the board. As a result, common shareholders have neither such contractual protection nor control of the board.

To the extent the interests of common and preferred shareholders converge, the combination of VCs' control and cash flow rights are likely to benefit common shareholders – which will typically include angel investors, founders, and employees. If the firm is likely to do extremely well, and the VCs expect to convert to common, the preferred-owning VCs will tend to have incentives to take steps that increase common shareholder value.

And even when the interests of the preferred and the common diverge, preferred control of the board may be efficient. Suppose, for example, that the value-maximizing course of action is to liquidate the firm. Under such a scenario, a board serving preferred shareholders may be more likely to make value-making decisions than a board serving common shareholders.

We show, however, that there are likely to be a broad range of situations in which VCs' debt-like liquidation preferences may well cause their interests to diverge from those of common shareholders, perhaps substantially. In such cases, we argue, common stockholders may be vulnerable to opportunistic behavior by VCs controlling the board. In particular, preferred-owning VCs may have an incentive to choose lower-value, lower-risk investment and exit strategies over higher-value, higher risk strategies. For example, VC-controlled boards may well prematurely push for liquidation events – such as dissolutions or mergers – that do not maximize expected corporate value. In addition, there are situations in which

a VC-controlled board has no incentive to seek additional financing or incur other costs to substantially increase firm value.¹³

We demonstrate that the possible costs imposed by preferred control of the board go beyond distorted decision-making once the preferred take control. The prospect of preferred opportunism makes it more expensive for entrepreneurs to raise capital from investors who typically invest through common stock – such as angel investors. It might also reduce entrepreneurs' willingness to turn to VC financing, even in cases where VC financing could add considerable value. Similarly, the prospect of ex post opportunism by preferred could reduce the incentive effects of the common stock and options heavily used to compensate employees of such companies.

We next consider three potential legal constraints on preferred boards' ability to transfer value from common shareholders: common shareholder voting rights, appraisal rights, and fiduciary duties -- and show that none of these can be expected to tightly constrain preferred opportunism.

Certain major (or “organic”) corporate transactions --- such as a merger – require the consent of shareholders. Thus, it might be argued, common shareholders might have the power to block transactions that hurt them, forcing the preferred shareholders to structure transactions in a way that is not value-transferring. However, as we explain, VCs usually receive the right to vote their preferred shares on an as-converted basis with common

¹³ Of course, VC control of the board -- facilitates other forms of VC opportunism that would arise regardless of the form of their investment (whether preferred, or common). VC's might push for quick IPOs for grandstanding purposes (at the expense of even their own limited investors) .See Gompers (1996); Lee and Wahal (2004) (describing the loss of wealth to investors in VC funds from grandstanding). VCs might take corporate opportunities from one portfolio company and give them to other portfolio companies in which they have larger stakes. Finally, VC's might engage in self-dealing transactions, such as selling themselves cheap stock (See, e.g., *Atlantec, Latif v. Nishan*). Here, however, our focus is on the problems that arise solely from the fact that the VC's investment takes the form of preferred stock and that they control the board.

shareholders whenever a stockholder vote is required to effect an organic change. And by the time the company is about to merge the number of preferred shares, on an as-converted basis, will typically far outnumber common. Moreover, we document that even in those cases where common stockholders preserve the right to vote as a class, preferred shareholders have often commandeered the class vote by, for example, issuing additional common stock to their hand-picked CEO.

Appraisal rights – the right to have one’s shares be purchased for fair value by the corporation -- also do not provide protection. These rights are triggered by certain corporate transactions, such as mergers. However, as others have shown, but the procedures implementing these rights are such that they cannot assure shareholders will receive fair value for their shares. Accordingly, they are almost never used by shareholders who believe that they are being underpaid in a merger and are of little use to common shareholders seeking to prevent preferred opportunism.

Common shareholders seeking to protect themselves may also consider resorting to fiduciary litigation. Directors owe fiduciary duties to the corporation and its shareholders. These duties are traditionally enforced through derivative suits – in which shareholders sue officers and directors on behalf of the corporation. Thus, common shareholders in venture-backed startup could try to influence board decisionmakers by threatening to sue directors for breaching their fiduciary duties.

But, as we explain, at least under current law in both Delaware and California, it is difficult for common shareholders to use the threat of fiduciary litigation to influence boards’ strategic decisionmaking, especially in connection with mergers. Delaware’s courts have been reluctant to hold directors liable for favoring one class of stock over another. Outside of the startup context, where common shareholders control the board, the courts

have repeatedly held that common-appointed directors do not owe a fiduciary duty to preferred shareholders, but rather only to common. And in the one case involving a preferred-controlled startup, the Delaware chancery court has ruled that the board does not owe a fiduciary duty to common shareholders.

California law is even more unfriendly to common shareholders. The state supreme court has ruled that appraisal is the exclusive remedy for shareholders alleging breach of fiduciary duty – even self dealing -- at the time of a merger – even when the breach is alleged to have occurred *before* the merger. Thus a preferred-dominated board can essentially insulate themselves from any fiduciary liability by pushing through a merger. Thus, fiduciary litigation does not hold provide much protection to common shareholders of startups.

After showing that there is unlikely to be substantial legal constraints on preferred boards' ability to expropriate value from common shareholders, we explain that reputational considerations are unlikely to prevent a preferred-dominated board from acting opportunistically toward common shareholders. Start-ups are not public companies subject to disclosure requirements. Information about them is scarce, and allegations about preferred opportunism are difficult to verify. Thus, common shareholders cannot easily use threat of publicity to deter preferred-dominated boards from inefficiently transferring value from common shareholders.

To be clear: we are not claiming that preferred-dominated boards currently are completely free to engage in opportunistic behavior at the expense of common. Even though the law would make it difficult for common shareholders to prevail and recover reasonable damages, if VCs and startup directors are litigation averse the mere threat of a suit may provide

some constraint on their behavior. However, given the current legal rules it is unlikely that this constraint is as tight as it should be.

We consider two types of legal changes – one to the tax laws and one to corporate law -- designed to reduce the vulnerability of common shareholders and the resulting costs. As we explained, the tax laws currently provide a subsidy to the use of preferred stock in ventures, such as startups, where common stock is heavily used for incentive compensation. The sale of preferred stock to VCs avoids establishing the fair market value of the common stock, enabling the firm to report to the IRS a low value on the common stock given to employees and reducing the joint tax burden of the parties. Were VCs to invest through common stock, the tax costs would rise. This subsidy for preferred (or penalty for common) can lead to the use of preferred stock in situations where – but for the tax subsidy – common stock investment would make the parties better off.

We suggest that the tax subsidy to preferred be eliminated by ensuring uniform tax treatment to incentive compensation regardless of the form of VC financing. One way to level the tax playing field would be tax all incentive compensation at disposition (rather than, as is now the case, partially at grant). Such an approach would obviate the need to value the stock at the time it is given to employees. The income generated upon disposition could be taxed at the capital gains rate, the ordinary income rate, or some intermediate rate.

To the extent that the use of preferred stock is driven by tax considerations – and VCs would otherwise invest through common stock (as they do in many other countries) – leveling the tax playing field would eliminate all of the distortions we identify in this paper by putting board control back in the hands of common shareholders, thereby better aligning the interests of the board with that of shareholders.

Of course, there may be situations where – even absent the tax subsidy – the parties will wish to use preferred stock, especially if the costs associated with dual-class structures can be reduced. Thus, we believe it is worth considering a new “balancing approach” to fiduciary duties in startups that would give preferred dominated boards more incentive to take into account the effects of their decisions on common shareholders. Under this approach, the startup board would be required to avoid taking actions that benefit certain classes shareholders of if those actions imposed a substantially larger cost on other classes shareholders. However, courts should refuse to review board decisionmaking when disinterested, informed shareholders of the affected classes ratify the decisions. Such a rule, which we describe in greater detail, would increase common shareholders’ leverage vis-à-vis preferred dominated boards, deter some preferred opportunism and reduce the resulting distortions. While such a rule could not eliminate the problems we identified, it may well move things in the right direction.

It might be argued that the existing arrangements are likely to be already optimal from the parties’ perspectives. If so, changing the rules might reduce the parties’ ability to reach an efficient outcome. After all, most of these arrangements described – the use of preferred stock, control of the board by preferred shareholders -- are purely contractual. They are chosen by the parties and, presumably, are designed to serve their interests.

But this argument would miss an important point. While much of these arrangements are contractual, both the tax law and the fiduciary duty law to which these arrangements are subject are not. Entrepreneurs and VCs have largely been forced to take the tax law and fiduciary duty law as they found them. And there is no reason to believe that tax law and corporate fiduciary duties, which have largely been developed by the legislature and the courts without much (if any) consideration to the unique circumstances of

venture-backed firms, are finely tuned to generate efficient arrangements in these startups.

To be clear: are analysis does not assume that VCs and entrepreneurs are failing to contract efficiently. Although we doubt that all entrepreneurs are well advised and fully informed when contracting with VCs,¹⁴ for purposes of this paper we assume that entrepreneurs and VCs negotiate arrangements that maximize the size of the pie within the framework provided by existing tax and corporate law. Rather, our claim is that changes to this legal framework may well allow the parties to further increase the size of the pie.

The purpose of this paper is threefold: (1) to describe the unique governance structure of startups that puts preferred shareholders, rather than common shareholders, in control of the board; (2) to demonstrate that, under such a structure, common shareholders are vulnerable to value-reducing opportunistic behavior by preferred controlled boards; and (3) to consider various changes in tax and corporate law aimed at reducing common's vulnerability and increasing the size of the startup pie for both VCs and entrepreneurs.

The remainder of this paper proceeds as follows. Part II describes the standard corporate governance arrangements of the typical corporation: the board, elected by and representing common shareholders, manages the corporation on behalf of common shareholders. It explains that other investors – such as preferred shareholders --- are protected solely by their contractual arrangements with the corporation, and explains why this arrangement is generally believed to be efficient.

¹⁴ Cf. Manuel A. Utset, Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital-Financed Firms, 2002 WIS. L. REV. 45, 100 (arguing that entrepreneurs are over-optimistic and negotiate agreements with VCs they later regret).

Part III describes the unique governance arrangements of venture-backed startups that result from the combination of control and cash flow rights received by VCs. It explains that venture capitalists receive substantial control rights, typically including board control, and describes the reasons why such rights are likely to increase the size of the pie. It also explains that the VCs almost always invest through preferred stock, in part because of a tax penalty imposed on the use of common stock. Thus, unlike in the typical corporation where the board is controlled by common stockholders, the board of VC-backed startups is controlled by preferred shareholders.

Part IV identifies the various costs to the parties that can arise from shifting control of the board from common stockholders to preferred stockholders. Preferred control of the board, it shows, can distort investment and exit decisions. The prospect of preferred opportunism can also increase the cost of angel financing, make VC financing less attractive to founders, and reduce the incentive effects of employee stock options – all of which further lower start-up value.

Part V considers possible legal and nonlegal constraints on preferred opportunism, including the requirement that shareholders vote to approve major corporate transactions; appraisal rights that are triggered in connection with mergers, and fiduciary duties, and VCs' reputation. It shows that none of these constraints are likely to adequately check preferred opportunism.

Part VI puts forward two sets of proposals – one regarding the taxation of incentive compensation in start-ups and the other regarding the fiduciary duty of startup boards. It explains how these proposals would reduce the distortions we identify by (a) reducing the tax-driven use of preferred stock and (b) improving the behavior of boards composed of preferred shareholders.

Part VII concludes.

II. The Typical Corporate Governance Arrangement

This Part describes the governance arrangement of a typical corporation. Section A describes the role and function of the board of directors. Section B describes common shareholders voting rights -- which include the right to elect the board of directors and to block certain corporate transactions proposed by the board. Section C describes the rights of other investors -- such as preferred shareholders -- which typically have no right to elect directors. Section D explains why this standard arrangement -- in which common shareholders and only common shareholders elect the board -- is believed to be efficient: that it puts control of the boards in the hands of the most residual claimants -- the common stockholders. Section E explains how other investors protect themselves from the possibility of opportunistic behavior on the part of a board controlled by common shareholders.

A. The Board's Role

The duty of the board of directors is to manage the corporation on behalf of shareholders. Although the board has formal authority to control the corporation, in a typical company directors are not expected to manage the company themselves on a day to day basis. Rather, the board is expected to delegate ongoing management to the company's officers, especially to the CEO.

However, all corporate structural decisions, such as whether to reincorporate in another state or merge with another company, are ultimately made by the board (which has the authority to accept or reject management's recommendation). The board is also supposed to hire and monitor the CEO

(and if necessary fire him), and typically must approve a wide variety of important decisions, such as how to respond to acquisition offers, whether to seek financing or distribute cash to shareholders, etc. The board thus has substantial power.

In carrying out its duties, members of the board are generally supposed to be guided by the interests of the corporation and its shareholders. In particular, the directors are considered to owe fiduciary duties to the “corporation and its shareholders.” However, as we explain in Part V, fiduciary duties (at least currently) generally cannot prevent preferred-appointed directors from deviating substantially from what is good for *common* shareholders.

B. Common Shareholders’ Voting Rights

Because fiduciary duties currently provide only a weak constraint on the board, the most important mechanism by which shareholders can control the board is their power to replace directors and, in certain cases, to block corporate transactions proposed by the board.

In the standard arrangement, common shareholders are generally entitled to elect directors to the board. These elections take place at the annual shareholder meeting.¹⁵ In addition, corporate state law may allow for special shareholder meetings to be called by a specified percentage of the shareholders prior to the next annual meeting.¹⁶ In certain cases, corporate

¹⁵ See Del. Code. Ann. tit. 8, Section 211(b); and Cal. Corp. Code § 301(a). For a discussion of rules in other states, see John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CALIF. L. REV. 1301, 1401 (2001).

¹⁶ *Id.*

state law may permit shareholders to vote by written consent in lieu of holding a meeting.¹⁷

Shareholders are also entitled to vote on certain so-called “structural” or “organic” changes that will substantially alter, or terminate, their investment interest. For example, both board approval and shareholder consent is required to amend the articles of incorporation, to sell substantially all the corporation’s assets, to merge the corporation into another, or to dissolve the firm. In addition, shareholders may generally vote to amend the corporation’s bylaws, the rules regulating corporate procedure, including restrictions on the exercise of the corporate power.¹⁸

C. Other Investors’ Voting Rights

Common shareholders are usually not the only class of investors in the firm. Many firms sell preferred stock – stock with special dividend and liquidation rights that we describe in more detail in Part III. And almost all firms borrow money from creditors. However, preferred shareholders’ and creditors’ voting rights are generally much more limited than those of common shareholders. In the typical corporation, the power to elect directors resides exclusively with common shareholders.

Preferred shareholders often have the right to vote – as a class – on certain corporate transactions and changes that are likely to materially affect their interests. The specific rights of preferred shareholders depend on the particular contractual arrangements they negotiate with the firm. Generally, preferred shareholders negotiate for the right to vote on matters such as

¹⁷ *Id.*

¹⁸ *See, e.g.,* 8 Del. C. § 107(b).

amendments to the certificate of incorporations, mergers and consolidations, as these may have an adverse effect on their rights.

However, in most public companies, the preferred stock agreements and certificates of incorporation do not give the shareholders the right to vote in the election of directors.¹⁹ Certain situations – such as a prolonged delay in the distribution of dividends to the preferred shareholders, may trigger a preferred shareholder right to participate in the election of directors.²⁰ Even in such an unusual event, however, the preferred are unlikely to obtain control of the board. Of course, preferred shareholders whose stock is convertible into common can vote after they convert their preferred stock to common. But they generally cannot vote for directors qua preferred shareholders.

Creditors' voting rights are even more limited. Like preferred shareholders, large lenders might bargain for the right to block certain corporate transactions that are likely to affect their interests. Specifically, creditors often negotiate for negative pledge clauses in the loan agreement that prohibit the company from giving certain security interests in its assets to other creditors. The loan agreement may also include additional debt covenants that prohibit or limit certain major transactions such as dispositions of the assets of the company, distributions to shareholders, and changing the business of the corporation.²¹

¹⁹ See D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399 (2002).

²⁰ See, e.g., Harvey R. Miller, *Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporations*, 23 SETON HALL L. REV. 1467, 1506 (1993).

²¹ See e.g. Robert M. Lloyd, *Financial Covenants in Commercial Loan Documentation: Uses and Limitations*, 58 TENN. L. REV. 335, 338-39 n.12 (1991), and George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CALIF. L. REV. 1073 (1995).

However, like preferred shareholders, creditors lack general control over the board. To the extent the debt is convertible into common stock, creditors can vote after they convert their debt into stock. But, like preferred shareholders, they rarely if ever can vote for directors qua creditors.

D. Explaining Common's Special Status

As we saw, in the typical corporation control of the board remains exclusively in the hands of common shareholders. Even if the firm has issued a substantial amount of debt and preferred stock, these classes of investors usually have no right to elect directors.

The lodging of voting rights exclusively in the hands of common shareholders is explained by economically-oriented legal scholars by common's position as residual claimants.²² Common shareholders are considered residual claimants because all other investors must be paid first before common shareholders receive anything. As residual claimants, common shareholders tend to benefit, on the margin, from increases in firm value and to lose, on the margin, from reductions in firm value. Thus, their private interests are generally aligned with the social goal of maximizing the value of the corporation as a whole.

Other investors' interests are generally not as well aligned with that of the corporations. Creditors, unlike shareholders, do not benefit from an increase in the value of the company above the sum of their total claims; they have no right to and do not share in any value above that amount. Thus, in many situations they have no incentive to boost corporate value; and in others they

²² See, e.g., Reinier Kraakman et al., *The Anatomy of Corporate Law: A Comparative and Functional Approach*, OXFORD UNIVERSITY PRESS, 33-34, (2004). Jonathan R. Macey, An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties, 21 *Stetson L. Rev.* 22, 23 (1991)

might have an incentive to engage in extremely low-risk strategies that do not maximize corporate value.²³

Preferred shareholders' interests are also generally not as well aligned with that of the corporation as are common shareholders'. Because of their liquidation preferences and preferred dividends, preferred shareholders may tend to be more risk averse than is optimal for the enterprise as a whole.²⁴ And in certain situations, even shareholders holding convertible preferred stock might not benefit from increasing firm value.²⁵ Thus, even shareholders holding convertible preferred stock generally do not have the right to vote for directors.

To be clear, we are not claiming that common shareholders are the only residual claimants. Because of the possibility of insolvency, all investors, including creditors are to some degree residual claimants²⁶ And other stakeholders besides investors, such as employees, might also be residual claimants. Indeed, when the firm is deeply insolvent, the main (or only) residual claimants may be creditors, not shareholders. But in most other cases, common shareholders are thought to be the class of investors whose interests are most closely aligned with total corporate value.

E. The Possibility of Common Shareholder Opportunism

²³ Of course, the interests of creditors holding convertible debt are better aligned with the goal of maximizing corporate value than the interests of creditors holding ordinary debt. But even convertible debtholders rarely are given the right to vote. See Alexander J. Triantis & George G. Triantis, *The Washington University Interdisciplinary Conference on Bankruptcy and Insolvency Theory: Conversion Rights and the Design of Financial Contracts*, 72 WASH. U. L. Q. 1231, 1253 (1994).

²⁴ See *infra* Part Part IV.

²⁵ See *infra* Part Part IV.

²⁶ See Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214 (1999).

Because of the possibility of insolvency, the board's decisions can affect the firm's ability to pay creditors and preferred shareholders. A decision to undertake a riskier project, or distribute large dividends to shareholders, may increase the likelihood that other investors will not be paid in full. A decision to undertake a less risky project, or to retain cash, might increase creditors' and preferred shareholders' expected recovery.

The common shareholders enjoy most of the upside from riskier courses of action and distributions but bear less of the cost on the downside should the firm fail. Thus, a board controlled by common shareholders might have an incentive to act "opportunistically" – to take steps that increase the value of common stock while reducing the value of other investors' interests by an even greater amount. For example, a board seeking to maximize common shareholder value might have an incentive to undertake excessively risky projects, or to distribute too much cash. The incentive to act opportunistically is most likely to arise when the firm is in the vicinity of insolvency or already insolvent.

However, creditors and preferred shareholders tend to anticipate the possibility that a board representing common shareholders will act opportunistically when lending money to or investing in the firm. As a result, they enter into contractual arrangements with the firm to protect their interests. For example, creditors often demand covenants entitling them to call default and accelerate payment if the firm's financial condition begins to deteriorate. These arrangements reduce the ability of a board representing common shareholders to act opportunistically toward other investors. By increasing the likelihood that creditors and preferred shareholders will be paid in full before common shareholders receive any value, these protective devices also tend to reinforce the residual status of common shareholders,

thereby strengthening the efficiency rationale for giving board control entirely to common shareholders.

III. Distinctive Arrangement of Venture-Backed Startups

This Part describes the distinct governance arrangement found in the typical venture-backed startup. Section A describes the control rights obtained by VCs investing in venture-backed startups – including de facto or actual board control -- and the reasons for their use. Section B explains that VC's cash flow rights always take the form of preferred stock with liquidation preferences and offers a tax explanation as well as agency cost explanations for the use of this security. The result of this combination of control rights and cash flow rights is that, in contrast to the standard corporate governance arrangement described in Part II, a venture-backed startup's board of directors is frequently controlled by investors owning preferred stock, rather than common stock.

A. VCs' Control Rights

VCs investing in startups arm themselves with a substantial variety of control rights, including protective provisions – and, most importantly for our purposes – in many cases de facto or formal control of the board. We first describe these rights and then describe the reasons for their use.

1. Protective Provisions.

As we explain in Section B, VCs invest through preferred stock. Like preferred shareholders in public companies, VCs are usually granted specific

veto rights called protective provisions. These provisions require VC approval for certain transactions, such as the sale of all or substantially all of the assets of the company. These rights include all those typically found in public company preferred stock. But they tend to go further. In fact, the VCs typically negotiate for a catch-all provision, in addition to a list of provisions that explicitly require their consent for most major transactions. Such catch-all provision allows the preferred to veto any action that materially modifies their rights under their agreements with the company.²⁷

2. Board Control

Protective provisions only give VCs the ability to block transactions unfavorable to them; they do not give the VCs power to initiate corporate action. Such power resides in the board. Thus, in addition to protective provisions, most VCs seek control over the board, either immediately or during a subsequent round of financing.

Board control gives VCs them substantial power over and above whatever contractual provisions they have negotiated. As Part II explained, the board of directors manages the business and affairs of the firm. It initiates, subject to shareholder approval, fundamental transactions – such as mergers, IPOs, or liquidations.²⁸ Although in public corporation most decisionmaking is delegated to the CEO, in the start up-context, members of the board are frequently and intimately involved in strategic decisionmaking and personnel issues. Board meetings are much more frequent than in public companies. The VCs serving as directors may also meet with the CEO and other key

²⁷ [add example?]

²⁸ 8 Del. C. 141(a); Cal. Corp. Code §300(a).

personnel outside of board meetings and even be personally engaged in some the day to day operations.²⁹

Most academics studying venture-backed startups have failed to understand the frequency with which VCs end up in control of boards.³⁰ VCs formally take a majority of the board seats in only about 25% of startups.³¹ In about 15% of startups, common shareholders maintain a majority of board seats through successive financings. In the remaining 60% or so neither common nor VCs end up with a majority of the seats; instead, the “swing votes” are held by so-called “independent directors” – industry experts agreed to by both the common stockholders and the VCs.

However, these outside directors are usually acquaintances of and recommended by the VCs. Entrepreneurs rarely have sufficient contacts to fill these positions, and tend to acquiesce to the VCs’ recommendations. Most of these outside directors have – or can expect to have – long-term professional and business ties with the VCs, who are repeat players. Cooperative outside directors can expect to be recommended for other board seats, or even to be invited to join VC fund as a “venture partner.” Thus, the outside directors are not truly independent. Should a conflict between the VCs and other investors arise, they can be expected to side with the VCs.³² As

²⁹ William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473, 508 (1990).

³⁰ See Bratton (2002); Kaplan and Stromberg (2003)

³¹ See Steven N. Kaplan & Per Stromberg, *Financial Contracting Theory Meets the Real World: Evidence from Venture Capital Contracts*, 70 REV. ECON. STUD. 281 (2003)

³² See Gordon Smith, *Control and Exit in Venture Capital Relationships* (working paper, 2005) 6. Our conversations with local VCs confirm this claim. While the independent directors might hold common stock in the startup, the value and anticipated value of their ties to the VCs (which include appointments to other boards, or as a venture partner in a VC fund) is likely to far outweigh the incentive effects of the common in situations where the common and the preferred have different interests.

a result, the percentage of start-up boards effectively controlled by VCs is closer to 80-90%.³³

It is worth noting that even when entrepreneurs control a majority of the board seats (after the first round of financing, entrepreneurs control a majority of the board seats in more than 15% of startups), VCs still have considerable power. As Gordon Smith as pointed out, even when VCs do not have effective or de facto majority of the board they can usually exploit staged financing and the blocking power of protective provisions to exert substantial control over board decisionmaking.³⁴ Thus, VC control is even more extensive than an analysis of board control would suggest.

3. Explanation for VCs' Control Rights

The agency cost explanations for VC control rights are simple. The entrepreneur frequently has little business experience and may have little business capability. The founder may, despite her best efforts, mismanage the VCs' money. Even if the entrepreneur has business experience, her goals may differ from that of the investors. The entrepreneur draws a salary and thus will prefer continuation even if the business should be shut down. The entrepreneur may also use the VCs' money to provide private benefits to

³³ Cf. Steven N. Kaplan, Berk A. Sensoy, and Per Stromberg, "What are Firms" Evolution from Birth to Public Companies" 28 (working paper, January 2005)(reporting that, by the time of the IPO, median VC directorships is 3, median management directorships is 2, and median outside directorships is 2).

³⁴ See Gordon Smith, Control and Exit in Venture Capital Relationships (working paper, 2005) 6. Cf. Paul A. Gompers, Optimal Investment, Monitoring, and the Staging of Venture Capital, 50 J. Fin. 1461 (1995). In future versions of this paper we intend to discuss in more detail the role played by staged financing.

themselves – such a high salary, perks such as luxurious offices, or prestige -- at the expense of investors' returns.³⁵

Board control allows the VCs to better monitor the operations of the firm, control entrepreneur opportunism,³⁶ and to replace the entrepreneur with a professional manager should the entrepreneur not prove up to the task.³⁷ Indeed, VCs eventually replace most founding entrepreneurs.³⁸

B. VCs' Cash Flow Rights

1. The Use of Preferred Stock

³⁵ See Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473 (1992).

³⁶ See D. Gordon Smith, *Venture Capital Contracting in the Information Age*, 2 J. SMALL & EMERGING BUS. L. 133, 138-140 (1998), and Sahlman (1990), *supra* note [].

³⁷ See Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473 (1992), William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891 (2002), D. Gordon Smith, *Control and Exit in Venture Capital Relationship*, working paper (Jan 2005). Absent board control rights, venture capitalists may not have sufficient incentives to undertake value-increasing activities benefit sufficiently from their own efficient activities to motivate them to undertake such activities as searching for competent executives to work for the company. See, e.g., Thomas Hellmann, *The Allocation of Control Rights in Venture Capital Contracts*, 29 RAND J. ECON. 57 (1998). Even if the entrepreneur is a good manager, board positions also give the VCs a formal mechanism for contributing their expertise and advice to the management team. As board members, the VCs can better help the company develop new opportunities, develop strategies, and recruit good personnel and identify new sources of capital. But the VCs don't need control of the board to perform these functions.

³⁸ Even in venture-backed firms that do well enough to go through an IPO, founders' involvement declines from the time the firms receive VC financing to the time of the IPO and thereafter. See Steven N. Kaplan, Berk A. Sensoy, and Per Stromberg, "What are Firms" Evolution from Birth to Public Companies" 23 (working paper, January 2005)(reporting that at time of IPO 43% CEOs are non-founders)

Startups issue two classes of stock: common and preferred. VCs invest almost exclusively through preferred stock.³⁹ The common stock issued by startups is held by founders, employees, and angel investors, and in certain cases strategic partners and third party service providers. The amount of this common stock is significant. One study finds that, of firms going public, median VC ownership is 53% of the shares; median founder ownership is 12%; median manager ownership is around 7%. The rest is owned by non-VC investors, other employees, and business partners.⁴⁰

Like much preferred stock issued by public companies, the preferred stock through which VCs invest are convertible to common shares. Typically, each preferred share can be converted into a single common share.⁴¹ Thus, on the upside, preferred stock offers the same payout as common stock. Nevertheless, the preferred is different from common stock in certain key respects that tend to make it “less residual” than the common in many situations. Most importantly, like public company preferred stock, preferred stock generally has liquidation preferences ahead of common.⁴² And, unlike public company preferred stock, the amount of these preferences often far

³⁹ See Steven N. Kaplan & Per Stromberg, *Financial Contracting Theory Meets the Real World: Evidence from Venture Capital Contracts*, 70 REV. ECON. STUD. 281 (2003). In fact, most venture-backed startups issue a new series of preferred stock each round of financing. Thus, there is usually more than one series of stock within the preferred class. While some of the rights of the preferred stockholders may be class rights, each series of preferred stock is assigned exclusive rights and preferences, which may give rise to conflict of interests within the preferred class. However, we will focus our analysis on the case in which there is only one series of preferred stock. This assumption does not materially affect the analysis. [TBA: discussion of the possibility that the startup has more than one series of preferred stock.]

⁴⁰ See Steven N. Kaplan, Berk A. Sensoy, and Per Stromberg, “What are Firms” Evolution from Birth to Public Companies” 26 (working paper, January 2005)

⁴¹ See Mann, O’Sullivan, Robbins, & Roberts, *supra* note [], at 860: (“One share of Series A Stock initially will be convertible into one share of Common Stock”.)

⁴² See Steven N. Kaplan & Per Stromberg, *Financial Contracting Theory Meets the Real World: Evidence from Venture Capital Contracts*, 70 REV. ECON. STUD. 281, ___ (2003) (finding that 97% of VC financings involve securities senior to common).

exceed the payment of the purchase price originally paid for the stock. Rather, the liquidation preference of VC preferred stock usually confers the right to payment of a multiple of the purchase price before common shareholders can receive any payment. Depending on the circumstances, such multiple can be substantially high, as much as 6 times the original purchase price, or even higher.⁴³ Thus, VC preferred stock is, relative to typical preferred stock, much more debt-like.

2. The Tax Explanation for Preferred Stock

A leading explanation for VCs use of preferred stock is that U.S. tax code (inadvertently) subsidizes VCs who invest with preferred stock rather than common stock. In particular, the use of preferred stock rather than common stock can reduce the tax cost of incentive compensation given to founders and other start-up employees.⁴⁴

Under current tax law, an employee receiving stock compensation is generally taxed on the value of the stock at ordinary income rates. Any subsequent appreciation above that value is taxed later, upon sale, at the much lower capital gains rate. Thus, everything else equal, a lower grant-date stock value reduces the parties' joint tax burden.⁴⁵ The IRS may challenge a grant-date value it believes to be low.

⁴³ See Richard A. Mann, Michael O'Sullivan, Larry Robbins, & Barry S. Roberts, *Starting From Scratch: A Lawyer's Guide To Representing A Start-Up Company*, 56 ARK. L. REV. 773, 860 (2004).

⁴⁴ See R. Gilson & D. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874 (2003), and Sahlman (1990), *supra* note [], at p 510.

⁴⁵ The corporation can, in principle, deduct the value of the stock in computing its taxable income. Thus, everything else equal, the higher is the value, the greater the deduction and tax savings for the corporation. However, most startups don't have taxable income for several years.

Consider VCs investing in ABC corporation, who are willing to pay \$10.00 per share for ABC corporation's common stock. If the investment takes the form of common stock sold to the VCs for \$10 per share, when ABC subsequently gives employees incentive stock, it cannot assign, for tax purposes, a value less than \$10.00. That price, reached through arm's-length bargaining, presumptively establishes the market value of ABC's common.

But when VCs invest with preferred stock – especially preferred stock with large liquidation preferences and other rights – the startup can argue that the price the VCs pay for the preferred stock does not indicate the value of the common. Thus, the startup continues to assign a low value, for tax purposes, to the common given to employees. VCs' use of preferred stock rather than common stock thus permits the parties to reduce the overall tax costs of the enterprise.

Suppose, for example, that the VCs investing in ABC are willing to purchase certain preferred stock for \$15.00 per share. The preferred stock is in fact worth more than the common because it carries additional rights, including a liquidation preference. Thus, the VCs are willing to pay \$5.00 more per share than the \$10.00 they are willing to pay per share of common. However, now there is no “smoking gun” evidence that the common stock is worth \$10 per share, and ABC can more comfortably take the position that the common is worth a much lower amount, such as \$1.50 per share. In fact, startups commonly take the position, for tax purposes, that the common stock is worth 10% of the price most recently paid for the preferred.

In short, the tax law penalizes VCs who use common stock by making it more costly for startups to provide incentive compensation to employees. In fact, there is evidence that VC's use of common stock outside the US – where these tax penalty is not imposed – is far more frequent than in the US.

Thus, there is reason to believe that much of VC's use of preferred rather than common is driven by tax considerations.⁴⁶

3. Agency Cost Explanations for Preferred Stock

Academics have also offered agency cost explanations for preferred stock. The liquidation preference of the preferred stock tends to reduce the cost of management opportunism and, to some extent, deter it. It leaves the managers, who hold common stock, a smaller share of the total distribution in the event of poor performance. Thus, a decrease in the valuation of the company may hurt the managers more than their pro rata share, increasing their incentive not to exploit their position as agents.⁴⁷

It is also argued that the use of convertible preferred shares helps align the incentives of entrepreneurs and the venture capitalists.⁴⁸ The convertible preferred stock motivates the entrepreneurs to increase the value of the firm more than they would have had the investors received straight equity because the entrepreneurs gain less in the downside. At the same time, the convertible preferred stock motivates the entrepreneurs to take less risk than they would have taken had the investors received pure debt interest, because the entrepreneurs now share in the gain from the upside with the preferred.

Finally, it is argued that an entrepreneur's willingness to issue convertible preferred shares is a signal that the firm is not substantially over priced and that the entrepreneur is motivated and confident in his ability to increase the

⁴⁶ [add discussion of options and ISOs]

⁴⁷ See Sahlman (1990), *supra* note __, at 510-511.

⁴⁸ See, e.g.; Leslie M. Marx, Efficient Venture Capital Financing Combining Debt and Equity, 3 *Rev. Econ. Design* 371, 372 (1998); William A. Sahlman, The Structure and Governance of Venture-Capital Organizations, 27 *J. Fin. Econ.* 473, 510 (1990).

value of the firm.⁴⁹ This is mainly due to the preferred shareholders' distributional priority rights – i.e. the liquidation preference – that provide that when the company performs badly the preferred shareholders have a right to all of the firm's value, leaving entrepreneurs with nothing.

There is reason to believe, however, that the agency cost explanations for the use of preferred stock cannot entirely explain its use in the U.S. Presumably, VCs in other countries face the same agency costs as US VCs. However, as noted earlier, the use of preferred stock is less common in other regimes with different tax laws, suggesting that tax law drives the use of preferred stock in at least certain situations.⁵⁰

III. Costs of Preferred Control of the Board

This Part describes the problems that can arise when preferred-owning VCs control, indirectly or directly, the board of a startup. These problems arise because of the different cash flow rights of preferred and common – differences that tend to be more pronounced in the venture-backed company. Section A introduces a simple example to illustrate when and how the payoffs of preferred stock and common stock are likely to differ.

Section B identifies three “ex post” forms of value-reducing opportunism that can arise due to these different payoffs when preferred control the board: (1) sub-optimal business strategies; (2) a tendency to prefer “liquidity events” (liquidation, merger, IPO) over higher-value strategies

⁴⁹ See, e.g., Jeremy C. Stein, Convertible Bonds as Backdoor Equity Financing, 32 J. Fin. Econ. 3, 15 (1992).

⁵⁰ See Steven N. Kaplan, Frederic Martel, and Per Stromberg, How Do Legal Differences and Learning Affect Financial Contracts? (working paper, 2004)p.8 (reporting that 28% of a sample of VC financing outside the U.S. used common stock, vs. 1% in the U.S.) Similar results are reported in Cumming (2001) and Lerner and Schoar (2003).

involving more risk; and (3) insufficient investment and effort on the part of the board. As we explain, the costs of this opportunism are borne, in the first instance, by common shareholders, reducing the value of common stock.

Section C identifies three “ex ante” costs that result from reducing the value of common stock: (1) the cost of angel financing for very early stage companies rises, making it more difficult for such ventures to get financing; (2) founders are likely to forego potentially value-adding VC financing because of fear of subsequent opportunistic behavior by the VCs; and (3) entrepreneurs and employees may be less willing to found/join startups knowing that much of their compensation will come in the form of common stock that subsequently may be devalued by preferred shareholders controlling the board. Section D considers who bears these costs.

A. Divergent Payoffs to Preferred and Common: Simple Example

Suppose the capital structure of a company (Startup) is equally divided into two classes of shares: a class of convertible preferred shares and a class of common stock. Startup has issued 50 shares of common stock to its founders and employees. In addition, 50 shares of the convertible preferred stock have been issued to VC investors at a price of \$1 a share. Each preferred share may be converted into a single share of common.

Like all preferred stock, Startup’s preferred comes with a liquidation preference: the right to receive, in a distribution event (e.g., liquidation, merger, IPO), a certain amount prior to and in preference to the common shares. Let us assume that the preferred shares have a 2X liquidation preference: they are entitled to receive, in a distribution event, up to two times the purchase price of the stock. Thus, the liquidation preference of the preferred shareholders as a class in this example is \$100.

Consider three scenarios: (1) a “bad” state of the world: Startup is sold (merged or liquidated) for an amount $\$V$ that is less than or equal to $\$100$; (2) a “good” state of the world: Startup is sold for an amount $\$V$ that is greater than or equal to $\$200$; and (3) an “intermediate” state of the world: Startup is sold for an amount $\$V$ between $\$100$ and $\$200$.

Scenario 1: “Bad” state: Startup sold for $\$V < \100 . Suppose the VCs holding preferred convert to common before the distribution. The company’s capital will now consist of 100 shares of common stock. Following such conversion, the VCs, formerly holding preferred shares, will hold 50/100 of the common, and therefore be entitled to receive half the proceeds of the sale, or $\$V/2$. The original common shareholders would receive $\$V/2$.

If the VCs do not convert, their liquidation preference of $\$100$ entitles them to receive the entire amount of the proceeds of the sale, $\$V$. Thus preferred will not convert, and receive $\$V$. Common shareholders receive nothing. In the bad state of the world, the payoffs to preferred and common are asymmetric: preferred is paid $\$V/50$ per share, common $\$0$.

Scenario 2: “Good” state. Startup sold for $\$V > \200 . If the VCs were to convert to common, the company’s capital will consist of 100 shares of common stock. Following such conversion, the VCs, formerly holding preferred shares, will hold 50/100 of the common, and therefore be entitled to receive half the proceeds of the sale, or $\$V/2$, which in this scenario exceeds $\$100$.

If the preferred-owning VCs do not convert, their liquidation preference entitles them to receive $\$100$. Common receives $\$V-100$, which is greater than $\$100$. Thus preferred will convert, and receive $\$V/2$. Common shareholders would also receive $\$V/2$. In the good state of the world, the payoffs to preferred and common are symmetric: both classes are paid the same amount per share.

Scenario 3: “Intermediate” state. Startup sold for $\$100 < \$V < \$200$. If preferred were to convert to common, there would be 100 shares of common outstanding of which the (formerly) preferred investors would own \$100. They would be entitled to receive $\frac{1}{2}$ the proceeds of the sale, or $\$V/2$, which is less than \$100.

If the preferred don't convert, they are entitled to their \$100 liquidation preference.⁵¹ Thus the preferred will remain preferred and receive \$100, or \$2 per share. Common will receive the remainder of the proceeds, $\$V-100$, or $(\$V-100)/50$ per share, which is less than \$100. Thus in the intermediate state of the world, the payoffs to the different classes are asymmetric.

The following table summarizes the payoffs under each scenario:

Scenario	Distribution to Preferred	Distribution to Common
1. Bad State ($V < 100$)	V	0
2. Good State ($V > 200$)	$V / 2$	$V / 2$
3. Intermediate State ($100 < V < 200$)	100	$V - 100$

B. Ex Post Costs of Preferred Opportunism

⁵¹ Under some arrangements, the investors are granted a right to receive not only the liquidation preference prior and in preference to the common shareholders, but also to participate with common on a pro-rata basis in any distribution of funds remaining following the payment of the liquidation preference. Suppose, for example, the preferred shareholders of Startup were participating preferred. In the intermediate state of the world, they would receive $\$100 + 50\% (\$V-\$100)$, while the common stock holders would receive $50\% (\$V-\$100)$. (In many cases, the participation of the preferred shareholders in a distribution of the funds remaining after the distribution of the liquidation preference is capped.) However, abstracting from the possibility of “participation” does not materially affect the paper's analysis.

As Section A explained, the different cash flow rights of preferred may yield payoffs that are quite different from those available to common shareholders. Only in the good state of the world, when preferred convert to common, are the payoffs congruent. Because of the difference in payoffs, there may well be many situations in which the interests of the preferred shareholders diverge from the efficient goal of maximizing the value of the company as a whole – that is, the joint value of the preferred and common.⁵² When preferred shareholders control the board, they may therefore act in ways that benefit their class at the expense of the corporation as a whole.⁵³ We identify three distortions that arise after preferred take control of board (which we therefore call “ex post” distortions): (1) The board may choose lower-risk, lower value business strategies over higher-risk, higher value strategies; (2) the board may push for immediate liquidity events (such as a merger, liquidation or IPO) even when the expected value of remaining independent is higher; and (3) underinvestment – the preferred board may exert insufficient effort to increase the value of the startup.

1. Sub-Optimal Business Decisions

The first possible ex post distortion caused by preferred control of the board is sub-optimal investment decisionmaking. Because of the preferreds’

⁵² For simplicity, we assume that the board’s decisions affect only the value of the firm’s equity. This assumption does not materially affect the analysis. In fact, most startups have little debt. See David Denis, *Entrepreneurial Finance: an Overview of the Issues and Evidence*, JOURNAL OF CORPORATE FINANCE 10, 301, 304 (2004).

⁵³ VC control of the board might enable them to engage in other forms of opportunism that reduce corporate value, such as self-dealing or taking of corporate opportunities. See supra note __. But these forms of opportunism are not a function of the VCs holding preferred stock. They arise even if the VCs own common stock. We therefore do not address these forms of opportunism in this paper, which focuses on the problems that arise solely from the fact that those controlling the board represent the interests of preferred shareholders rather than those of common shareholders.

liquidation preference and conversion rights, they tend to gain less from increases in firm value than they lose from decreases in firm value. This effect, in turn, may cause a board dominated by preferred shareholders to choose lower-risk, lower value strategies over higher-risk, higher value strategies.

For example, suppose that Startup can choose between (a) Riskless investment strategy (which will yield \$110 with certainty) and (b) High-Value Risky strategy that promises a payoff of \$300 with 50% probability and \$0 with a 50% probability. The expected value of the Very High-Value Risky Strategy is \$150. From a social perspective, Startup should choose this High-Value Risky strategy over the Riskless strategy because it maximizes total value.⁵⁴

Riskless Strategy. If the preferred shareholders retain their preferred shareholdings, they will enjoy a liquidation preference of 2X for each of their 50 shares purchased for \$1 per share, or \$100. Thus, the preferred shareholders will be better off enjoying their liquidation preference than converting. The liquidation preference grants the preferred shareholders the right to receive \$100, which is more than their pro-rata share of the distribution. The rest of the payout, \$10, will go to the common stockholders.

High-Value Risky Strategy. If there is a good outcome, with a payoff of \$300, preferred shareholders will convert to common and receive \$150. The original common shareholders will receive \$150. If there is a bad outcome, preferred shareholders and common will receive \$0. Thus, the expected value

⁵⁴ To be sure, risk averse parties might prefer a lower-risk/lower-value project to a higher-risk/higher-value project. But we are assuming risk-neutrality throughout for ease of exposition. The assumption does not change any of the analysis.

to both preferred shareholders and common shareholders of the high-value risky strategy is \$75, less than the value to preferred of the Riskless strategy.

To the extent preferred control the board, they will thus have an incentive to choose the inefficient strategy. The result is that the value of preferred will be higher (\$100 vs. \$75) and the value of the common will be lower by an even greater amount (\$10 vs. \$75).

To be clear, we are not claiming that preferred will always choose a low value strategies over high value strategies. If the payout of the High value risky strategy were sufficiently high – in this case more than \$400, preferred shareholders would prefer the High value risky strategy to the riskless strategy. Rather, our point is that in many situations the divergence of interests between preferred and common will cause a preferred-dominated board to choose projects that do not maximize total value for all shareholders.

Nor are we claiming that a board dominated by common shareholders would always choose the socially optimal strategy. The problem of differential payoffs cuts both ways. Just as what is good for preferred is not necessarily good for total shareholder value, what is good for common is also not necessarily good for total shareholder value. It should be easy to see that a common-dominated board might have an incentive to choose a high-risk strategy that promises less expected value than a lower-risk strategy. Again, our point is simply that a board dominated by preferred shareholders cannot be counted on to make value-maximizing decisions for the firm.

2. Sub-Optimal Exit Decisions: Bias in Favor of Liquidity

As just explained, convertible preferred shareholders tend to have less to gain from increases in firm value than they have to lose from equivalent

decreases in firm value. This bias affects not only investment decisions but also the choice between steering the company toward a liquidity event and continuing to run the company as an independent business. In particular, the difference in payoffs will bias preferred-dominated boards in favor of immediate “liquidity events” (liquidation, merger, IPO) even if expected firm value would be higher operating the firm as a private going concern. The reason is simple. Liquidity events promise an immediate payout (although in the case of an IPO, the payout might be delayed by a 6 month lockup). Continuing to operate the firm as a private concern exposes the preferred-owning VCs to risk.

For example, suppose that Startup can choose between (a) a merger that will yield \$110 with certainty and (b) remaining independent, which promises a payoff of \$300 with 50% probability and \$0 with a 50% probability. The expected value of independence is \$150. From a social perspective, Startup should remain independent because doing so maximizes total value.⁵⁵

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

Remaining Independent. If there is a good outcome, with a payoff of \$300, preferred shareholders will convert to common and receive \$150. The original common shareholders will receive \$150. If there is a bad outcome, preferred shareholders and common will receive \$0. Thus, the expected value

⁵⁵ To be sure, risk averse parties might prefer a lower-risk/lower-value project to a higher-risk/higher-value project. But we are assuming risk-neutrality throughout for ease of exposition. The assumption does not change any of the analysis.

to preferred shareholders and common shareholders of remaining independent is \$75, less than the value to preferred of the merger.

To the extent preferred control the board, preferred will have an incentive to effect the merger even though it generates less value for shareholders as a group. The preferred will be worth \$100 rather than \$75, and the common will be worth \$10 rather than \$75.

Again, we are not claiming that preferred will always choose to pursue an “exit” over remaining independent. If the expected payouts of remaining independent were sufficiently high, referred shareholders would prefer that path over merger. Nor are we claiming that a common-controlled board would always make the right decision. It would also have a bias – although in the opposite direction. Rather, our point is that in many situations the divergence of interests between preferred and common will cause a preferred-dominated board to push for a liquidity event that provides less value for all shareholders than remaining independent.⁵⁶

3. Underinvestment

It is well known that shareholders of public companies face an agency problem. Each shareholder owns only a small percentage of the firm’s stock,

⁵⁶ There might be other distortions in exit decisions arising from structure of VC financing contracts. For example, VC financings typically include provisions requiring the VCs to convert into common upon completion of a “qualified” IPO – an IPO above a certain per share dollar threshold. Apparently, investment banks are reluctant to take public companies that have outstanding preferred shares. The forced conversion provision is designed to prevent individual VCs from trying to hold up an IPO in exchange for a side payment from other VCs. However, such provisions may bias VCs as a group (and in particular participating preferred shareholders, see *supra* note x) in favor of a merger or non-qualified IPO that yields less value for shareholders as a group. See Thomas Hellmann, *IPOs, Acquisitions and the Use of Convertible Securities in Venture Capital*, 21 STETSON L. REV. 23, ___ (2002). If VCs had common to begin with, this exit distortion would not arise.

leading shareholders not to monitor the board and the firm's managers. The managers are thus given equity to incentivize them to maximize shareholder value. However, managers own only a small fraction of the firm's equity. As a result, they reap only a fraction of each dollar of additional company value they generate.⁵⁷ This may lead them to exert insufficient effort – or “shirk.”

In some respects, the problem of managerial shirking is much less severe in the start-up context. The firm's equity is concentrated in the hands of relatively few parties, including sophisticated VCs. These parties frequently sit on – and often control – the board. And concentrated ownership gives these investors and their representatives on the board a strong incentive to monitor the managers serving underneath them.

However, when the board is dominated by preferred shareholders, the board itself may engage in shirking: in many situations it is not worth it for a board representing the interests of preferred shareholders to try to increase firm value.

Return to the case of Startup. Suppose that VC's control the board. And that with some effort the value of Startup can be raised from \$110 to \$150 before the company is sold. If the value of Startup is \$110, preferred will get \$100. If the value of Startup is \$150, preferred will still get only \$100. Thus, they have no incentive to exert effort to increase the value. Indeed, they are indifferent across the range of values $\$100 < \$V < \$200$ —that is, values between their liquidation preference and the pro rata share, or conversion value (the value at which it makes sense to convert).⁵⁸ The result is that the value of common is worth \$10 ($\$110 - 100$) rather than \$50 ($\$150 - \100).

⁵⁷ See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

⁵⁸ More formally, for non-participating preferred, this means that within the range of $x \leq v \leq \frac{x}{p}$ the preferred are indifferent. Where v is the firm's value, x is the liquidation

To be sure, an increase in the valuation of the company within the economic indifference range might marginally benefit the VC from a reputational perspective so that it will not completely be indifferent to such increase. However, to the extent the reputational benefit of every additional \$1 in value is worth less than \$1, the VC will still have an insufficient incentive to increase value.

C. Ex Ante Costs of Preferred Opportunism

Section B identified three costs that arise *after* preferred take control of board (which we therefore called “ex post” costs). This Section describes three costs that arise when investors and employees anticipate the possibility that common will subsequently be devalued by a preferred-dominated board. We describe three such distortions: anticipated opportunistic behavior by preferred (1) raises the cost and reduces the availability of “angel” financing, an important early-stage source of capital for startups; (2) makes entrepreneurs less willing to accept VC financing, even when VC financing can add significant value; and (3) reduces the incentive value of common stock held by founders and employees of the startup.

1. Reduced Availability of Angel Financing

preference, and p is the preferred shareholders’ percentage holding. The preferred shareholders are indifferent because within this range they receive x regardless of the exact valuation.

It can be shown that participation rights reduce this problem (and eliminate it when they are uncapped). For participating preferred shares that are capped, the range is:

$\frac{y + (p - 1) \times x}{p} \leq v \leq \frac{y}{p}$ where y is the cap on their participation (since they receive y regardless of the exact valuation).

Most startups are unable to secure VC or other institutional financing in the first year of the business, when risk is highest. Thus, wealthy individual investors, referred to as “angels,” serve an important role of supporting these companies by supplying what is known as seed capital. In fact, the total amount of angel financing in the United States is much larger than the equivalent amount of venture capital financing – perhaps an order of magnitude larger.⁵⁹

Aside from timing, angel financing tends to differ from VC financing in a number of important respects. The amounts invested in a firm by a particular angel investor is likely to be much smaller than the amounts invested in VC financing rounds. And angels tend to lack expertise that would enable them to contribute additional value to the business.

Because angels invest less than VCs and tend to be less sophisticated, financing agreements are much more informal. Unlike VCs, angels generally do not acquire control rights and board positions. Most importantly, angels usually invest in straight common equity.⁶⁰ Thus, they are vulnerable to opportunism by preferred control board. To the extent that angels anticipate that subsequently investing VCs will take control of the board and engage in actions that reduce the value of common shareholders, the angels will expect a lower return from their investment. This, in turn, may discourage angels from investing in start-ups through common stock, or cause them to demand a larger stake in exchange for their investment, raising the cost of capital to entrepreneurs.

⁵⁹ See Andrew Wong, *Angel Finance: the Other Venture Capital*, Working Paper, University of Chicago (2002); Sahlman (1990).

⁶⁰ See Wong (2002), Thomas J Chemmanur & Zhaohui Chen, *Angels, Venture Capitalists, and Entrepreneurs: A Dynamic Model of Private Equity Financing*, (working paper), and Fen, Liang, & Prowse, *The Economics of the Private Market*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., Staff Studies Series No. 168, 1995.

To be sure, each angel could insist on receiving preferred stock with protective provisions from the startup, rather than common stock. Such provisions would offer some protection from subsequent opportunism by VCs. And, in fact, when angels act collectively and invest a significant amount of money in startups, they will often incur the expense of negotiating for preferred stock with such provisions. But even these startups are often first capitalized with individual angel investment, and the transaction costs of contracting over the preferred stock are sufficiently high that it is simply not worthwhile for each small angel investor to negotiate such arrangements. Thus, a substantial portion of angel investing will continue to be in the form of common stock.

2. Reduced Willingness to Use VC Financing

As noted earlier, VCs can add value to startups not only by supplying funds but also by providing monitoring, advice, and connections. VCs are experienced investors who actively and closely monitor the performance of portfolio company management, replacing personnel as necessary. VCs also offer guidance to the company. They help develop the company's internal organization, its business plan, and its marketing strategy. Finally, VCs with their wide network of contacts can be instrumental in helping the startup form strategic alliances. When the VC is respected as an astute investor by other VCs, its involvement with a startup can help the startup raise additional funds from other institutional investors.⁶¹

Despite the vast potential contribution of VCs to the company, founders are often hesitant and nervous about letting VCs invest in the

⁶¹ See David Denis, *Entrepreneurial Finance: an Overview of the Issues and Evidence*, JOURNAL OF CORPORATE FINANCE 10, 301, 305-307 (2004).

company. As a result, entrepreneurs often delay investments by VCs in their companies.⁶² This sentiment in part reflects entrepreneurs desire to retain autonomy and control, with all the psychic benefits that arrangement provides. But it also in part reflects fear of opportunistic behavior by VCs that take control of the firm. And such VCs are more likely to engage in opportunistic behavior if their financial payouts are likely to diverge from that of the founder, who holds common stock.

3. Reduced Incentive Effect of Common Stock

Emerging firms rely heavily on equity compensation to attract and incentivize employees. Indeed, the tax explanation for the use of preferred stock depends on startups heavily using stock and option compensation to pay employees.

Equity compensation allows liquidity-constrained firms, which are unable to pay competitive salaries and cash bonuses, to compete in the labor market for talented employees. In addition, the grant of equity compensation is intended to align the interests of the officers and other employees with the goal of maximizing firm value.

Employees of venture backed companies are typically issued common stock and options for common stock. In order for equity compensation to be an effective incentive it has to be valuable. As we have shown, however, the value of common stock can be compromised when the board represents the interests of preferred shareholders.

⁶² See, e.g., Bill Inmon, *Information Management: Charting the Course: Venture Capitalists and Innovation: 2003*, DM Review Magazine (Nov 2003) <http://www.dmreview.com/article_sub.cfm?articleId=7609> (visited Jan 2005)

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

However, not all of the current employees will have such leverage at that critical time. And by the time the firm goes through a liquidity event, many of its early employees, and possibly even the founders, will no longer have positions in the company. Even if the founders of the firm are still employed by the firm in some capacity they might not be considered crucial to its future operations at the time of a liquidity event.

Ex ante, any given employee cannot predict how long he will remain with the firm, or if he will be able to extract extra value at the time of a liquidity event. The risk of becoming a pure common stockholder, vulnerable to preferred opportunism, decreases the value assigned to the equity compensation by the employees. This, in turn, has two effects: it reduces the value of incentive compensation to employees, including founders, which might require the startup to pay more in cash; and it reduces the incentive effect of that equity, which might in turn reduce effort.

D. Who Bears these Costs?

To the extent preferred opportunism generates costs, those costs must be borne by someone. The precise incidence of these costs will depend on the efficiency and competitiveness of various markets -- the market for entrepreneurs, the market for angel financing, and the market

for VC financing, -- and, to the extent any of these markets are not fully competitive – the bargaining power of the various parties.

The most realistic scenario is that in which (a) none of these markets is perfectly competitive and (b) none of the parties has 100% of the bargaining power. Under these conditions, the costs of preferred opportunism will reduce the surplus that can be divided among the parties, and therefore each party's return. As a result, the costs of preferred opportunism will be borne, to varying degrees, by all of the parties, including the VCs.

It is easy to see how entrepreneurs holding common stock bear some of the identified costs. Ex post, preferred opportunism – by leading to suboptimal investment and exit decisions -- reduces the value of their common stock. Ex ante, it might make it more difficult for them to raise angel financing from equityholders.

How VCs would bear part of the costs is less obvious. But to the extent VCs share in the surplus created by the startup, a diminution of that surplus will reduce the VCs' returns. Knowing that the VCs may subsequently transfer value from common shareholders and take steps that reduce overall startup value, entrepreneurs will give up a smaller fraction of the firm for a fixed amount of VC investment. Entrepreneurs might also be more reluctant to get VC financing in the first instance, reducing the VCs' ability to invest in profitable ventures.

In short, while VCs gain ex post from preferred opportunism, they can be expected to “pay” for this opportunism ex ante through worse investment terms. If VCs could credibly commit in advance not to engage in such opportunism, the expected surplus – and their expected return –

would be higher. However, as we now explain, neither legal nor reputational constraints are likely to make such a commitment credible.

V. Weakness of Legal and Reputational Constraints

Part IV explained how common shareholders may be vulnerable to opportunism by a preferred-dominated board and identified a variety of costs such opportunism can impose. This Part considers the possibility that current legal rules and reputational considerations might adequately protect common shareholders from the opportunism described in Part IV. We examine mandatory shareholder voting rights (Section A); the appraisal remedy (Section B); director fiduciary duties enforced through derivative litigation (Section C); and VC's reputational concerns (Section D). We show that, both individually and collectively, these constraints are unlikely to fully protect common shareholders.

A. Shareholder Voting

Corporate law requires that shareholders approve certain major corporate transactions and changes – such as merger, dissolution, and amendments to the certificate of incorporation.⁶³ Thus, shareholders have the power to block such transactions and changes when they would hurt them. This power gives

⁶³ See, e.g., Del. Code. Ann. tit. 8, Section 251(c), and Cal. Corp. Code §§ 1200, 1101 (mergers); Del. Code. Ann. tit. 8, Section 242(b)(1), and Cal. Corp. Code §§ 902-3 (amendment to certificate or articles of incorporation); Del. Code. Ann. tit. 8, Section 271(a), and Cal. Corp. Code § 1001 (sale of assets not in ordinary course of business); and Del. Code. Ann. tit. 8, Section 275(b), and Cal. Corp. Code § 1900 (dissolution).

shareholders some ability to protect themselves from insider opportunism.⁶⁴ In principle, at least, shareholders' power to block transactions should ensure that the board takes an action only if it is value-increasing. Unfortunately, however, in venture-backed startups the voting mechanism is of little use for protecting *common* shareholders.

To begin, most important corporate decisions do not require any shareholder approval. Thus, the board generally has complete discretion in most of the decisions it faces. For example, absent an explicit bylaw to the contrary or the need to change the corporate charter, the board is free to make whatever business and investment decisions it wishes.

Moreover, even in those unusual transactions that require shareholder approval, corporate law generally does not require a separate class vote of *common* shareholders, but rather approval by approval by holders of a majority of the firm's outstanding stock entitled to vote on the transaction.⁶⁵ And VC financing arrangements typically allow the VCs to vote their preferred shares together with common when stockholder approval is required.⁶⁶ Importantly, VCs can vote on these issues without converting into common stock and thereby losing the privileges assigned to the preferred stock. Preferred shares get either 1 vote per share or the number of votes they

⁶⁴ This protection is limited, however, due to the board's control over the structure and timing of proposals presented to the shareholders and the board's ability to bundle the proposals. This bundling is designed to force shareholders to accept value-decreasing proposals. See Jeff Gordon, *Contractual Freedom in Corporate Law: the Mandatory Structure Of Corporate Law*, 89 COLUM. L. REV. 1549, 1578-9 (1989).

⁶⁵ See, e.g., Del. Code. Ann. tit. 8, Section 271(a) ("Every corporation may at any meeting of its board of directors or governing body sell, lease or exchange all or substantially all of its property and assets ... when and as authorized by a resolution adopted by the holders of a majority of the outstanding stock of the corporation entitled to vote thereon") Cf. Del. Code. Ann. tit. 8, Section 242(b)(2), which specifically requires a class vote for certain proposed amendments of the certificate of incorporation.

⁶⁶ See D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1471 (2002): ("venture capitalists hold residual control rights through their right to ... vote as a single class with the common shareholders.")

would have if converted into common. Thus, if each preferred share would convert to 5 common shares, a preferred share would get 5 votes. To the extent the preferred shares' voting power exceeds that of the common, the preferred can dictate the outcome of the vote.⁶⁷ In fact, by the second VC financing round, VCs obtain majority voting power in over 60% of venture backed startups.⁶⁸ By the time the startup must make exit decisions, common stockholders will generally have lost the ability to block transactions that hurt their interests.

Finally, even if common shareholders have the right to vote alone as a class, a preferred board can take various steps to force through a transaction that hurts common as a class. For example, preferred shareholders may partially convert into common in order to control the class vote.⁶⁹ A preferred controlled board can also ensure a favorable outcome to a common class vote by buying votes of enough common shareholders. Such vote buying is relatively easy in the start-up context. The board can issue additional shares to employees who would gain from the board's proposed course of action.⁷⁰ Or, as has allegedly occurred in one litigated case, the board can pay

⁶⁷ See Supra note ____.

⁶⁸ See *id.*, Steven N. Kaplan & Per Stromberg (2003): They report that founders relinquish voting control by the second VC round in all but 11.5% of the financing rounds. VCs obtain explicit voting control in over 40% of first VC round financings and in over 60% of second VC rounds.

⁶⁹ A related strategy was used by the preferred controlled board in *Orban v. Field*, No. 12820, 1997 Del. Ch. LEXIS 48 (1997). For accounting reasons, Staples Inc., the prospective buyer of Office Mart Holdings Corp., insisted that 90% of each class of stock vote in favor of a merger that would provide nothing to the common. (This vote was supposed to ensure that the transaction would qualify for the use of the pooling-of-interests method). The common refused to vote in favor of the merger. The preferred-dominated board facilitated preferred shareholder exercise of warrants to buy common stock in order to ensure 90% vote in favor of merger. A similar problem arises in the general context of 'conflict of interest voting', see Zohar Goshen, *Voting (Insincerely) in Corporate Law*, 2 THEORETICAL INQ. L. 815 (2001); Frank Partnoy and Shaun P. Martin, *Encumbered Shares* (working paper, 2005).

⁷⁰ See *Alantec*

employees to exercise options that are underwater and acquire common stock.⁷¹ Alternatively, the board can increase the compensation paid to employees holding stock in exchange for a favorable vote.

Both partial conversion by VCs and vote buying can prevent common stockholders from extracting part of the surplus. Both of these techniques allow the holders of the preferred stock to influence and actually participate in the vote of the common shareholders thus swaying the result to their favor even when a separate class vote of common is required to effectuate a transaction desired by the preferred.

To be sure, these techniques are not necessarily without cost to the preferred. For example, the preferred shareholders give up the right to the preferred-stock liquidation preference to the extent they convert some of their preferred into common. But a high preferred to common conversion rate would permit the preferred shareholders to control the common by giving up relatively few preferred shares. And if the control obtained by partial conversion can be used to transfer enough value from other common shareholders to the remaining preferred shareholders, preferred shareholders will find this strategy profitable. Moreover, the cost of some of these techniques – such as issuing new common stock – may fall exclusively on the existing common stockholders. In short, common shareholders often cannot count on voting rights to protect themselves from preferred opportunism – even when the action sought by the preferred requires a class vote by common shareholders.

B. Appraisal Rights

⁷¹ See *Latif v. Nishan Systems, Inc., et al.* (Santa Clara Sup. Ct., No. 1-03-CV-004-939).

Even if common shareholders do not have the voting power to block a proposed transaction that would hurt them, corporate law might give them appraisal rights in connection with the transaction – the right to sell their stock to the corporation for a “fair value.” To the extent that the appraisal remedy permits common shareholders to compel the firm to buy back their stock for the value it would have in the absence of preferred opportunism, the common could prevent the preferred from diverting value from them. Anticipating that common shareholders would seek appraisal, a preferred-dominated board might be reluctant to engage in opportunistic behavior at common shareholders’ expense. Unfortunately, appraisal is an extremely weak constraint on preferred opportunism.

To begin, appraisal rights are rarely available. The rights are generally triggered only in the event of a statutory merger. A preferred-dominated board could push through any other type of transaction – including transactions that are economically equivalent to statutory merger – without fear of triggering appraisal rights.

In addition, it is unclear whether courts would, in determining fair value, give common shareholders what they would have received in the absence of preferred opportunism. The appraisal proceeding tends to focus on the shares’ value at the time of the appraisal. Any value reducing misconduct that took place prior to the appraisal triggering event may not be accounted for in the appraisal process.⁷²

Moreover, even if appraisal rights are available, common shareholders are unlikely to receive, in current value terms, the “fair value” of their shares.

⁷² See Michelle M. Pepin, *Exclusivity of Appraisal - The Possibility of Extinguishing Shareholder Claims*, 42 Case W. Res. 955 (1992) (giving examples of such “re-appraisal misconduct causing misevaluation such as excess compensation being paid to officers).

Appraisal litigation is complicated and expensive.⁷³ It can take a number of years, and shareholders receive no money until it is concluded.⁷⁴ During this time, the corporation could become insolvent, in which case the appraisal claim would be subordinated to the claims of ordinary creditors. If the corporation remains solvent it must, at the end of the litigation, pay interest on the determined “fair value” from the date of the merger. However, the rate at which the corporation must pay interest is typically set too low to compensate the shareholders for the time value of money and the risk of nonpayment.⁷⁵

Finally, there are complicated procedural requirements and deadlines that must be satisfied to exercise the appraisal remedy. The shareholder is required to notify the company of the intension not to approve the disputed transaction, to abstain or vote against the transaction, and subsequently to file a petition requesting appraisal no more than 120 days following the transaction. This short period in which the shareholder may exercise the appraisal right may not enable him to discover the required evidence for proving allegations of wrongdoing to justify the petition.⁷⁶

⁷³ See Richard T. Hossfeld, *Short-Form Mergers After Glassman v. Unocal Exploration Corp.: Time to Reform Appraisal*, 53 DUKE L.J. 1337, 1339 (2004). In Delaware, shareholders seeking appraisal are barred from using class action suits. Each shareholder has to pursue his own individual claim. Thus, shareholders lose the important economic benefits of class actions, which allow a successful plaintiff to petition for attorneys' fees and expert witness costs. A class action also helps share the costs of litigation among the dissenting shareholders. As a result of the unavailability of class action, attorneys are generally reluctant to represent minority shareholders in an appraisal procedure on a contingency basis. See Elliott J. Weiss, *Balancing Interests in Cash-Out Mergers: the Promise of Weinberger V. UOP, Inc.*, 8 DEL. J. CORP. L. 1, 22 (1983).

⁷⁴ See Hossfeld (2004), *Supra* note [].

⁷⁵ See Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1 (1995); and Alexander Khutorsky, *Coming in From the Cold: Reforming Shareholders' Appraisal Rights in Freeze-Out Transactions*, COLUM. BUS. L. REV. 133 (1997).

⁷⁶ See Peter V. Letsou, *The Role of Appraisal in Corporate Law*, 39 B.C. L. REV 1121.

Most of these shortcomings of the appraisal remedy have already been widely recognized. Commentators have appropriately described it as “a remedy of desperation” that, unsurprisingly, few shareholders seek.⁷⁷ Appraisal is thus unlikely to protect common shareholders from preferred opportunism.

C. Fiduciary Duties Inadequate

As noted earlier, directors are considered to owe a fiduciary duty to the corporation and its shareholders. Directors have a duty of care requiring them to inform themselves adequately before making corporate decisions. Directors also have a duty of loyalty requiring them to promote the best interests of the corporation and its shareholders. Among other things, the duty of loyalty prohibits a director from taking actions – such as self-dealing or taking a corporate opportunity-- that would benefit himself or herself at the expense of the corporation and its shareholders. Such duties are enforced by means of derivative suits, which are described below.

However, at least in Delaware and California (the two states in which most Silicon Valley startups are incorporated), the caselaw makes it difficult for common shareholders to protect themselves against a preferred-serving board. Thus, at least currently, these fiduciary duties do not provide much constraint on a preferred board’s discretion.

1. Delaware

⁷⁷ See Richard T. Hossfeld, *Short-Form Mergers After Glassman v. Unocal Exploration Corp.: Time to Reform Appraisal*, 53 DUKE L.J. 1337, 1339 (2004).

Preferred controlled VC start-ups is not the only context in which the cash-flow interests of those controlling the board differ from those of other investors. The typical board is controlled by common shareholders, which will often have interests that conflict with those of other stakeholders, such as the firm's creditors or preferred shareholders. For example, a common-dominated board may wish to distribute a dividend that, while not prohibited by the firm's loan contracts, would severely reduce the value of the firm's debt. Or a board seeking to serve common may take steps that, although not prohibited by preferred stock agreement, impose substantial costs on the preferred.⁷⁸

When, as is typically the case, common controls the board, Delaware courts have generally held that directors owe a duty solely to common shareholders and are not required to take into account the interests of these other stakeholders.⁷⁹ These other investors, the courts have decided, are protected by the terms of their investment contracts and owed only the contractual duty of good faith.⁸⁰

⁷⁸ See, e.g., Easterbrook & Fischel, *Voting in Corporate Law*, 26 J. L. & ECON. 395 (1983); Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STEYSON L. REV. 23 (1991); Christopher W. Frost, *The Theory, Reality and Pragmatism of Corporate Governance in Bankruptcy Reorganizations*, 72 AM. BANKR. L.J. 103, 108 (1998); George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CALIF. L. REV. 1073, (1995); Brett H. McDonnell, *Corporate Governance and the Sarbanes-Oxley Act: Corporate Constituency Statutes and Employee Governance*, 30 WM. MITCHELL L. REV. 1227, 1234 (2004).

⁷⁹ See, e.g., *Benchmark Capital Partners IV, L.P. v. Vague, C.A. No. 19719*, (Del. Ch. 2002): ("A court's function in ascertaining the rights of preferred stockholders is essentially one of contract interpretation.")

⁸⁰ See, e.g., D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1471 (2002). The courts do, however, recognize an exception when the firm is insolvent or on the verge of insolvency. In that case, even directors of a common-controlled board are considered to owe a duty to creditors (instead of or in addition to common shareholders). See Alon Chaver & Jesse M. Fried, *Managers' Fiduciary Duty Upon the Firm's Insolvency: Accounting for Performance Creditors*, 55 VAND. L. REV. 1813 (2002); *Amussen v. Quaker City Corp.*, 156 A. 180, 181 (Del. Ch. 1931) (holding that

Consider *Equity-Linked Investors, L.P. v. Adams*,⁸¹ in which a venture-backed firm (“Genta”) with a common-controlled board faced a choice between liquidating (through dissolution or a sale) and continuing to operate as an independent entity. Liquidation would yield less than the \$30 million preference of the VCs’ preferred stock. Remaining independent offered the possibility of upside gain that would accrue to the common shareholders, but put the preferred shareholders at greater risk. The board decided to obtain debt financing that would enable Genta to continue operating. The VC challenged the transaction, alleging a breach of fiduciary duty to the preferred.

The court rejected the claim, writing:

“While the facts out of which this dispute arises indisputably entail the imposition by the board of (or continuation of) economic risks upon the preferred stock which the holders of the preferred did not want, and while this board action was taken for the benefit largely of the common stock, those facts do not constitute a breach of duty. While the board in these circumstances could have made a different business judgment, in my opinion, it violated no duty owed to the preferred in not doing so. The special protections offered to the preferred are contractual in nature. ... [g]enerally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of common stock--as the good faith judgment of the board sees them to be--to the interests created by the special rights, preferences, *etc.*, of preferred stock, where there is a conflict.”

Equity-Linked Investors, L.P. v. Adams would seem to suggest that, where the board has discretion, it should favor the interests of common. However, in the one Delaware case involving a venture-backed startup with a *preferred-dominated* board, *Orban v. Field*, the court held that, in a conflict between the

insolvent firm directors owe a duty exclusively to creditors). Cf. *In re Xonics, Inc.*, 99 B.R. 870, 872 (Bankr. N.D. Ill. 1989); *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, No. Civ.A.12150, 1991 Del. Ch. LEXIS 215 (1991) (holding that insolvent firm directors owe a duty to both shareholders and creditors).

⁸¹ 705 A.2d 1040, Del.Ch., 1997.

preferred and the common, the board does not owe a fiduciary duty specifically to the common and has wide discretion to benefit the preferred.⁸² What appears to unify Delaware approach to the conflict between preferred and common is that the board is always given wide discretion to favor the class of equity securities held by its members at the expense of equity securities not held by its members. We call this the “controlling-class primacy” approach to fiduciary duties.

In Orban, the preferred dominated board of Office Mart arranged for Office Mart to be acquired by Staples in a merger for a price that provided no payout to common shareholders. The common shareholders’ approval was not required to effect the merger --- the VC financing provisions allowed preferred to vote alongside common on an as-converted basis. However, for accounting treatment reasons Staples insisted that at least 90% of Office Mart’s common shares vote in favor of the transaction. Common shareholders, led by Office Mart’s founder and former CEO Orban, refused to back the deal, demanding part of the merger consideration (\$4 million) in exchange for their votes.

Office Mart’s board had wide discretion to benefit the common, as *Equity Investors* suggests is the board’s duty, but chose not to. Like the common-controlled Genta board, Office Mart’s board could have chosen to keep the company afloat in order to preserve the upside value of the common stock. Alternatively, the Office Mart board could have agreed to approve the merger – which would have benefited the preferred – on condition that the preferred share part of their merger proceeds with the common. However, Office Mart’s preferred-controlled board did not use its discretion to benefit the common. Rather, it approved and – sought to force through – a merger

⁸² See Orban, 1997 WL 15381 (Del. Ch.).

that provided nothing to common. This is clearly the worst possible outcome for that class, and it is completely inconsistent with the board using its discretion to benefit the common.

Staple's requirement that 90% of Office Mart's common approve the merger gave the common a second opportunity to extract some value for their stock. The board could have facilitated negotiations between the preferred – who desperately sought the merger – and the common – over the amount to be given the common in exchange for approval of the merger. Instead, the board again used its discretion to favor the preferred at the expense of common. It used corporate resources to arrange a series of transactions that enabled the preferred to exercise warrants to buy common, diluting the “pure” common position down to less than 10% of the common class. The preferreds holding over 90% of the common stock then voted their common stock in favor of the merger, allowing the transaction to go forward. In the end, common shareholders were totally wiped out.

Orban sued, alleging that the board had violated its duty of loyalty to common. The court ruled: “It cannot be said that the Board breached a duty of loyalty in making this decision. ...the common stockholders had no legal right to a portion of the merger consideration under Delaware law or the corporate charter.”

This ruling can easily be criticized as inconsistent with *Equity Investors*. It is true that common shareholders had no legal right to a portion of the merger consideration. But it is also the preferred shareholders, qua shareholders, did not have the legal right to compel the firm to merge. The board had discretion over whether to even consider a merger, and thus could have legally used this discretion to benefit common shareholders by either keeping the firm going as a separate entity (as the Genta board did) or by

extracting value from the preferred shareholders in exchange for agreeing to merge.

Moreover, when Staples insisted on obtaining 90% approval by common shareholders, the board was certainly not under a duty to dilute the common shareholders and make their votes unnecessary to effectuate the merger. It could choose whether to facilitate dilution of the common or not. Had the board not diluted the common, the preferred could be expected to buy off the common. Yet, inconsistent with *Equity Investors*, the board used its discretion to help the preferred eliminate the common's bargaining power.

However, our purpose here is not to criticize the reasoning in *Orban*. Rather, it is simply to show that Delaware courts can be expected to give wide latitude to boards to serve the interests of particular classes of stock at the expense of other, and thus common shareholders cannot look out to fiduciary duties as a means of protecting themselves from preferred opportunism.

As Chancellor William Allen has said:

"It is easy to say that a director's duty runs to the corporation and all of its shareholders, but such a statement gives faint guidance to a director when conflicts among shareholder constituencies arise, as they do. For example, when merger considerations must be apportioned between Class A and Class B stock directors are inevitably faced with a conflict among classes of stock and, in most such instances, such directors will themselves own more of one class than another. Does such fact alone deprive such directors of the presumptions ordinarily accorded to their good faith decisions and require them to establish the intrinsic fairness of the apportionment? And, if so, do different directors have different burdens depending upon which class of stock they happen to own more of. It is not my impression that that is the law. ..."⁸³

2. California

⁸³ See, e.g., *Freedman v. Restaurant Assoc. Industries, Inc.* No. Civ.A. 9212, 1987 Del. Ch. LEXIS 498 (1987).

Although common stockholders of a Delaware corporation are unlikely to be able to look to fiduciary litigation in Delaware courts for relief from preferred board opportunism, they are still much better off than common stockholders of a California corporation. California is considered to be a state whose corporate law is friendly to shareholders. But in many situations that are likely to arise in the context of venture-backed startup, California law is much more hostile to common shareholders than is Delaware.

The California Supreme Court has held that, under Section 1312 of the California Corporations Code, officers, directors, and controlling shareholders of California corporation cannot be sued for breach of fiduciary duty if, at the time shareholders wish to sue, (a) the corporation is merging with a third party and (b) the plaintiff-shareholders are aware of all the facts at the time of the merger.⁸⁴ Under such a situation, a shareholder complaining of breach of fiduciary duty – whether that breach occurred in connection with the merger or years before – is relegated to appraisal remedy (which, as we saw, is not a useful remedy). This means that officers, directors, and controlling shareholders of a California corporation can breach fiduciary duty – through gross negligence, self-dealing transactions and taking of corporate opportunities -- and then “cleanse” the act through a merger. Indeed, in a recent litigation by a founder against a preferred controlled board, VCs were able at the trial level to derail the lawsuit using Section 1312.

3. Costs of Litigation

It is worth noting that plaintiffs seeking to sue preferred-controlled board face not only unfavorable law but also reputational costs to resorting to litigation.

⁸⁴ Steinberg v. Amplica, 42 Cal. 3d 1198, 233 Cal. Rptr. 249 (1986)

Consider the recent example of Epinions.com. The co-founders of Epinions.com, including a very successful entrepreneur named Naval Ravikant, filed suit against several prominent VC firms for fraud in connection with a merger that wiped out their common shares. Before the law suit, Ravikant had become a partner at another VC firm, Dot Edu Ventures. Shortly after the lawsuit was filed, Dot Edu Venture's other partners expelled Ravikant under pressure from other VC firms – who presumably threatened to refuse to work with Dot Edu Ventures on deals until they pushed out Ravikant.⁸⁵ According to one person close to the situation: “[Ravikant] had better win this suit and he better hope that he makes enough for life, because he'll never work as a VC again.”

This story is consistent with that of an entrepreneur who told us that the lawyer he hired to sue VCs attempted to persuade him several times not to bring the case. She told him that it would cost hundreds of thousands of dollars and that he risked not being able to get VC funding – or even work at a high level position at another startup – again.

D. Reputational Considerations

A number of commentators have acknowledged the VCs are not legally constrained from acting opportunistically toward entrepreneurs. But most of these commentators have argued that reputational considerations will nevertheless deter VCs from opportunistic behavior. This Section explains why reputational considerations are, in most cases, unlikely to prevent VCs from acting in the ways we have described.⁸⁶ Indeed, reputational concerns

⁸⁵ <http://www.privateequityweek.com/pew/freearticles/1107338724787.html>

⁸⁶ See Bernard Black & Ronald Gilson, *Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets*, 47 J. FIN. ECON. 243, 254 (1998); William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN.

of both VCs and entrepreneurs are likely to exacerbate – not mitigate – the problems we have identified.

It has been argued that VCs would be constrained by reputational considerations from exploiting entrepreneurs. The argument goes like this: VCs often compete to fund the best start-ups.⁸⁷ The dimensions along which VCs compete are “terms” of the deal as well as reputation – especially, the reputation for successfully steering their portfolio companies to IPOs.⁸⁸ A VC fund that acquires a reputation for engaging in value-reducing transactions designed to transfer value from common shareholders to preferred would, everything else, equal, lose good deals to other VCs with better reputations.⁸⁹

This argument assumes that entrepreneurs can easily acquire information about VCs’ behavior at other firms. A VC cannot acquire a bad reputation for engaging in value-reducing behavior unless outsiders have access to the information necessary to draw such a conclusion.

Unfortunately, such information is not easily available. The firms in which VCs invest are small private companies, not public ones that release detailed information to the SEC and the public. There are no analysts or financial journalists covering these firms. Indeed, startups often go to great length to keep information about their operations under tight control.

Moreover, because VC investment is usually syndicated, there are often multiple VCs sitting on a startup board. These VCs, if they enter at different rounds, may have diverging economic interests. Thus, even if it were

ECON. 473, 513 (1990). But see Manuel Utset, *Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital-Financed Firms*, 2002 WIS. L. REV. 45.

⁸⁷ See Sahlman (1990) at 513: (“Venture capitalists who abuse their power will find it hard to attract the best entrepreneurs, who have the option of approaching other venture capitalists or sources other than venture capital.”)

⁸⁸ See Black & Gilson (1998) at 245

⁸⁹ See Edward B. Rock & Michael L. Wachter, *Symposium: Team Production In Business Organizations: Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 IOWA J. CORP. L., 913, 929, (1999)”

possible to identify a particular board has having made value-reducing decisions, it would be very difficult for outsiders to acquire the facts necessary to know which particular VCs are more likely to act opportunistically than others.

To be sure, a founder who believes he has been the victim of value-decreasing opportunism by a VC-controlled board could attempt to publicly disseminate the information. But, without a substantial amount of information, the founders' audience will have difficulty determining whether the VCs acted opportunistically or not. Founders are likely to be bitter when their own startup, in which they have likely invested considerable time, effort, emotional energy, and money, does not do as well as expected, even if the VCs have not been acting opportunistically. Thus, would be entrepreneurs might treat the complaints as sour grapes.

Even if the founder is believed, it is not clear how she would benefit from such a publicity campaign. Indeed, "going public" with these types of complaints is likely to be very costly. At least in Silicon Valley, VCs are a tight-knit community, and an attack against one VC is considered to be an attack against all. Apparently, many entrepreneurs have refused to speak with reporters about their experiences with VCs lest it ruin their chances of getting funding for another startup. Thus, reputational considerations may cut in the opposite direction – and facilitate rather than prevent preferred opportunism.

VI. Toward Improving Venture Capital Contracting

In this Part, we put forward two proposals for improving governance arrangements in venture-backed startups. The first, discussed in Section A, is to change the tax treatment of incentive compensation to eliminate the penalty imposed on VC's use of common stock. This proposal would eliminate the tax distortion in favor of preferred stock and would, to the extent tax considerations drive the use of preferred, increase the number of startups in which there is only one class of shares outstanding: common. Such an equity structure would, of course, eliminate all the distortions we identify in this paper.

Whether or not the tax playing field is leveled, we believe that fiduciary duty should be modified to improve the decisionmaking of startup boards of firms that continue to have both preferred and common stock outstanding. Thus, in Section B, we propose imposing what we call a "balancing test" duty on boards of firms with different types of shares outstanding. Under this duty, directors could be liable for breaching a duty of loyalty to shareholders boards if they favor one class of shares over another and the cost to the disfavored class was substantially larger than the benefit to the favored class. However, courts should refuse to review board decisions under such a "balancing tests" whenever a majority of the informed, disinterested stockholders in each affected class of stock ratify the board's decisions. Such a duty, we should directors could escape liability different classes of shareholders not to make clear that boards of solvent firms – even boards controlled by preferred shareholders – be considered to owe a fiduciary duty to common shareholders when their interests conflict with those of other investors.

A. Tax

As explained, the leading explanation for VCs use of preferred stock is that U.S. tax code (inadvertently) subsidizes VCs who invest with preferred stock rather than common stock.

Under current tax law, an employee receiving stock compensation is generally taxed on the value of the stock at ordinary income rates. Any subsequent appreciation above that value is taxed later, upon sale, at the much lower capital gains rate. Thus, everything else equal, a lower grant-date stock value reduces the parties' tax burden.⁹⁰ However, the IRS may challenge a grant-date value it believes to be low.

If VCs are willing to pay \$10.00 per share for a startup corporation's common stock, and the startup subsequently gives employees incentive stock, it cannot assign, for tax purposes, a value less than \$10.00. That price, reached through arm's-length bargaining, presumptively establishes the market value of the common.

But when VCs invest with preferred stock – especially preferred stock with large liquidation preferences and other rights – the startup can argue that the price the VCs pay for the preferred stock does not indicate the value of the common. Thus, the startup continue to assign a low value, for tax purposes, to the common given to employees. VCs' use of preferred stock rather than common stock thus permits the parties to reduce the overall tax costs of the enterprise. The tax law penalizes VCs who use common stock by making it more costly for startups to provide incentive compensation to employees and, as we saw, there is evidence that this tax penalty affects VCs'

⁹⁰ The corporation can, in principle, deduct the value of the stock in computing its taxable income. Thus, everything else equal, the higher is the value, the greater the deduction and tax savings for the corporation. However, most startups don't have taxable income for several years.

choice of security. In other countries, where such a penalty does not exist, the use of common is much more frequent.

To the extent the use of preferred stock is driven by tax considerations, what is privately optimal for the parties might not be socially optimal. A solution would be to level the tax playing field between the two types of securities. This would allow the parties to choose the security that maximizes the size of the pie, without taking into account the government's take.

One way to do this is to aggressively enforce the tax laws to force startups issuing preferred stock to properly value common stock given to employees. But such an approach is, we think, impractical (valuation is very difficult) and would impose additional costs on small firms, which is likely to be undesirable.

The approach we propose goes in the other direction: startup firms should be allowed to value, for tax purposes, common stock given to employees at a rate below the price paid for the common stock by investors. One possible formula would be to allow incentive stock given to employees to have a grant-date value of zero for tax purposes. Any subsequent appreciation would be taxed as capital gains. If the stock is sold within a year, of course, the employee would pay the short term capital gains rate, which is the same as the ordinary income rate. Alternatively, the appreciation could be taxed at the ordinary income tax rate, or at any rate in between.

B. Balancing Approach to Fiduciary Duties

As explained in Part __, Delaware courts have given common-controlled boards substantial leeway to make decisions that favor common shareholders at the expense of the preferred and have similarly given

preferred shareholders and that preferred-dominated boards substantial discretion to favor preferred at the expense of common.

This controlling-class primacy approach may be more defensible when common control the board – because the preferred have contractual provisions designed to protect against common opportunism. But it is hard to see how controlling-class primacy serves the parties’ joint interest when preferred control the board and common have no contractual provisions protecting them. In that situation, the only mechanism that can protect common shareholders is fiduciary duties – which the Delaware court has, essentially, stripped away.

We propose that boards of firms that have outstanding more than one class of stock be subject to a “balancing test.” Specifically, they should be considered liable for violating their fiduciary duty of loyalty to shareholders if, in favoring one class of shares over another, the cost they impose on the adversely affected class substantially exceeds the benefit to the one (or more) classes of shareholders.⁹¹ However, boards could insulate themselves from liability by having a majority of informed, disinterested stockholders of the affected classes ratify the board’s decision. The purpose of this standard – and giving boards the ability to escape liability by obtaining shareholder approval – is to encourage boards to take into account the effect of their actions on different classes of stockholders.

To be sure, it will be difficult for courts to evaluate and compare values. But courts are routinely called on to do so in corporate litigation – in appraisal proceedings, entire fairness litigation.

⁹¹ Liability would not be precluded by 102(b)(7) provision, which does not cover duty of loyalty claims.

We should emphasize that our goal is not to encourage litigation. The purpose of shifting the standard – and defenses to liability – is to encourage preferred dominated boards to offer better terms to common shareholders. Most boards will seek disinterested director approval or shareholder vote in order to reduce risk of liability. The need to obtain disinterested director approval or shareholder will, in turn, deter boards from trying to push through decisions that are harmful to common shareholders. Our hope is that even before courts adopt such a rule that lawyers seeking to minimize lawsuits and achieve fair outcomes consistent with fiduciary law will advise boards. **[MORE TO TBA]**

VII. Conclusion

[TBA]