ADVENTURE CAPITAL

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This symposium Article traces the history and rise of venture capital and venture-backed startups in the United States from a business law perspective and explores the current big questions in the field. This examination highlights that after lawmakers shaped the enabling environment for venture capital to flourish, corporate and securities law has responded to the rise of venture-backed startups incrementally but with profound effect. Although business law has not always fit easily with the distinctive features of venture-backed startups, it has provided an enormous space in the private realm for them to order their governance and maneuver with relative freedom. This private realm is a good fit for the needs of startups that drive economic growth and innovation, but their activity can also create lingering issues of social costs and policy that are difficult to address. Grappling with this reality is essential to continuing to foster a vibrant venture capital ecosystem while also developing a coherent business law response to the current wild era of "adventure capital."

TABLE OF CONTENTS

I. THE RISE OF VENTURE CAPITAL AND DISTINCTIVE FEATURES OF VENTURE-BACKED STARTUPS 1344
A. A BRIEF HISTORY OF VENTURE CAPITAL 1345
B. VENTURE-BACKED STARTUP FEATURES AND GOVERNANCE 1350

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II. BUSINESS LAW'S CREATION AND RESPONSE TO THE RISE OF VENTURE CAPITAL AND VENTURE-BACKED STARTUPS 1354
A. THE EVOLUTION OF CORPORATE AND SECURITIES LAW IN AN AGE OF VENTURE CAPITAL AND STARTUPS 1355
1. Corporate Law and Venture-Backed Startups 1356
2. Securities Law and Venture-Backed Startups 1358
B. THE WILD ADVENTURES AND MISADVENTURES OF VENTURE-BACKED STARTUPS IN THE PRIVATE REALM 1361
III. THE BIG QUESTIONS 1366
CONCLUSION 1370

Venture capital has fueled the rise of some of largest businesses in the world.[1] This relatively small asset class produces huge social and economic impact. By one measure, venture capital funds less than one percent of companies started in the United States each year, yet accounts for the backing of nearly half of the companies that enter the public markets.[2] Among U.S. public companies founded since 1968, venture-backed companies account for 77% of total U.S. market capitalization, 41% of total employees, and 92% of research and development spending.[3] Further, the impact of venture capital is not only evidenced in public markets, but also spans the footprint of disruptive startups operating in the private realm and the technology that they generate. From the personal computer you use to access the internet to the search engine by which you navigate it, the innovation fueled by venture capital touches everyday life in innumerable ways.[4]

The industry that produces such outsized social and economic impact is notably of relatively recent vintage and the result of both business and legal transformation. Some of today's venture capital resembles aspects of the risk-sharing ventures of centuries ago from Genoese merchants to American whalers, but the modern industry began in earnest in the mid-twentieth century—originally coined "adventure capital."[5] It was not, however, until

1. Elizabeth Pollman, *Startup Governance*, 168 U. PA. L. REV. 155, 156 (2019).
2. Josh Lerner & Ramana Nanda, *Venture Capital's Role in Financing Innovation: What We Know and How Much We Still Need to Learn*, 34 J. ECON. PERSPS. 237, 237 (2020).
3. Will Gornall & Ilya A. Strebulaev, *The Economic Impact of Venture Capital: Evidence from Public Companies* (Working Paper 2021), https://papers.ssrn.com/sol3/papers.cfmid=2681841 [https://perma.cc/3AMU-7KRV].
4. TOM NICHOLAS, VC: AN AMERICAN HISTORY 2 (2019).
5. Lerner & Nanda, *supra* note 2, at 238–39; SEBASTIAN MALLABY, THE POWER LAW: VENTURE

the 1980s when venture capital really took off. In 1979, the Department of Labor changed an Employment Retirement Income Security Act ("ERISA") rule that freed pension fund managers to take portfolio diversification into account in fulfilling their "prudence" standard.[6] With this change, pension fund managers could allocate a portion of their funds to venture capital even if companies in the venture fund's portfolio were relatively illiquid or failed.[7] With a greater influx of investment dollars, the venture capital sector grew quickly,[8] and in less than half a century has become "the dominant source of financing for high-potential startups commercializing risky new ideas and technologies."[9]

Although a significant and growing body of scholarly literature examines venture-backed startups, many questions remain open and legal scholars do not often step back to examine the broader landscape of business and legal transformation in this area. How has business law facilitated and responded to the rise of venture capital? What is the social welfare impact of venture capital? Should the law do more to shape the direction of entrepreneurial finance or startup governance? This Article takes aim at stimulating discussion and research about these important questions.

First, the Article traces the history and rise of venture capital in the United States and highlights that venture capital contracting has largely settled upon an established set of practices that create distinctive governance features in startups and the types of companies funded.[10] This discussion illuminates how the rise of the modern venture capital industry evolved to rely on laws that enable private business entities and private markets.

CAPITAL AND THE MAKING OF THE NEW FUTURE 18, 26 (2022). *See generally* NICHOLAS, *supra* note 4 (detailing the origins and history of venture capital).

6. Lerner & Nanda, *supra* note 2, at 238–39.

7. *Id.*

8. Paul Gompers & Josh Lerner, *The Venture Capital Revolution*, 15 J. ECON. PERSPS. 145, 148 (2001) (noting that within less than a decade after the Department of Labor changed its rule, venture capital investment multiplied and pension funds accounted for more than half of all investment dollars into venture capital funds).

9. Lerner & Nanda, *supra* note 2, at 239.

10. The focus in this Article is primarily the U.S. venture capital industry and startups. The distinctive features and set of practices that have become closely associated with venture capital emerged out of the United States, and the National Venture Capital Association estimates that it generates approximately half of the world's venture capital financing. *See id.* Notably, however, non-U.S. venture capital has grown in the past two decades and is worthy of further study as well. *Id.*; CB INSIGHTS, STATE OF VENTURE: GLOBAL 2022 RECAP 14 (2023) (providing an overview of global trends in venture capital); *Global Guide*, DEALROOM.CO, https://dealroom.co/guides/global-venture-capital-monitor [https://perma.cc/2BLP-97E6] (noting growth in non-U.S. venture capital by geographic region); *see also* Gompers & Lerner, *supra* note 8, at 163–64 (noting a shift toward increased globalization of venture capital at the turn of the twenty-first century).

Second, it argues that after lawmakers shaped the enabling environment for venture capital to flourish, in subsequent decades, corporate and securities law has responded to the rise of venture-backed startups incrementally and with some challenges or tensions with the distinctive features of venture capital and startups. The big picture, however, is that the enabling nature of corporate law and the deregulatory trend of securities law have facilitated an enormous space in the private realm for venture-backed startups to order their governance and maneuver with relative freedom. This private realm is highly useful for cultivating startups that drive valuable innovation and create outsized economic impact.

Notably, venture-backed startups also create lingering issues of social costs that have prompted rising concerns in recent years. Therefore, the Article concludes by highlighting two promising avenues for developing a deeper understanding of whether a business law response is warranted: a more systematic study of impacts on stakeholders such as employees and customers or users, and further inquiry into whether and when any governance intervention would be optimal using a realistic understanding of a startup's timeline in the venture cycle. Building a solid foundation of understanding of these issues in the current era would advance a measured approach to the future of business law, while continuing to promote a vibrant ecosystem of startups and venture capital.

The Article proceeds as follows. Part I traces the rise of venture capital and the distinctive features of venture-backed startups. Following on this background, Part II examines how corporate and securities law has facilitated and responded to venture capital and venture-backed startups. Finally, Part III identifies and starts a conversation about the big questions that the current regime raises.

I. THE RISE OF VENTURE CAPITAL AND DISTINCTIVE FEATURES OF VENTURE-BACKED STARTUPS

Entrepreneurs have long sought financing for risky ventures.[11] The venture capital industry emerged in the United States in the mid-twentieth century with its own unique history, and subsequent decades have witnessed its meteoric rise and establishment as a key driver of innovation and economic growth in society. This Part provides an overview of the origins and development of venture capital, as well as an examination of the special characteristics and governance of the startup companies they fund. Although the venture capital industry continually changes, and startup governance

11. *See generally* NICHOLAS, *supra* note 4, at 315 (tracing the history of venture financing from the whaling industry to Silicon Valley).

varies by individual company, certain patterns have taken shape that can be described by their distinctive features.[12]

A. A Brief History of Venture Capital

Throughout the history of entrepreneurship in the United States, wealthy individuals and family offices have served as notable sources of funding when commercial banks and Wall Street financiers have been unwilling to invest or lend to risky new enterprises.[13] It was not until the period after World War II, however, that formalized organizational structures started to emerge to provide high-risk, innovative new firms with financing.[14] Startup capital before that time was relatively scarce—representing what many perceived as a funding gap or market failure.[15]

Historians pinpoint several key institutions, individuals, and policies that played an important role in catalyzing the modern venture capital industry. A few highlights are worth discussing here to capture how government policy as well as trial and error from enterprising individuals and firms were required before hitting upon the modern formulation of venture capital investing.

Some start the story with one of the most serious early experiments—American Research & Development Corporation ("ARD").[16] The Boston-based firm made high-risk investments in companies working on technology developed for World War II.[17] The firm, established in 1946 by Harvard Business School professor Georges Doriot and MIT President Karl Compton, was structured as a publicly traded closed-end fund and imbued with public-service motives.[18] It did not ultimately serve as a model organization for later venture investors as the public structure ensnared it in

12. *Id.* at 9 ("Although there have been some organizational structure and strategy innovations, these have been paradoxically rare in an industry that finances radical change."); Pollman, *supra* note 1, at 162–70, 196–200 (describing the distinctiveness of startups and their life cycle and governance).

13. NICHOLAS, *supra* note 4, at 80–90. Wealthy families that "dabble[d]" in investing in "risky fledgling businesses" in the 1940s included the Whitneys and the Rockefellers. MALLABY, *supra* note 5, at 25. An informal San Francisco lunch club emerged in the 1950s convening a small group of what today might be termed "angel investors" who listened to entrepreneurs' pitches and made handshake deals, including for the tape-recording pioneer Ampex that was wildly successful. *Id.* at 26–27. By contrast, commercial banks lacked domain expertise in tech firms and were not a clear fit for risky, unprofitable ventures that might require long periods of funding with uncertain futures and high likelihood of failure. NICHOLAS, *supra* note 4, at 107. Insurance companies and other institutional investors were subject to regulatory constraints, a culture of conservative investment styles, and a lack of facilitating intermediaries. *Id.*

14. NICHOLAS, *supra* note 4, at 107–43.

15. *Id.* at 107–09.

16. *Id.* at 1; Gompers & Lerner, *supra* note 8, at 146.

17. Gompers & Lerner, *supra* note 8, at 146.

18. *Id.*; MALLABY, *supra* note 5, at 28.

regulation that restricted its ability to invest fresh capital into portfolio companies, calculate the value of its investments, and grant employee stock options.[19] Further, the firm's public-service ethos that disdained financial incentives disappointed staff and investors, and prevented the firm from productively abandoning underperforming portfolio companies.[20]

Nonetheless, ARD provided proof of concept of a couple of key ingredients for venture investing. First, a single investment—Digital Equipment Corporation—accounted for the lion's share of all the gains that ARD generated over a quarter century.[21] This represented an early demonstration of what later became known as the "power law"[22] or "long-tail investing"[23] business model that attracted the attention of others interested in financing technological innovation. A small number of big "hits" can drive a fund's success despite numerous other failures. Second, the leader of ARD and a key figure in risk capital during this era,[24] Doriot, was deeply involved in providing managerial counsel as well as capital to his portfolio companies.[25] In his view, founders were the visionary stars and venture capitalists' role was to provide wisdom and guidance.[26]

Another important development of the era was the passage in 1958 of the Small Business Investment Company ("SBIC") Act, which reflected the U.S. government's effort to respond to the perceived funding gap for entrepreneurial finance.[27] Under the SBIC Act, a privately-owned investment fund aimed at making investments in qualifying small businesses would be eligible for favorable tax treatment and a government loan at nominal rates.[28] The program engendered debate between advocates of government subsidy to encourage small business formation and those who believed in market-based solutions.[29] Neither side received total vindication as the government intervention made clear impact, but it was market players who ultimately pioneered what became the venture capital industry.

19. MALLABY, *supra* note 5, at 30.

20. *Id.* at 30–31. ARD's inability to impress Wall Street investors and difficulties with its regulatory structure, culminating in a raid of the firm's offices by the SEC, contributed to the firm's ultimate end in 1972 when it was acquired by an industrial conglomerate. *Id.* at 29–31.

21. MALLABY, *supra* note 5, at 28–29.

22. *Id.* at 29.

23. NICHOLAS, *supra* note 4, at 2.

24. MALLABY, *supra* note 5, at 29 (citing SPENCER E. ANTE, CREATIVE CAPITAL: GEORGES DORIOT AND THE BIRTH OF VENTURE CAPITAL (2008)).

25. *Id.* at 29.

26. *Id.*

27. NICHOLAS, *supra* note 4, at 132–33.

28. *Id.* at 135–36.

29. *Id.* at 132–35.

Practically speaking, the limitations on SBICs proved too restrictive for pioneering investors in the nascent venture capital industry who sought to finance startups—highly risky innovative ventures with the potential for outsized returns.[30] Most SBICs were small and undercapitalized.[31] SBICs could not exceed a fund size of $450,000 to qualify for maximum assistance, and "could not compensate their investment staff with stock options, nor could they invest more than $60,000 into a portfolio company . . . ."[32] SEC registration rules were burdensome and costly, and SBICs and their shareholders were subject to double taxation.[33] In sum, these rules were poorly suited for enabling venture capitalists to provide adequate capital to high-growth, innovative companies, and to compensate the investors for their efforts. Despite these drawbacks, or perhaps thanks to the lessons they generated, the program shed light on the legal policies and financial institutions that would clear the way for venture capital and startup entrepreneurship to thrive.[34]

The year before the SBIC Act's passage, and before ARD had financed Digital Equipment, one of the most significant events occurred in the history of venture capital—a tremor that became an earthquake that eventually opened a new landscape in the orange groves around Stanford University. A group of eight young Ph.D. graduates had been recruited by the renowned inventor William Shockley to work at Shockley Semiconductor Laboratory on developing new semiconductor devices at Fred Terman's new research park.[35] These "Traitorous Eight" young engineers quickly became "fed up" with "suffering" under Shockley, the famous Nobel Prize winning "father of the semiconductor," who acted as a "tyrant."[36] One of the group members, Eugene Kleiner, had a connection through his father to a New York investment firm.[37] He wrote and asked if perhaps a financier could find an employer willing to hire all eight as a team.[38] Their "act of defection" in 1957 "created the magic culture of the Valley,"[39] and it was made possible by an equally visionary young banker, Arthur Rock, who was given the letter by

30. *Id.* at 139; MALLABY, *supra* note 5, at 41–43. Early problems with violations of SBIC rules, as well as significant issues with fraud and malpractice, led Congress to impose additional burdens, exacerbating the restrictions that limited the program's utility. NICHOLAS, *supra* note 4, at 139.

31. NICHOLAS, *supra* note 4, at 139.

32. MALLABY, *supra* note 5, at 41.

33. NICHOLAS, *supra* note 4, at 139–40.

34. *Id.* at 142. Because of the structural design flaws of the program, "most SBICs gave up trying to invest in technology ventures. By 1966, only 3.5 percent of SBIC portfolio companies were engaged in applied science . . . ." MALLABY, *supra* note 5, at 43.

35. MALLABY, *supra* note 5, at 17.

36. *Id.* at 17, 21–24 (noting Shockley "was at once a scientific genius and a maniacal despot").

37. *Id.* at 24.

38. *Id.*

39. *Id.* at 17.

Kleiner's father.[40] Rock had already immersed himself in the emerging semiconductor industry and was intrigued by the request from an elite team so he flew out to San Francisco to meet with them. Rock proposed a possibility they had not even imagined: striking out on their own as founders of a new company that he would help finance.[41]

Rock's vision was radical at the time.[42] And, after trying to raise capital from numerous backers without avail, just one wealthy individual willing to fund the Shockley rebels emerged from Rock's search—Sherman Fairchild.[43] But Fairchild cut a hard bargain—the eight co-founders put up a small amount of cash in return for 100 shares each, the budding venture capitalist bought 225 shares at the same price, 300 shares were set aside for recruiting managers, and Fairchild put in $1.4 million in the form of a loan that came with control via a voting trust and an option to purchase all of the company for $3 million down the line.[44] The startup, Fairchild Semiconductor, was wildly successful—within two years, each of the Traitorous Eight and Rock received six hundred times what they had invested, but Fairchild, the passive financier, did even better.[45]

Beyond the obvious riches, one important takeaway from the Fairchild Semiconductor adventure was that without dedicated pools of money looking to finance startups, the investors held the bargaining power and the innovators got short shrift. In the 1960s, after a taste of success, Rock moved out to California, and, with a like-minded partner, started to raise a venture fund with a limited partnership structure in which the two general partners would seed the fund with some of their own capital.[46] By eschewing SBIC loans and public market money, they raised over $3 million from thirty "limited partners"—wealthy individuals who served as passive investors—and avoided the regulatory restrictions that had held back SBICs and ARD.[47] They had enough money to supply risky yet promising startups with the capital needed to grow aggressively, and they incentivized entrepreneurs and

40. *Id.* at 24, 31.

41. *Id.* at 32–33. Rock was joined by a Hayden, Stone & Co. partner, Alfred "Bud" Coyle. *Id.* at 32.

42. *Id.* at 35.

43. *Id.* at 36–37.

44. *Id.*

45. *Id.* at 38–39. The legacy of Fairchild Semiconductor is enormous. By 2014, seventy percent of publicly traded tech companies in Silicon Valley could trace their lineage back to the founders and employees of Fairchild. *Id.* at 21 (citing David Laws, *Fairchild, Fairchildren, and the Family Tree of Silicon Valley*, COMPUT. HIST. MUSEUM: CHM BLOG (Dec. 20, 2016)), https://computerhistory.org/blog/fairchild-and-the-fairchildren [https://perma.cc/34HW-JGBX]).

46. *Id.* at 44. The limited partnership structure had been used by another early venture firm, Draper, Gaither & Anderson. *Id.*

47. *Id.*

key employees with equity.[48] After fund raising, they made concentrated bets on a dozen or so companies, respectfully exercised a measure of governance control with the aim of helping the entrepreneurs succeed, and returned a handsome share of profits to limited partners on a set timeline by identifying and nurturing hits that could find an exit by going public or being acquired.[49]

A winning formula for financing risky technology startups was finally found—it involved private business entities and private markets. Venture capitalists in the subsequent period built upon these early lessons, fine-tuning investment and governance practices, and pushing for favorable government policies. By the 1970s, several pioneering venture capital firms emerged alongside the early players—including Sequoia and Kleiner Perkins, among others.[50] They funded some of the big hits of the era, including Intel, Apple Computer, and Genentech.[51] In this period, the importance of deal flow, repeat entrepreneurship, incentive compensation, and governance support were solidified.[52] Venture capitalists learned to lower their risk by actively guiding founders and staging financings, with each capital infusion calculated to encourage the company to hit an agreed milestone and leaving open the possibility of abandoning underperforming startups.[53] Silicon Valley became an ecosystem of early-stage finance and entrepreneurship with universities, a pool of potential founders, specialized investors, large tech companies and employees, lawyers with dealmaking savvy, and more.[54]

Further, the National Venture Capital Association, a trade association of venture capitalists founded in 1973, lobbied heavily for the legislative change that freed pension funds from previous restrictions in allocating a portion of their capital to venture funds.[55] Pension funds joined university endowments, insurance companies, and a handful of wealthy individuals in this nascent asset class.[56] With a supply side boost of capital thanks to supportive policymakers, the venture capital industry rapidly grew in the 1980s.[57]

48. *Id.* at 44–45.
49. *Id.* at 46–47, 50.
50. NICHOLAS, *supra* note 4, at 225–27, 206–14.
51. *Id.* at 201–05, 215–22; Lerner & Nanda, *supra* note 2, at 239.
52. NICHOLAS, *supra* note 4, at 203.
53. MALLABY, *supra* note 5, at 59, 81.
54. *Id.* at 81; NICHOLAS, *supra* note 4, at 232. *See generally* ANNALEE SAXENIAN, REGIONAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE 128 (1996) (tracing the history of Silicon Valley and the development of a thriving regional network-based system).
55. NICHOLAS, *supra* note 4, at 7.
56. Lerner & Nanda, *supra* note 2, at 239.
57. NICHOLAS, *supra* note 4, at 232–34 ("Annual new commitments to VC funds had been about $100 to $200 million during the 1970s, but they exceeded $4 billion annually during the 1980s.").

Over time it became clear that the venture capital industry and the tech firms they financed were subject to boom and bust cycles.[58] Further, it remained difficult to systematically generate outsized returns from "long-tail" portfolios.[59] The top-quartile funds have typically outperformed the bottom quartile by a wide margin.[60] But the overall trendline was one of continued growth and maturation of the industry and the Silicon Valley ecosystem.[61] By the 1980s and 1990s, a set of practices around venture capital investing took shape which fostered a distinctive set of features for venture-backed startups that remain today.

B. VENTURE-BACKED STARTUP FEATURES AND GOVERNANCE

As the discussion so far has highlighted, the rise of the venture capital industry reflected a historically contingent confluence of business and legal transformation. Pioneers of the industry experimented with a variety of arrangements and then settled on a model that uses the limited partnership form to raise and deploy pools of risk capital over a set period of time. Further, the industry matured through the development of contracting and governance mechanisms aimed at addressing the particular challenges involved in financing and nurturing high-risk and potential high-reward innovative, young companies. The discussion will now turn to those practices and their implications for the kinds of businesses that get funding, and their governance.

It is worth emphasizing at the outset that the most fundamental aspect driving venture capital investing is the "power law." As noted above, this is not a true law in any sense. Rather it is a phenomenon or understanding that a very small subset of deals typically generates the bulk of the returns for a successful venture capital fund.[62] As one well-known venture capitalist, Peter Thiel of Founders Fund, has explained, "This is a scary rule, because

58. *Id.* at 236–37.

59. *Id.* at 2, 305, 307.

60. *Id.* at 310; MALLABY, *supra* note 5, at 376–77; *see also* Robert S. Harris, Tim Jenkinson, Steven N. Kaplan & Ruediger Stucke, *Has Persistence Persisted in Private Equity? Evidence from Buyout and Venture Capital Funds* 22–23 (Fama-Miller, Working Paper 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2304808 [https://perma.cc/E2P9-2RXE] ("[W]e do find persistence for VC funds using the performance of the previous fund (and indeed the second previous fund) at fundraising . . . . VC funds with previous performance in both the top and second quartiles outperform the S&P 500.").

61. NICHOLAS, *supra* note 4, at 234–39.

62. PETER THIEL WITH BLAKE MASTERS, ZERO TO ONE: NOTES ON STARTUPS, OR HOW TO BUILD THE FUTURE 86 (2014) ("The biggest secret in venture capital is that the best investment in a successful fund equals or outperforms the entire rest of the fund combined."); MALLABY, *supra* note 5, at 6–9 (noting "the most pervasive rule in venture capital" is that "each year brings a handful of outliers that hit the proverbial grand slam, and the only thing that matters in venture is to own a piece of them").

it eliminates the vast majority of possible investments."[63] Why? As no one knows with certainty in advance which companies will succeed, and as innovative startups are highly risky, many will fail or have mediocre returns. For this reason, "every single company in a good venture portfolio must have the potential to succeed at vast scale."[64] Downside risk is limited to the total investment 1x while upside gain could be 100x or more within a relatively short amount of time.[65] Venture capitalists are therefore not just looking for startups with the possibility of becoming profitable—they are aiming at investing only in startups that have the potential to utterly disrupt or create industries with large addressable markets.[66] Crystallizing this point, Bill Gurley of Benchmark Capital has remarked, "Venture capital is not even a home run business. It's a grand slam business."[67]

Further, the power law operates within an assumption that often goes unarticulated—not only must venture capitalists aim to invest only in potential grand slams, but they also need startups to find an exit within a timeframe that roughly corresponds with the term of their fund. There are just two main paths to a successful exit: sell the company or go public.[68] As venture capitalists typically use a 10–12 year term for their fund,[69] this dynamic shapes the type of companies they invest in and the way that they

63. THIEL, *supra* note 62, at 86.

64. *Id*. at 87 (emphasis omitted).

65. MALLABY, *supra* note 5, at 251; MAHENDRA RAMSINGHANI, THE BUSINESS OF VENTURE CAPITAL: THE ART OF RAISING A FUND, STRUCTURING INVESTMENTS, PORTFOLIO MANAGEMENT, AND EXITS 248–51 (2021) (discussing venture capitalists' "agony of missed opportunities" and how some firms such as Bessemer Venture Partners showcase them in an "anti-portfolio" of companies they declined to invest in).

66. MALLABY, *supra* note 5, at 383.

67. Chris Dixon, *Performance Data and the 'Babe Ruth' Effect in Venture Capital*, ANDREESSEN HOROWITZ (June 8, 2015), https://a16z.com/2015/06/08/performance-data-and-the-babe-ruth-effect-in-venture-capital [https://perma.cc/2ZK4-42JS].

68. Pollman, *supra* note 1, at 164 ("Unlike traditional closely held corporations, startups are aimed at eventually being acquired by another corporation or transforming to a public corporation—their existence in startup form is understood to be ephemeral like a caterpillar in its chrysalis."); *see also* Mark A. Lemley & Andrew McCreary, *Exit Strategy*, 101 B.U. L. REV. 1, 6 (2021) ("Venture capitalists . . . naturally want to get paid. But the way they get paid is unique among funders because it depends on selling the company."). *See generally* Elizabeth Pollman, *Startup Failure*, 73 DUKE L.J. 327 (2023) (explaining the M&A trade sale and IPO pathways to successful exit and how startup failures are commonly dealt with by venture capitalists and entrepreneurs).

69. Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1071–72 (2003) (describing typical features of VC funds including the ten-year term structure). VC funds often provide for the possibility of a one- or two-year extension at the discretion of the general partner VC managing the fund. J. Brad Bernthal, *The Evolution of Entrepreneurial Finance: A New Typology*, 2018 BYU L. REV. 773, 843 n.276.

govern them.[70] One venture capitalist put it succinctly, "I sell jet fuel."[71] Venture-backed startups must grow fast to succeed.[72]

This dual reality of power law returns and the need for exit on a relatively short timeframe distinguishes venture capital and the types of startups they invest in from other businesses or stages of a business life cycle. For example, private equity portfolios typically aim to optimize each portfolio company's performance and leverage the gains.[73] They often target existing, underperforming businesses rather than help build new, innovative companies that have a large risk of failure.[74] Other private businesses include traditional closely held enterprises that range from small mom-and-pop businesses to virtual behemoths such as Cargill and Koch Industries.[75] These companies often begin as sole proprietorships, partnerships, or family businesses, and organically grow over time without a particular aim at exit.[76]

In turn, because venture capitalists are specialized intermediaries uniquely tailored to financing innovative startups, they have developed contracting and governance mechanisms aimed at addressing the particular constellation of issues that these companies pose: uncertainty, information asymmetry, agency costs, and incomplete contracting.[77] In the early stages

70. MALLABY, *supra* note 5, at 386 ("Venture capital is suitable only for the ambitious minority that wants to take the risk of growing fast . . . ."); *see also* Lemley & McCreary, *supra* note 68 ("From the very outset of a startup's life, VCs (and therefore the startups they fund) are focused on an 'exit strategy': a way to turn the VCs' equity into liquid cash.").

71. Erin Griffith, *More Start-Ups Have an Unfamiliar Message for Venture Capitalists: Get Lost*, N.Y. TIMES (Jan. 11, 2019), https://www.nytimes.com/2019/01/11/technology/start-ups-rejecting-venture-capital.html [https://perma.cc/93KL-N5NS] (discussing how taking venture capital can change a startup's trajectory and put pressure to grow aggressively).

72. One puzzling issue concerns why the relatively short fund length is sticky among venture capitalists despite variation in the maturation of firms in different industries and different areas of industry focus for venture capital firms. *See* Lerner & Nanda, *supra* note 2, at 253.

73. *See* Elisabeth de Fontenay, *Private Equity Firms as Gatekeepers*, 33 REV. BANKING & FIN. L. 115, 130 (2013–2014) ("The literature suggests that private equity firms make certain subtle changes that, while modest, have a measurable impact on company performance. And the use of leverage magnifies the return to shareholders . . . .") (footnote omitted).

74. *See id.* at 131 (describing private equity firm practices).

75. Elizabeth Pollman, *Team Production Theory and Private Company Boards*, 38 SEATTLE U. L. REV. 619, 626 (2015) (describing the universe of private companies).

76. *See id.* Because of the growth and liquidity pressures that often come with venture capital, a commonly debated topic among entrepreneurs is whether to take financing from such investors. *See, e.g.*, Griffith, *supra* note 71 (discussing startup founders choosing to forego venture capital financing because of concerns about "the pressure of hypergrowth").

77. *See, e.g.*, Paul A. Gompers, *Optimal Investment, Monitoring, and the Staging of Venture Capital*, 5 J. FIN. 1461, 1467 (1995); Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 282 (2003); JOSEPH A. MCCAHERY & LUC RENNEBOOG, VENTURE CAPITAL CONTRACTING AND THE VALUATION OF HIGH-TECHNOLOGY FIRMS 1–26 (Joseph A. McCahery & Luc Renneboog eds., 2003); William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473, 493 (1990).

of a startup, its success is highly uncertain—more so even than the usual new business because startups are typically innovative, not replicative.[78] Entrepreneurs often have more information than investors and their interests are not fully aligned.[79] Contracts between entrepreneurs and venture capitalists will inevitably be incomplete because of the participants' bounded rationality and their inability to foresee and resolve all potential contingencies.[80]

These were the challenges faced by the pioneers of venture capital, from Georges Doriot to Arthur Rock. And, since the maturation of the venture industry in the 1980s and 90s, a set of contracting practices for venture capital funds and startup investing has become the norm, creating an "interrelated bundle of incentives and protections" that facilitates the flow of funds to entrepreneurs.[81]

Venture capital firms raise capital from passive limited partners, organized in funds with 10–12 year terms, charging an annual management fee and a percentage of profits.[82] Acting as general partner of the fund, venture capitalists make and monitor investments in a portfolio of startups.[83] Startup founders and employees will typically have an incentive-based ownership stake that vests over time and takes the form of common stock or options.[84] Venture capitalists invest in syndicated, staged financing rounds for convertible preferred stock that come with liquidation preferences and other protections for downside risk and the ability to convert into common on the upside.[85] Notably, venture contracts separate cash flow ownership

78. *See, e.g.*, DANIEL F. SPULBER, THE INNOVATIVE ENTREPRENEUR 2 (2014) ("Innovative entrepreneurs differ from replicative entrepreneurs who imitate or purchase existing business models. The innovative entrepreneur combines inventions, initiative, and investment to create the start-up.").

79. *See, e.g.*, Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 983 (2006); Robert P. Bartlett, III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 40–41 (2006).

80. Oliver Hart, *Incomplete Contracts and Control*, 107 AM. ECON. REV. 1731, 1732, 1737 (2017); Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473, 473 (1992).

81. *See* Michael Klausner & Kate Litvak, *What Economists Have Taught Us About Venture Capital Contracting*, *in* BRIDGING THE ENTREPRENEURIAL FINANCING GAP: LINKING GOVERNANCE WITH REGULATORY POLICY 54, 71 (Michael J. Whincop ed., 2001) ("[T]he two sets of contracts [for venture capital funds and startup investing] create interrelated bundles of incentives and protections that allow investors to make essentially blind investments that ultimately end up in the hands of entrepreneurs who go on to create great wealth.").

82. Gilson, *supra* note 69.

83. *Id.*; *see also* Klausner & Litvak, *supra* note 81, at 55 ("[T]he data show that VCs add value in screening investments, monitoring their portfolio companies, and facilitating the professionalisation of these companies' management.").

84. Klausner & Litvak, *supra* note 81, at 62.

85. *Id.* In the seed stage or earlier, a startup might self-fund, raise money from family and friends or angel investors, or participate in an accelerator program. Bernthal, *supra* note 69, at 789–817; Pollman, *supra* note 1, at 170–71.

from voting and other control rights. Venture capitalists typically participate in board governance and bargain for shareholder voting rights and the right to veto certain major management decisions.[86] Over the life cycle of a venture-backed startup, as it increases the number of participants with varied interests and claims, the vertical and horizontal tensions among and between common and preferred shareholders tend to multiply.[87] Ultimately, if a venture-backed startup survives past its early stage, governance complexity increases and pressure builds for the startup to find a liquidity event.[88]

These basic contours of venture capital investing and governance are well understood. Naturally, much more could be said about industry trends and entrepreneurial finance. The point here is to highlight that the basic practices of venture capital in the United States have been established for over four decades now—and have become sticky—fostering a distinctive set of companies and governance in the business world.[89]

With this foundation set, the next Part can take up the big picture view of how business law has enabled and responded to the rise of venture capital and startups, with subsequent discussion to explore the lingering issues of social costs and policy they raise.

II. BUSINESS LAW'S CREATION AND RESPONSE TO THE RISE OF VENTURE CAPITAL AND VENTURE-BACKED STARTUPS

As the previous Part has highlighted, the rise of the modern venture capital industry developed to take advantage of laws that enable *private* business entities and *private* markets. Both state business law and federal securities laws facilitated this combination.[90]

Traditionally, business entity formation and governance have been a matter of state law. Under enabling state laws, venture capitalists can form limited partnerships for the purpose of raising and operating venture funds, and founders can form corporations through which to engage in startup

86. *See* Kaplan & Strömberg, *supra* note 77, at 313.

87. Pollman, *supra* note 1, at 159–60.

88. *Id.* at 209–16.

89. As Klausner and Litvak explain, "[t]he success of these contracts is reflected in the high volume of funds invested with VCs" and "the success of venture-backed firms." Klausner & Litvak, *supra* note 81, at 54. Although the U.S. style of venture capital investing has been influential around the world, laws and practices in other regions demonstrate global variation. *See, e.g.*, LIN LIN, VENTURE CAPITAL LAW IN CHINA 318 (2021) (describing the Chinese venture capital market developing through heavy governmental intervention).

90. The focus of this Article is on business law, but notably other areas of law including tax, labor, intellectual property, antitrust, and immigration also foster the environment for venture capital and entrepreneurship. *See, e.g.*, NICHOLAS, *supra* note 4, at 317 ("Government has various levers at hand to affect the supply of and demand for venture capital, and policies with regard to taxation, immigration, and labor law have historically been key influences.").

entrepreneurship. The internal affairs doctrine provides that the law of a firm's state of incorporation governs the relationships among the firm, its investors, and managers.[91] Venture capitalists and startup entrepreneurs have predominantly chosen Delaware as their preferred state for formation of limited partnerships and corporations.[92]

Federal securities law, under the architecture of the Securities Act of 1933 and the Exchange Act of 1934, has partitioned issuers, securities, and offerings into two realms—public and private—with each side bearing distinct privileges and burdens.[93] Public company stock, once registered, can be freely issued and traded, but the issuing companies are subject to extensive mandatory disclosure as well as active enforcement mechanisms.[94] Conversely, the issuance and trading of private company stock must conform to restrictions of registration exemptions, but regulation of private firms is otherwise light.[95] Investment funds are subject to an analogous public-private divide.[96] Since Rock started his first fund in the 1960s, venture capital firms have organized their activity to fall on the private side in both the arrangement of their own funds and the portfolio companies in which they invest.

Given the importance of business law to venture capital and venture-backed startups, this Part takes up the question of how the law has responded to the developments traced thus far and describes the big picture of the growth of the private realm and the wild (and sometimes questionable) adventures of startups in it.

A. THE EVOLUTION OF CORPORATE AND SECURITIES LAW IN AN AGE OF VENTURE CAPITAL AND STARTUPS

Corporate and securities law have taken vastly different approaches to the rise of venture capital since the industry began to solidify, grow, and

91. *See* RESTATEMENT (SECOND) OF CONFLICTS OF L. § 302 cmt. a (AM. L. INST. 1971); *see also* Cort v. Ash, 422 U.S. 66, 84 (1975).

92. *See, e.g.*, Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737, 1739–40 (1994); Susan C. Morse, *Startup Ltd.: Tax Planning and Initial Incorporation Location*, 14 FLA. TAX REV. 319, 329–33 (2013); Gregg Polsky, *Explaining Choice-of-Entity Decisions by Silicon Valley Start-Ups*, 70 HASTINGS L.J. 409, 411 (2019).

93. Elisabeth de Fontenay & Gabriel Rauterberg, *The New Public/Private Equilibrium and the Regulation of Public Companies*, 2021 COLUM. BUS. L. REV. 1199, 1201. *See generally* George S. Georgiev, *The Breakdown of the Public-Private Divide in Securities Law: Causes, Consequences, and Reforms*, 18 N.Y.U. J.L. & BUS. 221 (2021) (describing the public-private divide under U.S. federal securities laws).

94. de Fontenay & Rauterberg, *supra* note 93; *see also* Elizabeth Pollman, *Private Company Lies*, 109 GEO. L.J. 353, 366–67 (2020) (describing active enforcement of public company fraud through government action and private securities litigation).

95. de Fontenay & Rauterberg, *supra* note 93, at 1201–02.

96. *Id.* at 1209, 1215.

mature in the 1980s. They have in common one high-level response: neither creates a legally defined category for venture-backed startups.[97]

While the key corporate law state for startups—Delaware—has been generally enabling and highly regarded, its case law has not been particularly favorable for startup participants as it is not crafted for the distinctive characteristics of these companies and is instead often made in the context of very different public corporations. Despite these tensions, for the most part, startups are able to take advantage of the enabling nature of Delaware corporate law through venture contracting practices and can avoid *ex post* litigation, so state corporate law ultimately creates an environment for highly flexible governance practices and a stable backstop, albeit sometimes problematic, for the rare disputes that go to court.

By contrast, securities laws have responded to the rise of venture capital and venture-backed startups with enormously favorable provisions and a deregulatory trend that has facilitated a radical transformation of private markets over the past several decades. The combination of these relevant state corporate and federal securities laws, which are discussed further below, work in tandem to foster a growing public-private divide and startup governance challenges that characterize the present era and raise big questions for the role of business law in the future.

1. Corporate Law and Venture-Backed Startups

Delaware famously makes and applies one general corporate law.[98] Thus, the same statute and case law generally apply whether the corporation at hand is one of the world's largest public corporations or a brand-new private startup. The rise of venture capital and venture-backed startups has therefore posed interesting and challenging issues of fit between corporate law and startup participants' interests and needs.

As permitted under Delaware corporate law, venture-backed startups customize their governance arrangements through the organic documents of the corporation (charter and bylaws) and extensive shareholder agreements, typically re-bargaining these arrangements in each round of venture

97. Pollman, *supra* note 1, at 162–63 ("The law does surprisingly little to formally define startups or mandate their governance."). In the public realm, the JOBS Act of 2012 created an IPO on-ramp and the category of "emerging growth company" as a subset of public company regulations with reduced reporting obligations for up to five years. Georgiev, *supra* note 93, at 246, n.79.

98. Nixon v. Blackwell, 626 A.2d 1366, 1379–81 (Del. 1993) (declining to adopt special rules for private corporations when not qualified as statutory close corporation); *see also* Andrew S. Gold, *Theories of the Firm and Judicial Uncertainty*, 35 SEATTLE U. L. REV. 1087, 1088 (2012) ("Delaware courts generally adopt one corporate law for various different types of corporations (from closely held to public . . . ."). Delaware has special subchapters devoted to statutory close corporations and public benefit corporations. 8 DEL. CODE ANN. tit. 8, Subchapters XIV and XV.

financing.[99] Delaware's enabling approach is a boon in this regard. For example, it is mandatory to have a board of directors, but Delaware corporate law requires only one director, allows for different sizes and compositions, and does not impose requirements of independence, qualifications, committees, or the like.[100] When disputes arise, however, Delaware case law takes a highly fact-specific approach and often imposes its most rigorous standard of scrutiny—entire fairness—when venture-backed startups are involved because they generally lack disinterested and independent boards and shareholders.[101]

Over time, this divergent dynamic between public and private corporations and fiduciary litigation has become more pronounced as federal securities law has added a layer of corporate governance requirements on public companies, requiring majority independent boards.[102] In addition, Delaware corporate law doctrine has developed more pathways to lighter review under the deferential business judgment rule if certain process protections are followed with disinterested and independent board members and/or shareholders.[103] This means that absent specific conflicts or the like, most public company boards would receive deferential review if their decisions are challenged and could likely dispose of litigation in early motion practice, whereas startup boards would not often be so lucky and might be encouraged to incur costly procedures such as banker fairness opinions or special committees that are not otherwise a fit for the norms or circumstances.[104]

Furthermore, some venture-backed startup cases involving fiduciary litigation under the strenuous entire fairness standard have provoked controversy. Most notably, in a case involving a conflict between the interests of the common and preferred shareholders in an M&A exit, *In re Trados*, the Delaware Court of Chancery declared that directors owe a

99. Pollman, *supra* note 1, at 205. For an argument against allowing private ordering through private shareholder agreements, *see* Jill E. Fisch, *Stealth Governance: Shareholder Agreements and Private Ordering*, 99 WASH. U. L. REV. 913, 913–14 (2021).

100. *See* 8 DEL. CODE. ANN. tit. 8, § 141.

101. Pollman, *supra* note 1, at 217.

102. *See, e.g.*, Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1523 (2005) (discussing federal corporate governance provisions in the Sarbanes-Oxley Act of 2002); Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779, 1779 (2011) (discussing federal corporate governance provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010).

103. Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304, 311–14 (Del. 2015); Kahn v. M&F Worldwide Corp., 88 A.3d 635, 651–54 (Del. 2014).

104. On navigating Delaware corporate law expectations in the realm of venture-backed startups, *see* Steven E. Bochner & Amy L. Simmerman, *The Venture Capital Board Member's Survival Guide: Handling Conflicts Effectively While Wearing Two Hats*, 41 DEL. J. CORP. L. 1, 2 (2016); Abraham J.B. Cable, *Does* Trados *Matter?*, 45 J. CORP. L. 311, 312–13 (2020).

fiduciary duty to maximize value for the common shareholders as residual claimants.[105] Corporate law scholars have pointed out that this approach can give rise to inefficient outcomes that fail to maximize aggregate welfare.[106] Similarly in cases involving venture capital contracts and the status of preferred shareholder rights, Delaware courts have taken a strict construction approach that has elicited criticism given its potential to disrupt expectations and allocated risks.[107]

None of these doctrinal tensions have been insurmountable impediments.[108] On balance, venture-backed startups and their participants have largely learned to take advantage of the freedom for private ordering and to generally avoid litigation. This latter point is likely a matter of practicality—given that failure or economic realities often make litigation less relevant for startups[109]—as well as norms in an ecosystem of repeat players and reputational concerns.[110] Further, a community of knowledgeable and experienced lawyers has flourished over decades, playing an important role as dealmakers and guides providing counsel to venture-backed startups through contracting practices, conflicts, fiduciary duties, and more.[111]

2. Securities Law and Venture-Backed Startups

While corporate law's response has been a mix of enabling rules with certain doctrinal tensions in application, securities law has provided a veritable windfall to the venture capital industry. The legal transformation to

105. *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 40–41 (Del. Ch. 2013).

106. Pollman, *supra* note 1, at 190–91, 216–19; Robert P. Bartlett, III, *Shareholder Wealth Maximization as Means to an End*, 38 SEATTLE U. L. REV. 255, 290–95 (2015); William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815, 1816, 1885–87, 1904–06 (2013).

107. *See, e.g.*, Benchmark Cap. Partners IV, L.P. v. Vague, No. Civ.A 19719, 2002 WL 1732423, at *6–7 (Del. Ch. 2002), *aff'd sub nom.* Benchmark Cap. Partners IV, L.P. v. Juniper Fin. Corp., 822 A.2d 396 (Del. 2003) (unpublished table opinion); Bartlett, *supra* note 79, at 95–113; Bratton & Wachter, *supra* note 106, at 1816.

108. For an argument that a special form of business corporation should be created to better fit the distinctive characteristics of venture-backed startups, *see* Gad Weiss, *The Venture Corporation*, (Columbia L. Sch. Working Paper, 2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4338030 [https://perma.cc/TRP2-ZPTT].

109. Brian J. Broughman & Matthew T. Wansley, *Risk-Seeking Governance*, 76 VAND. L. REV. 1299 (2023); Pollman, *Startup Failure*, *supra* note 68, at 33.

110. *See, e.g.*, Gilson, *supra* note 69, at 1085–87.

111. *See, e.g.*, Bochner & Simmerman, *supra* note 104, at 10; Cable, *supra* note 104, at 321; Mark Charles Suchman, On Advice of Counsel: Law Firms and Venture Capital Funds as Information Intermediaries in the Structuration of Silicon Valley (February 1994) (Ph.D. dissertation, Stanford University) (on file with Stanford University). The National Venture Capital Association has also played a notable role in coordinating a set of model venture capital agreements with annotations about relevant corporate law rules and doctrine. *See Model Legal Documents*, NVCA, https://nvca.org/model-legal-documents [https://perma.cc/MT69-6Z7X].

securities laws regulating private markets and companies has occurred incrementally over many years. In the aggregate, this deregulatory shift has been sufficiently dramatic to raise existential questions about the coherence of the securities law framework and its approach to venture capital and venture-backed startups.

First, in 1988, during a period of rapid growth in funds allocated to venture capital, the Securities and Exchange Commission ("SEC") adopted Rule 701, permitting private companies to issue equity-based compensation to employees and service providers, in limited amounts, without registering the offering or providing extensive disclosures.[112] As the history of venture capital illuminates, equity-based compensation for founders and entrepreneurs has long been understood as a key ingredient for attracting and retaining talent in risky enterprises, and the SEC's rule added important clarity for startups to offer equity compensation to prospective employees lacking sophistication or high net worth.[113] At the time of adoption, the SEC had come under considerable pressure from scholars, industry representatives, and lawyers to create this special exemption.[114] And, under continued lobbying pressure from industry players, the SEC has periodically, across decades, increasingly relaxed various aspects of the remaining Rule 701 restrictions, "turning [a] small exemption into a significant channel of securities offerings to household investors."[115]

Second, a long trajectory of additional deregulatory actions since the early 2000s has opened the floodgates to private markets and loosened restrictions.[116] The result is larger, more complex private markets and a regulatory environment in which two firms that are virtually identical in value, number of employees and shareholders, access to capital, and size and footprint of operations can be subject to vastly different regulatory obligations and oversight.[117] The implicit bargain that venture-backed startups faced through the 1990s of becoming a public company subject to an extensive federal regulatory regime in order to access large and liquid pools of capital has been replaced by a new set of options.

112. 17 C.F.R. § 230.701 (2018); *see also* Yifat Aran, *Making Disclosure Work for Start-Up Employees*, 2019 COLUM. BUS. L. REV. 867, 870–71 (describing the history of Rule 701).

113. Aran, *supra* note 112, at 888.

114. *Id.* at 889.

115. *Id.* at 891–92.

116. Georgiev, *supra* note 93, at 223–24.

117. *Id.* at 224 (describing a "regulatory paradox" of different treatment for public and private firms); de Fontenay & Rauterberg, *supra* note 93, at 1199–1200, 1205, 1226, 1243 (observing that incremental securities law changes that have occurred serially over the past two decades have produced "two widely different ecologies for firms" and "[a]s a result, two similar corporations, one public and the other private, will be subject to very different corporate governance mandates").

After the dot-com bust and financial accounting scandals of the early 2000s, Congress passed the Sarbanes-Oxley Act of 2002, setting in motion a narrative of "over-regulation" amid a deepening decline in IPO activity.[118] While the costs and obligations on public companies concerning governance arrangements, internal controls, and disclosures indeed ratcheted up, a set of market forces including increased M&A activity and greater availability of private capital also took effect.[119] The number of IPOs and U.S. publicly traded companies significantly dropped.[120] Shortly after Congress passed the Dodd-Frank Act of 2010 in the wake of the global financial crisis, further increasing regulatory burdens on public corporations, it passed the JOBS Act of 2012, which deregulated major aspects of the rules concerning venture financings and easing startups' exit pathway with a new IPO on-ramp.[121] The venture capital industry, startups, and exchanges that stood to gain from the changes lobbied heavily in favor of them.[122] As the "SEC continued to prioritize the deregulation of the *private* markets in the name of *public* capital formation,"[123] the tables began to turn—going public changed from a rite of passage that successful startups would go through after a few years in the venture cycle to an idiosyncratic, firm-specific choice that could be significantly delayed.[124] The pathway to exit via M&A became much more common than IPO.[125]

118. *See* Georgiev, *supra* note 93, at 262.

119. *Id.* at 259–63; Paul Rose & Steven Davidoff Solomon, *Where Have All the IPOs Gone?: The Hard Life of the Small IPO*, 6 HARV. BUS. L. REV. 83, 87 (2016).

120. Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 HASTINGS L.J. 445, 454–55 (2017) ("From 2001 through 2012, there were an average of only 99 IPOs per year, compared to 310 IPOs per year between 1980 and 2000."); Andrew Ross Sorkin, *C.E.O.s Meet in Secret Over the Sorry State of Public Companies*, N.Y. TIMES (July 21, 2016), https://www.nytimes.com/2016/07/21/business/dealbook/ceos-meet-in-secret-over-sorry-state-of-public-companies.html [https://perma.cc/98EY-QSPX] ("In 1996, there were 8,025 public listed companies in the United States; by 2012, the number of companies was about half: 4,101, according to the National Bureau of Economic Research.").

121. Georgiev, *supra* note 93, at 264–65; *see also* Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. PA. L. REV. 179, 181 (2012) (discussing the JOBS Act provisions affecting startups and the private market). Meanwhile, the SEC has done little to adjust accredited investor requirements over many years, despite economic growth and inflation, thereby providing a greater number of investors access to private investments. *Id.* at 226–27. The percentage of households qualifying as accredited investors since 1983 has increased from 2 to 13% of all U.S. households. Georgiev, *supra* note 93, at 272.

122. Michael Rapoport, *Tallying the Lobbying Behind the JOBS Act*, WALL ST. J. (May 25, 2012, 9:31 AM), https://www.wsj.com/articles/BL-WB-34693 [https://perma.cc/TUA4-6XBP]; Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 FORDHAM L. REV. 3389, 3392 (2013).

123. Georgiev, *supra* note 93, at 267.

124. de Fontenay & Rauterberg, *supra* note 93, at 1238–40; *see also* Pollman, *supra* note 1, at 209–16 (observing governance and liquidity pressure building in late stages of mature venture-backed startups).

125. Steve Blank, *When Founders Go Too Far*, HARV. BUS. REV., Nov.–Dec. 2017 at 94, 99 ("[A] start-up is 30 times as likely to be acquired as to go public.").

With massive inflows of private capital and new investors to private markets, the SEC's rationale for its deregulatory trend took an ironic twist away from capital formation to "democratizing" access to private markets.[126] Delayed timelines to venture-backed startup exits had effectively allowed startups to grow larger and for much of their growth to occur on the private side of the divide.[127] "Unicorn" companies that raised venture financing at a private valuation of $1 billion or more exploded.[128] In 2020, the SEC adopted extensive rule amendments to permit larger and more frequent private offerings to be offered more widely to the general public.[129]

In hindsight, it became evident that a slow-motion series of piecemeal securities law developments transformed the public-private divide and the environment in which startups go through the venture cycle.

B. THE WILD ADVENTURES AND MISADVENTURES OF VENTURE-BACKED STARTUPS IN THE PRIVATE REALM

With an understanding of the business and legal history that has brought about and transformed venture capital, startups, and the regulatory environment that they enjoy, the discussion can now explore the implications of these developments and what the role of business law might be in the future.

The heart of the matter concerns the enormous space that business law creates for venture-backed startups to operate for long periods without significant governance or disclosure requirements. Accountability mechanisms beyond the internal participants' private ordering are also vastly limited in comparison with those in the public company context.[130] Private

126. Georgiev, *supra* note 93, at 266–68.

127. Mark Suster & Chang Xu, UPFRONT VENTURES, *Is VC Still a Thing?* 23–25 (2019), https:// www.slideshare.net/msuster/is-vc-still-a-thing-final [https://perma.cc/7ZA5-7HUQ]; *see also* Rodrigues, *supra* note 122.

128. Georgiev, *supra* note 93, at 266–68. On the outcomes of the first batch of unicorns, *see* Abraham J.B. Cable, *Time Enough for Counting: A Unicorn Retrospective*, 93 YALE J. ON REGUL. BULL. 23, 23–24 (2021), https://www.yalejreg.com/bulletin/time-enough-for-counting-a-unicorn-retrospective [https://perma.cc/LZ2G-7JG8].

129. Georgiev, *supra* note 93, at 267, 272. A number of other regulatory developments also opened the gate to private market investing. *See, e.g.*, Revisions of Guidelines to Form N-1A, Investment Company Act Release, 17 C.F.R Parts 239, 274 (1992) (increasing limit to 15% on mutual fund holdings of restricted securities or other assets not having readily available market quotations); U.S. Dep't of Labor, Div. of Fiduciary Interpretations, Opinion Letter on Private Equity Investments in Retirement Plans (June 3, 2020), https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/information-letters/06-03-2020 [https://perma.cc/7YK4-9UPG] (allowing defined contribution plan to offer private equity as an investment option).

130. *See, e.g.*, Holger Spamann, *Indirect Investor Protection: The Investment Ecosystem and Its Legal Underpinnings*, 14 J. LEGAL ANALYSIS 16, 16–17 (2002) (arguing that the key mechanisms protecting portfolio investors in public company stock are provided indirectly by an "ecosystem that investors (are legally forced to) inhabit, as a byproduct of the self-interested, mutually and legally

startups are generally free from securities class actions, short sellers, quarterly earnings pressures, public stock prices, and the like. Further, regulators at different levels from federal to local, in different areas of subject matter expertise, face challenging dynamics responding to innovative startups—their activity might fall into unmapped territory, legal gray areas, or regulatory blind spots until egregious circumstances develop.[131] With limited resources, regulators might prioritize oversight and enforcement of large established companies.

This environment of relative freedom to push the envelope fits the needs of venture capital and startups, which are fundamentally "a machine for running experiments."[132] Moreover, given the power law, these startup experiments are typically not seeking to hit a single or double—they aim at "disrupting entrenched corporate power" in lucrative markets that could be grand slams.[133] As we have seen, venture capitalists are looking for "radical departures from the past."[134] Room for maneuvering without disclosures that would prematurely share information with competitors or potential competitors is important for incubating innovative products and services. Longer timelines for staying private enable startups to try moonshots that might take significant time to develop or find product-market fit.

Recent years have witnessed venture-backed startup activity that has increasingly raised concern about the growing public-private divide and startup governance, however. The private space and relative freedom that are embraced by startup entrepreneurs and venture capitalists have given rise to scandals from Theranos to FTX, governance fiascos such as WeWork, and controversial products and services such as Juul's vaping technology and Uber and Lyft's ride sharing services. With a massive influx of private capital over the past decade, venture capital has spread sectorially to startups aimed at widespread industries from health to transportation.[135] And with this long timeline and large footprint have come concerns about harms to

constrained behavior of third parties without a mandate to help the investors such as speculators, activists, and plaintiff lawyers").

131. *See, e.g.*, Tim Wu, *Agency Threats*, 60 DUKE L.J. 1841, 1851–52 (2011); Elizabeth Pollman & Jordan M. Barry, *Regulatory Entrepreneurship*, 90 S. CAL. L. REV. 383, 383 (2017); Eric Biber, Sarah E. Light, J.B. Ruhl & James Salzman, *Regulating Business Innovation as Policy Disruption: From the Model T to Airbnb*, 70 VAND. L. REV. 1561, 1624–25 (2017); Chris Brummer, Yesha Yadav & David Zaring, *Regulation by Enforcement*, 96 S. CAL. L. REV. (forthcoming 2024).

132. Benedict Evans, *When Big Tech Buys Small Tech*, BENEDICT EVANS (Nov. 12, 2021), https://ben-evans.com/benedictevans/2021/11/12/when-big-tech-buys-small-tech [https://perma.cc/6NUL-DSBY]; *see also* MALLABY, *supra* note 5, at 11–12 (describing the philosophy of venture capital that the future "cannot be predicted" but it "can be *discovered* by means of iterative, venture-backed experiments").

133. MALLABY, *supra* note 5, at 388.

134. *Id.* at 14.

135. *Id.* at 13.

customers, employees, and other stakeholders, as well as questions about how society is impacted more generally by venture capital.[136]

A vivid example of this complex dynamic of startups in the private realm comes from the burgeoning artificial intelligence ("AI") industry. AI is posed to deliver some of the biggest financial hits of the current generation of startups and it threatens to destabilize countless industries and impact social and economic activity globally in unpredictable ways. Sam Altman, the CEO-founder of OpenAI, which has developed ChatGPT, currently valued at $29 billion, has declared that it is better to continue running the company privately so that his decisions are not limited.[137] Altman remarked, "When we develop superintelligence, we're likely to make some decisions that public market investors would view very strangely."[138]

Notably, however, Altman made these statements about staying private while on a world tour of meetings with governments in which he warned them of the existential threat posed by AI. He testified to the U.S. Congress: "I think if this technology goes wrong, it can go quite wrong."[139] And although he originally expressed a desire for his company to work with governments on responsibly regulating AI, he threatened that OpenAI would leave Europe in response to new European Union regulations.[140] He later backtracked after EU lawmaker pushback,[141] but he could not unring the proverbial bell that raised questions about the dangers of the technology being developed and the sincerity of its stewards' statements about embracing regulation.

As regulators' ability to rein in the harms posed by venture-backed startups is often limited as a practical matter, and the protections of public

136. *See, e.g.*, Amy Deen Westbrook, *We'(re) Working on Corporate Governance: Stakeholder Vulnerability in Unicorn Companies*, 23 U. PA. J. BUS. L. 505, 508 (2021) (exploring "changes that might be made to rein in unicorns and protect stakeholders"); Donald C. Langevoort & Hillary A. Sale, *Corporate Adolescence: Why Did "We" Not Work?*, 99 TEX. L. REV. 1347, 1349–50 (2021) (exploring "risk-taking and rule-breaking" in "high-tech start-up companies" and arguing that "start-up adolescence is . . . [a] real cause for concern").

137. Rachel Shin, *Sam Altman Says OpenAI Won't Go Public Now Because He May Have to Make 'A Very Strange Decision' That Investors Will Disagree With*, FORTUNE (June 6, 2023, 2:37 PM), https://fortune.com/2023/06/06/sam-altman-openai-wont-go-public-now-decisions [https://perma.cc/75YE-28CX].

138. Amy Thomson, *ChatGPT Maker OpenAI Is Staying Private So It Can Make 'Strange' Decisions*, BLOOMBERG (June 6, 2023, 10:31 AM), https://www.bloomberg.com/news/articles/2023-06-06/openai-staying-private-and-free-to-make-strange-decisions [https://perma.cc/JX9Z-ASUB].

139. Noor Al-Sibai, *OpenAI CEO Hopeful World Leaders Will Save Us From AI He's Building*, FUTURISM, https://futurism.com/openai-sam-altman-world-leaders [https://perma.cc/8LFX-7LUU].

140. Shiona McCallum & Chris Vallance, *ChatGPT-Maker U-Turns on Threat to Leave EU Over AI Law*, BBC (May 26, 2023), https://www.bbc.com/news/technology-65708114 [https://perma.cc/8SVQ-2BVY].

141. *Id.*

markets are absent, focus has shifted to startup governance and the failures of private ordering to create checks and balances. For over a decade, with more private capital available in a low-interest rate environment and intense competition for venture deals, many venture capitalists adopted "founder-friendly" stances.[142] Some founders have been allowed to act as "monarchs" with "unchecked power."[143] Critics have expressed concern that venture capitalists have turned into "hype" people exercising little managerial oversight—"a money-hungry mob" pushing for "hyper growth" instead of the prudent "midwives to innovation" they had been in the past.[144]

In some instances, utterly disastrous startup governance has come to light. One example is the collapse of FTX, one of the largest cryptocurrency exchanges, once privately valued at $40 billion.[145] The CEO-founder was "the paragon of crypto," and vaulted to celebrity status as he led the startup through rocket-ship growth.[146] After troubling reports came to light about potential leverage and solvency concerns, customers attempted to pull out of FTX, precipitating the company's downfall. Prosecutors and regulators quickly closed in on the CEO-founder, asserting that FTX had been illegally using clients' deposits.[147] Shortly after, the CEO-founder resigned and the company filed for bankruptcy. One of the biggest unicorns crumbled within days.

In the aftermath, FTX installed a new CEO to handle the bankruptcy—the same person who had handled the cleanup of the massive accounting and audit scandal at Enron that had prompted the passage of the Sarbanes-Oxley Act in 2002.[148] After taking the helm at FTX, he said: "Never in my career have I seen such a complete failure of corporate controls and such a complete absence of trustworthy financial information as occurred here."[149] The

142. *See, e.g.*, Blank, *supra* note 125, at 101 (explaining the rise of founder-friendly governance); Broughman & Wansley, *supra* note 109, at 55 (discussing venture capital competition and founder-friendly governance).

143. Charles Duhigg, *How Venture Capitalists Are Deforming Capitalism*, NEW YORKER (Nov. 23, 2020), https://www.newyorker.com/magazine/2020/11/30/how-venture-capitalists-are-deforming-capitalism [https://perma.cc/9CDA-HYMQ]; *see also* Blank, *supra* note 125, at 101.

144. Duhigg, *supra* note 143.

145. Darreonna Davis, *What Happened To FTX? The Crypto Exchange Fund's Collapse Explained*, FORBES (June 2, 2023, 10:35 AM), https://www.forbes.com/sites/darreonnadavis/2023/06/02/what-happened-to-ftx-the-crypto-exchange-funds-collapse-explained [https://perma.cc/W43Z-H3KK].

146. Eric Wallerstein*, FTX and Sam Bankman-Fried: Your Guide to the Crypto Crash*, WALL ST. J. (Jan. 19, 2023, 11:57 AM), https://www.wsj.com/articles/ftx-and-sam-bankman-fried-your-guide-to-the-crypto-crash-11669375609 [https://perma.cc/NEH2-7MS8].

147. *Id.*

148. Dan Byrne, *FTX Collapse Is a Case Study in Bad Governance*, CORP. GOVERNANCE INST. (Nov. 22, 2022), https://www.thecorporategovernanceinstitute.com/insights/news-analysis/governance-causes-ftx-collapse [https://perma.cc/8622-7X6M].

149. *Id.*

company had no board of directors—none of the well-known venture firms that had financed FTX had taken seats.[150] According to media reports, "control was in the hands of 'a very small group of inexperienced, unsophisticated and potentially compromised individuals.' "[151] Company financials were not tracked.[152] Software was reportedly used to conceal the misuse of client money.[153] The CEO-founder was arrested and charged with multiple criminal counts, and other top executives pleaded guilty and admitted that they knew what they did at the startup was wrong.[154] Potentially billions of dollars in customer funds went missing.[155]

Apart from governance scandals is the separate concern that with venture capitalists raising and deploying dramatically larger funds, they might end up funding money-losing companies that are creating "disruption without social benefit."[156] In some cases, startups might in fact be "destroying social value" and crowding out the development of superior technologies.[157] Venture capital goes to a narrow slice of potential innovators and not necessarily those that would produce the most social value or positive innovation.[158] Even venture capitalists themselves have raised this concern, for example noting, "We wanted flying cars, instead we got 140 characters."[159] And while the social value that Twitter produced is certainly debatable, it compares favorably to many other startup inventions including robotic pizza makers and "Juicero" juicers.[160] Commentators have also

150. Noam Wasserman, *FTX and the Problem of Unchecked Founder Power*, HARV. BUS. REV. (Dec. 1, 2022), https://hbr.org/2022/12/ftx-and-the-problem-of-unchecked-founder-power [https://perma.cc/7LCY-HSYM]; MICHAEL LEWIS: GOING INFINITE 129 (2023) ("All of [the VC firms] caved to Sam's refusal to give them a seat on the board (he had no board) or any other form of control over the business.").

151. Byrne, *supra* note 148.

152. Wallerstein, *supra* note 146.

153. *Id.*

154. *Id.*; *see also* Corinne Ramey & James Fanelli, *Caroline Ellison Apologizes for Misconduct in FTX Collapse*, WALL ST. J. (Dec. 23, 2022, 4:22 PM), https://www.wsj.com/articles/caroline-ellison-apologized-for-misconduct-in-ftx-collapse-11671818789 [https://perma.cc/T3PD-FGTU].

155. Alexander Saeedy, *FTX Says $8.9 Billion in Customer Funds Are Missing*, WALL ST. J. (Mar. 2, 2023, 10:12 PM), https://www.wsj.com/articles/ftx-says-8-9-billion-in-customer-funds-are-missing-c232f684 [https://perma.cc/LJ3G-NZMW].

156. Martin Kenney & John Zysman, *Unicorns, Cheshire Cats, and the New Dilemmas of Entrepreneurial Finance*, 21 VENTURE CAP. 35, 39 (2019).

157. *Id.*; Duhigg, *supra* note 143.

158. Lerner & Nanda, *supra* note 2, at 238, 251; *see also* NICHOLAS, *supra* note 4, at 311 (raising concerns that the VC model is "largely incompatible" with financing companies that "require high levels of initial capital and sustained financial support to grow" such as certain companies in the clean energy sector).

159. Pascal-Emmanuel Gobry, *Facebook Investor Wants Flying Cars, Not 140 Characters*, BUS. INSIDER (July 30, 2011, 7:38 AM), https://www.businessinsider.com/founders-fund-the-future-2011-7 [https://perma.cc/UY9E-9BZ4].

160. *See* Yuliya Chernova, *More Startups Throw in the Towel, Unable to Raise Money for Their Ideas*, WALL ST. J. (June 9, 2023, 12:01 AM), https://www.wsj.com/articles/more-startups-throw-in-the-towel-unable-to-raise-money-for-their-ideas-eff8305b [https://perma.cc/NB65-PEMF]; Sam Levin,

raised concerns that only a relatively small number of venture capital investors shape the direction of a substantial amount of the capital that is financing radical technological change.[161]

A number of proposals for reform have been offered. These have tended to be somewhat narrowly focused on particular aspects of problematic facets of the public-private divide and startup governance. For example, proposals from scholars and regulators include special disclosure regimes for unicorns,[162] enhanced disclosures for startup employees,[163] expanded anti-fraud enforcement efforts,[164] facilitating private company stock trading for price accuracy,[165] and reforming the "shareholders of record" trigger for public company status.[166]

Without a more systematic approach to these issues, however, it is difficult to know if there is a problem with venture-backed startups and the private realm, and whether private ordering, new lawmaking, or enforcement could provide a solution. The next Part takes up some of the larger issues and promising avenues for future research.

III. THE BIG QUESTIONS

It might be impossible to accurately calculate the social welfare impact of venture capital, but researchers have begun to ask this question.[167] For most industry players, researchers, and others who are involved in some way in startups and venture capital, the answer is intuitively positive—despite

Squeezed Out: Widely Mocked Startup Juicero is Shutting Down, GUARDIAN (Sept. 1, 2017), https://www.theguardian.com/technology/2017/sep/01/juicero-silicon-valley-shutting-down [https://perma.cc/CN53-JHPS].

161. Lerner & Nanda, *supra* note 2, at 238, 251.

162. Jennifer S. Fan, *Regulating Unicorns: Disclosure and the New Private Economy*, 57 B.C. L. REV. 583, 607 (2016); Michael D. Guttentag, *Patching a Hole in the JOBS Act: How and Why to Rewrite the Rules That Require Firms to Make Periodic Disclosures*, 88 IND. L.J. 151, 156 (2013); Renee M. Jones, *The Unicorn Governance Trap*, 166 U. PA. L. REV. ONLINE 165, 165–67 (2017).

163. Aran, *supra* note 112; Anat Alon-Beck, *Alternative Venture Capital: The New Unicorn Investors*, 87 TENN. L. REV. 983, 997 (2020).

164. Pollman, *supra* note 94, at 402; Verity Winship, *Private Company Fraud*, 54 U.C. DAVIS L. REV. 663, 665 (2020).

165. Matthew Wansley, *Taming Unicorns*, 97 IND. L.J. 1203, 1247 (2022); *see also* Jesse M. Fried & Jeffrey N. Gordon, *The Valuation and Governance Bubbles of Silicon Valley*, COLUM. L. SCH. BLUE SKY BLOG (Oct. 10, 2019), https://clsbluesky.law.columbia.edu/2019/10/10/the-valuation-and-governance-bubbles-of-silicon-valley [https://perma.cc/8P4V-LDYK] (expressing concern for "governance bubbles" in venture-backed startups due to a dynamic of "one-sided market sentiment" in which "structural features . . . favor the expression of positive sentiments"). For a contrary perspective expressing skepticism about arguments that unicorns pose investor protection and other problems, *see* Alexander I. Platt, *Unicorniphobia*, 13 HARV. BUS. L. REV. 116 (2023).

166. Allison Herren Lee, Remarks at The SEC Speaks in 2021, Going Dark: The Growth of Private Markets and the Impact on Investors and the Economy (Oct. 12, 2021), https:/sec.gov/news/speech/lee-sec-speaks-2021-10-12 [https://perma.cc/C437-MPXA].

167. *See, e.g.*, Lerner &. Nanda, *supra* note 2, at 238.

drawbacks and harms, the gain is incalculably large as it is a key economic driver of growth and innovation that changes millions of lives.[168] The vibrant U.S. venture capital ecosystem is a jewel of the economy that countries around the world seek to emulate. Innovation is not automatically good for society,[169] but "in the long run, innovation is essential to productivity gains and economic growth."[170]

As one researcher explained: "Venture capitalists generate private value in the form of fund-level returns, but the social value they create surely exceeds that. That social value is equivalent to private value plus all other returns realized from the technological change that venture financing enables."[171] And on the latter point, "[n]umerous innovations developed by VC-backed firms, from memory chips to recombinant insulin . . . have moved society forward—and in turn, stimulated additional waves of technological development with immense collective impact."[172]

At the same time, even those who have a rosy or optimistic view about the aggregate social value that venture capital produces might be uncomfortable with the lingering impacts on stakeholders that arise in the context of venture-backed startups. Further, the rise of founders with unchecked power and the decline in active corporate governance by venture capitalists is concerning to many observers.

This Article offers two promising avenues for further inquiry for legal scholars and policymakers. Although the social welfare impact of venture capital may be somewhat intractable in the abstract, there are concrete related questions that would benefit from additional legal study and debate.

First, researchers can usefully focus attention on studying which persons impacted by venture-backed startups, if any, are systematically suffering harm. Key areas for additional investigation include startup employees and customers or users.

A number of researchers have raised concerns about startup employees developing incorrect expectations about the value of their equity

168. *See, e.g.*, William A. Sahlman, *Risk and Reward in Venture Capital*, HARV. BUS. SCH. N9-811-036, at 2 (2010) ("The societal return on venture capital has been, and remains, very high.").

169. Christopher Buccafusco & Samuel N. Weinstein, *Antisocial Innovation*, 58 GA. L. REV. 573 (2024) (arguing that "the law is deeply committed to fostering innovation," but many innovations are neutral or "simply bad for society" such as cigarette additives, worker surveillance, and firearm bump stock); *see also* Robin C. Feldman, David A. Hyman, W. Nicholson Price & Mark J. Ratain, *Negative Innovation: When Patents Are Bad for Patients*, 39 NATURE BIOTECH. 914, 914 (2021) (identifying negative innovation, "in which patent law drives innovation into spaces that are affirmatively harmful to patients").

170. NICHOLAS, *supra* note 4, at 2–3.

171. *Id.* at 316.

172. *Id.*

compensation or suffering losses by exercising vested options and incurring tax consequences.[173] Assessing the value of startup equity compensation is challenging because of the lack of liquidity and a clear market price.[174] Further, as discussed above, startups rely on Rule 701 to avoid registering compensatory offerings with the SEC, and have limited disclosure obligations.[175] Complex and often opaque capital structures add to the challenges for startup employees to evaluate their equity compensation.[176] Venture capitalists typically receive preferred stock, which comes with contractual protections such as liquidation preferences, and is considerably more valuable than the common stock for which employees are typically granted stock options.[177] In short, an illiquid market, incomplete information, and complex capital structures often make it difficult for startup employees to make informed decisions about their equity compensation.[178] A more systematic study of the issue offers a concrete path for legal reform that could temper some of the harms of startup governance failures or fraud as other startup participants—venture capitalists, founders, and executives—are often better situated to bear the risk or avoid creating the harm in the first place.

Another group of individuals impacted by startups that deserves deeper inquiry are customers or users.[179] Some salient examples of startups that have harmed users in recent times have included the blood-testing company

173. *See, e.g.*, Abraham J.B. Cable, *Fool's Gold? Equity Compensation & the Mature Startup*, 11 VA. L. & BUS. REV. 615, 615, 617 (2017) (noting the investment decisions and tax consequences for startup employees related to stock options, and questioning the merits of a permissive regulatory approach to equity compensation for mature startups); Anat Alon-Beck, *Unicorn Stock Options—Golden Goose or Trojan Horse?*, 2019 COLUM. BUS. L. REV. 107, 117 (discussing stock option-related dilemmas faced by startup employees); Will Gornall & Ilya A. Strebulaev, *Squaring Venture Capital Valuations with Reality*, 135 J. FIN. ECON. 120, 123 (2020) (observing that "[m]any employees use post-money valuation as a reference when valuing their common stock or option grants, which can lead them to dramatically overestimate their wealth"); Yifat Aran & Raviv Murciano-Goroff, *Equity Illusions*, 2023 J. L., ECON., & ORGANIZATION at 1, 1, https://doi.org/10.1093/jleo/ewad017 [https://perma.cc/523C-UV7P] (finding that "employees commonly respond to economically irrelevant signals and misinterpret other important signals," suggesting that startup employees' "illusions . . . can lead to inefficiencies in the labor market, which sophisticated employers can legally exploit").

174. Aran & Murciano-Goroff, *supra* note 173.

175. *Id.* at 1–2.

176. Yifat Aran, *Making Disclosure Work for Start-Up Employees*, 2019 COLUM. BUS. L. REV. 867, 906–08.

177. Gornall & Strebulaev, *supra* note 173, at 128.

178. Aran & Murciano-Goroff, *supra* note 173, at 2.

179. Other stakeholders that startups may systematically impact include suppliers and lenders, though these parties are often more sophisticated and in contractual relationships with startups, and may be better positioned to protect themselves from potential harms. For a discussion of the social welfare costs of financial misrepresentations to various stakeholders generally, see Urska Velikonja, *The Cost of Securities Fraud*, 54 WM. & MARY L. REV. 1887 (2013).

Theranos, vaping pioneer Juul, and the crypto exchange FTX.[180] Determining whether startups pose distinctive risks to customers is difficult, however. Corporate harms and externalities are certainly not unique to startups—closely held and publicly traded companies are involved in a range of pressing social issues from the opioid crisis to environmental pollution and catastrophes. Nonetheless, one could imagine that startups more frequently pose risks, or uncertain impacts, to customers or users stemming from the innovation or technology that is at the heart of venture-backed experiments. And yet, attempting to regulate the harms from innovation through corporate and securities laws may be inefficient or worse. Further work could be done to bring together relevant research across silos of business law, technology and innovation law, and regulatory and enforcement approaches.

Second, a worthy area of legal focus is whether and when a governance intervention is optimal on a startup's timeline in the venture cycle. Many observers have bemoaned bad startup governance and even blamed it for major scandals, yet little work has been done to examine how the venture contracting and governance model could change to incentivize active monitoring or whether regulatory mandates are necessary.[181]

For example, would additional disclosure, due diligence, independent directors, audited financials, or some other mechanism improve startup governance? Is there a bargaining or market failure that prevents such a governance mechanism from being used in most startups? As many startups fail, particularly in their early stages, increasing governance or compliance costs may be unwise and impinge on the valuable space for maneuvering in the private realm that fosters a thriving startup ecosystem. Further, as startups mature, they are often navigating increasing potential tensions among a larger number of participants and greater costs of bargaining, while

180. Rishub Karan Das & Brian Christopher Drolet, *Lessons from Theranos – Restructuring Biomedial Innovation*, 46 J. MED. SYS. 24, 25 (2022) (noting that "Theranos' equipment provided inaccurate results . . . resulting in thousands of unnecessary and negative experiences for patients" including "emotional trauma following false cancer diagnoses" and "treatment decisions . . . using inaccurate diagnostics"); Jamie Ducharme, *How Juul Hooked Kids and Ignited a Public Health Crisis*, TIME (Sept. 19, 2019, 6:04 AM), https://time.com/5680988/juul-vaping-health-crisis [https://perma.cc/M4YA-QSTJ] ("To a remarkable degree, a single company is front and center in one of the biggest public-health crises facing the country: the sharp rise in vaping among teenagers and young adults."); Peter Whoriskey & Dalton Bennett, *Crypto's Free-Wheeling Firms Lured Millions. FTX Revealed the Dangers.*, WASH. POST (Nov. 16, 2022, 3:58 PM), https://www.washingtonpost.com/business/2022/11/16/ftx-collapse-crypto-exchanges-regulation ("In bankruptcy filings, FTX revealed that it could owe money to more than a million people and organizations.").

181. Relatedly, business lawyers and scholars could explore whether there are organizational models for incubating and financing "tough tech" that would produce social value. *See* Lerner & Nanda, *supra* note 2, at 256.

trying to find a path to a successful exit.[182] Therefore, it may be relatively easy to point to startup governance failures as a problem in the abstract, but difficult to find an ideal moment in the timeline to introduce mandatory obligations and to know which solutions, if any, are optimal. As the topic of startup governance garners more attention, it is important to bolster the empirical and theoretical foundations for understanding whether any legal reform is due.

In sum, while the U.S. venture capital ecosystem is a jewel of the economy and a key driver of innovation, it has also catalyzed concerns about social costs which are worthy of further examination. Further inquiry into two key areas—whether any stakeholders systematically experience negative impacts and potential improvements to the venture contracting and governance model—could help illuminate a path for the future of business law in this area.

CONCLUSION

Technology and innovation in the digital era have profoundly transformed business and society. This Article has investigated how law, particularly corporate and securities law, has facilitated and responded to the rise of venture capital that has been the key financial driver of this transformation.

The discussion has explored in particular how, after lawmakers shaped the enabling environment for venture capital to flourish, corporate and securities law has responded to the rise of venture-backed startups incrementally but with profound effect. Although business law has not always fit easily with the distinctive features of venture capital and startups, it has provided an enormous space in the private realm for venture capital and startups to maneuver with relative freedom. This private realm is a good fit for the needs of innovative companies, but their activity creates lingering issues of social costs and policy. Important and promising areas of future research lie ahead to develop a coherent business law response to the current wild era of adventure capital.

182. Pollman, *supra* note 1, at 209–16.