2023

Dual Fiduciaries: Unicorns, Corporate Law and the New Frontier

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C.M. Bruner and M.T. Moore (eds.), A Research Agenda for Corporate Law (forthcoming 2023, Edward Elgar)

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ABSTRACT

Legal and regulatory structures influence the shift in equities in the United States from public markets to private markets, entrepreneurial opportunities and new firm formation. There is a rise in the number of "unicorn" firms, which are privately held venture-capital backed startups that are valued at $1 billion or more. The number of unicorns in the United States and overseas has grown exponentially over the last few years. This chapter discusses the rise of the unicorns and with it the increasing importance of corporate governance and fiduciary duties. There are new vertical and horizontal conflicts among common and preferred shareholders that corporate law scholars, practitioners and judges will have to grapple with.

TABLE OF CONTENTS

I. WHAT IS A UNICORN FIRM?

Unicorns are taking the world by storm. A unicorn firm is a privately held venture-capital backed startup that is valued at $1 billion or more. The term was coined in 2013 by the venture capitalist Aileen Lee to describe a phenomenon where a startup firm is able to raise large amounts of capital without going public.[1]

The markets for allocating risk capital to startups are typically viewed as inefficient and the financing of startup firms present countless underlying challenges to prospective investors due to information gaps.[2] Such inefficiencies are the product of the uncertainty, high risk, and information asymmetry problems, which until recently precluded many investor groups from backing startup firms.[3] Startups fiercely competed over limited pools of funding, but unicorn firms are able to raise nearly limitless pool of funds, leaving the investors to compete for the chance to invest in these firms.[4]

In the past, private tech companies were only able to raise such large amounts of money after an IPO, when they transformed from a privately held corporation to one that is publicly traded on an exchange with dispersed ownership. The transformation allowed startups to raise large amounts of capital from public markets and attract human capital.[5] These days, however, entrepreneurs can access capital for their businesses while avoiding public markets, thanks to the entrance of new non-traditional investors.[6]

The shift in equities in the United States from public markets to private markets has significant implications for corporate law and governance. This chapter explains the

For comments and suggestions, thanks are due to Yifat Aran, Chris Bruner, Marc Moore, Casimiro Nigro, Charlie Korsmo, Juliet Kostrizky, Robert Rapp, and Eric Talley. A special thank you to my amazing research assistant John Livingstone. All errors are my own. This book chapter will be published by C.M. Bruner and M.T. Moore (eds.), A Research Agenda for Corporate Law (forthcoming 2023, Edward Elgar).

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[1] *See* Aileen Lee, *Welcome to the Unicorn Club: Learning from Billion-Dollar Startups*, TECHCRUNCH (Nov. 2, 2013), https://techcrunch.com/2013/11/02/welcome-to- the-unicorn-club/ [https://perma.cc/7WQP-NG6S].

[2] *See* Anat Alon-Beck, The Coalition Model, a Private-Public Strategic Innovation Policy Model for Encouraging Entrepreneurship and Economic Growth in the Era of New Economic Challenges, 17 WASH. U. GLOBAL STUD. L. REV. 267 (2018).

[3] *See* Anat Alon-Beck, *Unicorn Stock Options – Golden Goose or Trojan Horse?*, 2019 COLUM. BUS. L. REV. 107 (2019).

[4] *See* Anat Alon-Beck, *Alternative Venture Capital: The New Unicorn Investors*, 88 TENN. L. REV. 985 (2020).

[5] *See*, *e.g.*, Shai Bernstein, *Does Going Public Affect Innovation?*, 70 J. FIN. 1365, 1398 (2015).

[6] 4Q 2018 PITCHBOOK-NVCA VENTURE MONITOR [hereinafter 4Q 2018 PITCHBOOK].

evolution of private markets and unicorn firms to date. It explores how the various methods of capital formation in the private market are affecting corporate governance, where different groups of investors with vastly different incentives are vying for control. It closes with inquiries designed to address corporate governance failures and our understanding of founder fiduciary duties.

II. HOW DOES A PRIVATE FUNDRAISING ROUND WORK?

Deregulation of the US securities laws and changes in market conditions, provided incentives for the new market actors to invest in unicorn firms. When a startup decides to raise capital from the private market, they typically do so via a private placement (also known as a private offering or unregistered offering). Any offer or sale of securities is subject to registration under federal (and state) securities laws, unless there are exemptions from registration.[7] Registered offerings are subject to comprehensive disclosure requirements, [8] higher compliance costs and provide access to a broad group of potential investors.[9] A private placement however is exempt from registration with the SEC under one of the many Securities Act exemptions and is not subject to broad disclosure requirements.[10]

Private offerings are not subject to the same federal disclosure regime, financial reporting requirements, regulatory scrutiny or SEC oversight, as public ones.[11] The issuer provides a private placement memorandum (PPM) to prospective investors when offering equity (stock or another security) or debt in the startup.[12] The PPM describes the terms of

[7] There is a debate on whether it contributed to the reduction of information asymmetry and agency costs. *See* Darian M. Ibrahim, *Public or Private Venture Capital*, 94 WASH. L. REV. 1137, 1144 (2019) ("Mandatory disclosure reduces the costs of acquiring information by forcing corporations to release information to the markets at pre-set times."). *See also* Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 716, 738 (2006) ("Disclosure duties reduce...information gathering costs."); *id.* at 738 ("absent mandatory disclosure duties, information traders would engage in duplicative efforts to uncover nonpublic information").

[8] *See* Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1076 (1995) ("Early in the process of drafting the Securities Act [of 1933], the administration considered and rejected merit review in favor of a pure disclosure statute . . . .").

[9] *See also* EVA SU, CONG. RESEARCH SERV., R45221, CAPITAL MARKETS, SECURITIES OFFERINGS, AND RELATED POLICY ISSUES (2018), https://fas.org/sgp/crs/misc/R45221.pdf.

[10] Section 3 of the Securities Act identifies classes of securities that are exempt from the registration requirements. 15 U.S.C. § 77c. Section 4 of the Securities Act identifies a number of transactions that are exempt from the registration requirements. 15 U.S.C. § 7d.

[11] *See* Ibrahim, *supra* note 7.

[12] It is also referred to as an offering memorandum or offering document.

the proposed deal, including the following information: Notices to Investors,[13] Executive Summary, Company Purpose and Overview, Terms of the Offering and Securities, Risk Factors, Use of Proceeds, Financial Information, Management, Legal and Tax Matters and Exhibits.[14] According to Rule 10b-5 of the Exchange Act (1934), the issuer cannot provide false or misleading information or omit any material statements.

An investment in a startup firm is considered a high-risk investment.[15] It is very hard to value the intangible assets involved. In the event of default, intangible assets are worthless to investors. According to Jensen and Meckling's[16] traditional "agency theory,"[17] there is always uncertainty surrounding the entrepreneur's (agent's) possible mismanagement and opportunistic conduct.[18] The asymmetric information problem is caused by the fact that the entrepreneur has the daily involvement with the firm, and, therefore, knows more than the prospective partners, investors or suppliers, about her company's outlook.[19] Investors also have to deal with extreme "lock-in" of their capital

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[13] It is common practice for the PPM investor notices to include the following information: 1. No registration with SEC and reliance on exemptions from registration; 2. No public market for the securities; 3. High degree of risk; 4. Restrictions on transfer of the securities; 5. No representations outside the offering materials; 6. Descriptions and summaries of documents; 7. Investors are not getting legal, business, or tax advice; 8. Right of issuer to modify or withdraw the offering; and 9. Investor can ask questions and receive information.

[14] The PPM will allow the prospective investor to learn about the business and management team, prior performance, future prospects, the terms of the offered security, the planned use of the funds to be raised, and the risks of the investment. The exhibits usually include the following information: 1. Instructions for investing. 2. Subscription/Purchase agreement. 3. Governing documents (Certificate of Formation/Incorporation, Bylaws or Operating Agreement for an LLC), 4. Material contracts. 5. Investor questionnaire, and W-9.

[15] *See* Alon-Beck, *supra* note 3.

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

[17] *Id*.

[18] *See also* PAUL A. GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 127-31 (1999); Manuel A. Utset, *Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital-Financed Firms*, 2002 WIS. L. REV. 45, 55 (2002) ("Venture capitalists in most instances negotiate to get outright control of the board."). The agency relationship problem, the need to encourage the agent (entrepreneur) to behave in a manner that will maximize the investor's ("principal's"), interests is quite common. The problem exists in all cooperative efforts and in all organizations. *See* Jensen & Meckling, *supra* note 16, at 309.

[19] Laura Lindsey, *Blurring Firm Boundaries: The Role of Venture Capital in Strategic Alliances*, 63 J. FIN. 1137 (2008). *See also* GOMPERS & LERNER, *supra* note 18, at 128 (discussing the asymmetric information problem). The investors are not usually involved with daily management and decision making, and therefore, will not possess the same information as the entrepreneur. GOMPERS & LERNER, *supra* note 18, at 127-31 (discussing the information asymmetry and other risks that venture capitalists face while dealing with start-ups). *See also* Utset, *supra* note 18, at 56.

due to the illiquidity of private company stock.[20] Mostly institutional and high-net-worth investors can take advantage of private placements. PPMs are not open to the general public (non-accredited "retail investors") due to legal and regulatory restrictions.

III. NEW FRONTIERS FOR CORPORATE LAW

Once a company raises money, corporate law takes the forefront in how it interacts with its investors. But unlike securities laws which is predominantly national, corporate law is state law, changing depending on which state the company is incorporated in. Delaware, the leader in corporate law in the United States, is the preferred incorporation home for unicorns around the world.[21] The state has a well-earned reputation for being management and director friendly.

As new players begin to invest in these firms, they lead to new corporate governance impacts down the road. New nontraditional tech investors, including mutual funds, hedge funds, sovereign wealth funds and corporate venture capitalists (together " Alternative Venture Capitalists" or "AVCs") are entering the funding pool and have different objectives than the traditional venture capital funds.[22] They look for the next billion-dollar start-up and encourage its management team and board of directors to stay private longer.[23]

These new types of investors do not simply represent a new source of capital. They are transforming the capital structure of the firms they are investing in via new contractual rights and classes of equity. This has very practical implications for the fiduciary duties that unicorns and their boards of directors owe to all shareholders, including minority common shareholders - employees. The most important change comes with the usage of

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[20] The private startup company legal form is set to "lock-in parties while developing vulnerable match-specific assets." *See* Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 J. CORP. L. 913, 919 (1999).[[ANAT – need to revised this lead-in]] This article builds on the work of Rock and Wachter and postulates that capital lock-in is important for startup companies, including large unicorns, because the cost of investing in innovation-driven products or services is very high and risky. In order to allow startup firms to continue to raise capital (or debt), investors cannot easily threaten to exit and to withdraw their investment from the firm. It is thus important to turn to the changes in the market, the rise in investors with aggressive redemption rights, and the ways this rise changes the traditional governance structure of VC-backed unicorn firms.

[21] *See* Anat Alon-Beck, *Where do Unicorns Incorporate?* (on file with author, work in progress).

[22] *See* Anat Alon-Beck, *Alternative Venture Capital: The New Unicorn Investors*, 88 TENN. L. REV. 985 (2020).

[23] *See* 4Q 2018 PITCHBOOK, *supra* note 6; *see* Sergey Chernenko, Josh Lerner & Yao Zeng, *Mutual Funds as Venture Capitalists? Evidence from Unicorns* 19 https://www.hbs.edu/faculty/Publication%20Files/18-037_02aee6d2-1209-449e-84df-c3730b4d74b.pdf. 34(5) Rev. Fin. Studies 2362 (2021).

common and preferred equity classes over simply issuing these AVC investors with preferred stock.

The typical U.S. VC-backed startup has two classes of stock: common and preferred (which can include multiple series). The startup company usually issues preferred stock to VCs,[24] with each round of new financing.[25] In contrast, founders, employees, angels, or other early investors are issued common stock.[26] Preferred stock is a type of stock that grants its holders priority over common stock in the event of sale or liquidation and in the payment of dividends.[27] If the firm is sold or dissolves, then the preferred stockholders, typically VCs, will receive an amount equal to their liquidation preference before the common shareholders (the founders, employees, or angel investors) receive anything.

This is changing in several ways. Unicorns are privately held firms that deal with "horizontal" and "vertical" governance issues.[28] Vertical or horizontal disputes between shareholders arise when some shareholders "seek to enhance their influence and control relative to other shareholders."[29] Therefore, exploring the developments of new contractual

[24] VCs traditionally invest in startups using convertible preferred stock. *See* Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281 (2003); *see also* William A. Sahlman, *The Structure and Governance of Venture Capital Organizations*, 27 J. FIN. ECON. 473 (1990).

[25] *See* Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 981-82 (2006) ("Like most preferred stock, VCs' preferred shares carry a liquidation preference and are convertible into common. Thus, to the extent that VCs retain their preferred stock, their cash flow rights are debt-like; to the extent that they convert, their preferred stock offers the same cash flow rights as common stock.").

[26] *See* Fried & Ganor, *supra* note 24, at 981.

[27] For more on the exit strategy of VCs, see D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315 (2005). For helpful background on the distinction between cash-flow and control rights, see Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 784-85 (2017). *See also* Fried & Ganor, *supra* note 24, at 981; William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815, 1875 (2013) ("[VCs] holding preferred sometimes take voting control and can dominate the boards of directors even when holding a minority of the votes."); Smith, *supra* at 316 ("Before venture capitalists invest, they plan for exit."); Utset, *supra* note 18, at 61 ("Venture capitalists in most instances negotiate to get outright control of the board.").

[28] *See* Elizabeth Pollman, *Startup Governance*, 168 U. PA. L. REV. 155 (2019).

[29] *See* Robert P. Bartlett & Eric Talley, *Law and Corporate Governance*, *in* 1 THE HANDBOOK OF THE ECONOMICS OF CORPORATE GOVERNANCE 177, 185-86 (Benjamin E. Hermalin & Michael S. Weisbach eds., 2017) ("privately held firms tend historically to grapple with "horizontal" governance dilemmas, involving disputes among competing shareholders (or classes of shareholders) who seek to enhance their influence and control relative to other shareholders. To the extent this trend continues, the study of governance in privately held firms is likely to become more critical to important policy debates.").

rights, fiduciary duties and power struggles in unicorn firms is extremely important because courts will be required to decide on disputes between various startup shareholders. This is also one of the reasons for recent litigation over fire sales.[30] A "fire sale" is a sale of company's securities at a price that is well below market value, generally because the company issuing them is in deep water financially.

Control matters under Delaware Law, since the court applies heightened standards of judicial review. There are two main concepts of control: a "controlled board" and a "controlling stockholder". Delaware courts are already grappling with determining which strategic or powerful contractual rights (such as consent or blocking powers) deem an investor (or debtor) in a startup to be a "controlling stockholder," who also owes a fiduciary duty to the company.

When a shareholder exercises her controlling power, she becomes or embodies the corporation and thus assumes a duty to further the interest of all shareholders.[31] Non-shareholding debtors may also assume these fiduciary duties if they usurp the control of a Delaware corporation's board of directors.[32] However, these duties remain only so long as they are being actively used to "dictate the destiny of the corporation" or maintain their control.[33]

What about a "controlled board"? Historically, board of directors of tech companies were controlled by venture capital investors. It was very common, for example, that fire sales resulted in payouts only to the preferred shareholders (due to liquidation preferences), i.e., the venture capital investors. Whereas the other common shareholders, such as employees, usually didn't get anything from the sale. Things began to change in 2013 when the Delaware Chancery Court issued an opinion *In re Trados Inc*.[34]

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[30] *Trados* involved claims against the board of a startup that was sold in a merger transaction. The court applied the fairness review standard. *In re Trados Inc. S'holder. Litig*., 73 A.3d 17 (Del. Ch. 2013). For an example of a subsequent court attempting to interpret *Trados*'s holding on the mechanics of fairness review, see *In re Nine Systems Corp. S'holder. Litig.,* 2014 WL 4383127 (Del. Ch. 2014). *See also* Bratton & Wachter, *supra* note 26. *See* Abraham J.B. Cable, *Opportunity-Cost Conflicts in Corporate Law***,** 66 CASE W. RES. L. REV. 51, 75-76 (2015). *See also* Adam Katz, *Addressing the Harm to Common Stockholders in* Trados *and* Nine Systems, 118 COLUM. L. REV. ONLINE 234 (2018).

[31] David Kershaw, *Delaware's Fiduciary Imagination*: *Going-Privates and Lord Eldon's Reprise*, 98 WASH. U. L. REV. 1669, 1705 (2021).

[32] *Id*., citing *Harriman v. E.I. DuPont De Nemours & Co.*, 372 F. Supp. 101 (D.Del. 1974).

[33] *Id*., citing *Harriman* at 105-106.

[34] *See In re* Trados Inc. S'holder Litig., 73 A.3d 17, 78 (2013). Several legal scholars analyzed the *Trados* decision. *See* Abraham Cable*, Does* Trados *Matter?*, 45 J. CORP. L. 311 (2020); *see* Robert P. Bartlett III, *Shareholder Wealth Maximization as Means to an End*, 38 SEATTLE U. L. REV. 255, 290–95 (2015) (criticizing the court's reasoning for failing to recognize the board as a venue for bargaining over the company's future); Bratton & Wachter, *supra* note 26, at 1874–900 (discussing *Trados* in articulating an over-arching "theory of preferred stock"); Charles R. Korsmo, *Venture Capital and Preferred Stock*, 78 BROOK.

The Delaware court adopted a rule of "common maximization," which means that the board of directors have to take the common stockholder interests into account and seek value for the common in the event of a sale.[35] The *Trados* court recognized that the board of directors was conflicted when making the decision to sell and held that the board owes "its primary duty to common shareholders when the interests of preferred shareholders and common shareholders come into conflict."[36]

The picture is perhaps more complicated today with the rise of unicorn firms. There are many different types of investors with different incentives, contractual rights and characteristics, including pooled investment vehicles, who owe fiduciary duties to their own investors. The court will need to determine whether the new investor groups or the founders are now to be treated as a controlling stockholder and who really controls the board.

The decision to deem an investor or founder as a controlling stockholder imposes fiduciary duties on them with regards to minority common stockholders. If a stockholder isn't controlling, contract law governs. If, however, the court decides that a stockholder is a controlling stockholder, then fiduciary doctrine takes over. Under the current fiduciary duty doctrine, a controlling stockholder is required to maximize firm value and is subordinate to the rights of common. However, Delaware courts have shifted their perspective on the source of this control, with a series of recent decisions in which control stems from external factors, rather than ownership status.[37] The court's decision on these matters is important for the future of strategic investments in startup firms.

IV. ONE SIZE DOES NOT FIT ALL

Until about 10 years ago, Silicon Valley startups used certain VC- favored investment structures in order to attract these investors. Until now, typically a start-up that was trying to raise capital from VCs, used the following arrangements: initial Delaware C-

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L. REV. 1163, 1165, 1185–89 (2013) (discussing *Trados* as a basis for "reassess[ing] the law's treatment of preferred stock in the venture capital context"); Elizabeth Pollman, *Startup Governance*, 168 U. PA. L. REV. 155 (2019); Simone M. Sepe, *Intruders in the Boardroom: The Case of Constituency Directors*, 91 WASH. U. L. REV. 309, 320 & n.12 (2013) (discussing *Trados* in an economic analysis of constituency directors); Leo E. Strine, Jr., *Poor, Pitiful, or Potently Powerful Preferred*, 161 U. PA. L. REV. 2025, 2039 (2013) (discussing *Trados* in a response to Bratton and Wachter).

[35] For more on this rule, see Cable *,supra* note 31.

[36] *See* Cable*, supra* note 31.

[37] *Controller Confusion: Realigning Controlling Stockholders and Controlled Boards,* 133 Hav. L. Rev. 1706, 1713 (2020).

Corp corporation form,[38] 10,000,000 authorized shares of Common Stock,[39] one share class – Common, four-year founder vesting with a cliff and "double-trigger" acceleration (which refers to acceleration based on the occurrence of two distinct events.)[40]

Depending on the source of the funding, the investors may have considerably different incentives and objectives. The traditional VC usually do not allow single-trigger acceleration because they want to make sure that in the event of an acquisition in the future, the founder and key employees will remain with the firm. However, with the entrance of AVCs, these new investors are not placing similar restrictions on founders. In 2020-2021, startups saw the highest median VC investments since 2008. Startup founders (specifically, unicorn founders) are setting very different terms and adopting new founder-favored structures.

A skillful venture VC fund will help the start-up develop the company.[41] Not only do VCs provides a startup (budding or unicorn) with cash,[42] but the VC managers also provide services (such as mentoring to budding startups) and networks of additional investors, potential acquirers, new partners and customers (to both).[43] VCs also generally

[38] Brian J. Broughman, Jesse M. Fried & Darian M. Ibrahim, *Delaware Law as Lingua Franca: Theory and Evidence*, 57 J. L. & ECON. 865 (2014).

[39] Manoj Viswanathan, *The Qualified Small Business Stock Exclusion: How Startup Shareholders Get $10 Million (Or More) Tax-Free*, 120 COLUMBIA L. REV. F. 29 (2020).

[40] For more on "double acceleration" see Craig Jacoby, *Pulling the Trigger(s): What Are Single-Trigger and Double-Trigger Acceleration and How Do They Work?,* COOLEY GO, https://www.cooleygo.com/what-are-single-and-double-trigger-acceleration-and-how-do-they-work/ (last visited Jan. 14, 2022) ("Double-trigger acceleration, as the name implies, requires two events to trigger acceleration – most typically the sale of the company and the involuntary termination of the employee, usually within 9-18 months after closing, and in some cases including a short pre-closing window (3 months or shorter) to counter any preemptive termination by the company to avoid a payout… a double trigger is designed to protect a startup employee from being terminated by an acquirer in connection with integration or as an economic decision where the value of the unvested equity into which the employee can vest is materially greater than the cost to the acquirer of finding a replacement for the employee.")

[41] *See* DAN SENOR & SAUL SINGER, START-UP NATION: THE STORY OF ISRAEL'S ECONOMIC MIRACLE 161 (2009); *see also* Lindsey, *supra* note 19; Ola Bengtsson & David H. Hsu, *How Do Venture Capital Partners Match with Startup Founders?* (2010), https://ssrn.com/abstract=1568131 (According to Bengtsson & Hsu, "personal similarity matters in the VC matching market."). *See also* Lars Ola Bengtsson, *Repeated Relationships Between Venture Capitalists and Entrepreneurs* 3-5 (2006) (unpublished MBA thesis, University of Chicago) (on file with University of Chicago, Graduate School of Business) (Bengtsson examined data on 1500 serial entrepreneurs. He found that a failed entrepreneur is twice as likely to repeat VC relationships (as evaluated against a successful entrepreneur.).

[42] SENOR & SINGER, *supra* note 37, at 161.

[43] *See id.* at 161; *see also* Lindsey, *supra* note 19 (discussing & adding to the literature that explores the value added by venture capitalists by way of support, advice and enhanced governance. According to Lindsey, "[P]reviously documented mechanisms include venture capitalists helping firms to recruit key managers (Gorman and Sahlman, 1989, Hellmann and Puri, 2002), monitoring and advising through service

understand the technical information necessary for the investment, and moreover, have developed contractual mechanisms to monitor the innovator and help guide her decision-making process.[44]

Founders, however, often worry about their ability to maintain control over the firm, following new rounds of financing. The traditional pattern is that the founders get diluted and have to give up voting control to secure more funding. If the VC has control over the board of directors, then it can also fire the founders. Fried and Broughman show that the Mark Zuckerberg's example (of a founder maintaining control after an IPO) is an exception to the rule. To illustrate, Fried and Broughman prove that the ex-ante likelihood of founders reacquiring control via IPO is extremely low.[45] The rise and power of unicorn firms changes this equilibrium and enables unicorn founders to maintain control over their company.[46]

V. OLD DUAL FIDUCIARIES

Traditionally, VC used to be the controlling shareholders and controlled the board of directors. VCs typically required preferred stock, extensive control rights and obtained

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on the company's Board of Directors (Lerner, 1995, Baker and Gompers, 2003), and implementing other strong governance mechanisms (Hochberg, 2004). Facilitating strategic alliances is an additional channel through which venture capitalists add value."); *see also* Yael V. Hochberg, Alexander Ljungqvist & Yang Lu, *Networking as a Barrier to Entry and the Competitive Supply of Venture Capital*, 65(3) J. FIN. 829 (2010) ("Incumbents appear to benefit from reduced entry by paying lower prices for their deals.").

[44] *See* Jensen & Meckling, *supra* note 16 (establishing that agency problems due to conflicts between investors and managers can have an effect on the interest of both equity and debt holders to supply capital and invest ["[i]t is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal's viewpoint. In most agency relationships the principal and the agent will incur positive monitoring and bonding costs (non-pecuniary as well as pecuniary), and in addition there will be some divergence between the agent's decisions and those decisions, which would maximize the welfare of the principal."]); *see also* Utset, *supra* note 18, at 56; *see also* GOMPERS & LERNER *supra* note 18, at 127-31(discussing the information asymmetry issue and other risks that venture capitalists face while dealing with start-ups).

[45] Jesse M. Fried & Brian J. Broughman, *Do Founders Control Start-Up Firms that Go Public?*, 10 HARV. BUS. REV. 50, 51 (2020). They focus on control that is both strong (founders have enough voting power to ensure they remain in the saddle) and durable (control lasts at least three years).

[46] Recent research further shows that technology companies that do decide to go public are likely to have dual class of share structures, because their founders want to avoid the pressures (of short-termism) and are pushing to retain more influence over "their" firms and the management and strategy. Many venerable VCs view the unicorn phenomenon with scorn, operating under the assumption that billion-dollar valuations are a distraction—and potentially a detriment—to the traditional startup funding model." *See* 4Q 2018 PITCHBOOK, *supra* note 6, at 3.

control of the start-up's board of directors.[47] Until the recent rise of the unicorn firms and the mega-deals, VCs were more often than not, able to acquire substantial power over the other stockholders in the startup.[48] The control over the board enabled VCs to monitor the entrepreneur-funder, and perhaps replace her if she was not performing. This has changed due to multiple reasons, including the entrance of new market players, and new regulations.

In order to gain from their investment and provide liquidity to the investors in their fund, VCs will look for a quick exit. If the firm conducted an IPO[49] (or was sold for a very high price), then the VC would convert their preferred stock to common at a pre-defined ratio because the amount they will receive for the common exceeds the liquidation preference.[50]However, the most common form of a VC exit was a sale.[51] According to Fried and Ganor, VCs have a bias towards immediate liquidity events, even if "the expected value of remaining an independent private company is higher."[52] This may also stem from

[47] Fried & Ganor, *supra* note 24, at 970 n.9 ("preferred stock offers investors more senior rights than does common stock. Most importantly, preferred stockholders have a "liquidation preference": a claim to the proceeds from the sale of the business that ranks ahead of claims by common shareholders. Preferred stock is said to be "convertible" if the holder has the right to convert to a designated number of common shares. Most preferred stock issued to VCs is convertible.").

[48] Evan Epstein, *The Case for Better Governance at Venture-Backed Companies*, https://evan-epstein.medium.com/the-case-for-better-governance-at-venture-backed-companies-1a0c016436be (citing the *Basho* case in which a VC used "hardball" tactics to force the company to accept "oppressive" financing terms).

[49] Many have written on VCs' exit at IPO. *See* Christopher B. Barry, Chris J. Muscarella, John W. Peavy III & Michael R. Vetsuypens, *The Role of Venture Capital in the Creation of Public Companies: Evidence from the Going Public Process*, 27 J. FIN. ECON. 447 (1990); William L. Megginson & Kathleen A. Weiss, *Venture Capital Certification in Initial Public Offerings*, 46 J. FIN. ECON. 879 (1991); Peggy M. Lee & Sunil Wahal, *Grandstanding, Certification, and the Underpricing of Venture Capital Backed IPOs*, 73 J. FIN. ECON. 375 (2004); Paul A. Gompers, *Grandstanding in the Venture Capital Industry*, 42 J. FIN. ECON. 133 (1996).

[50] Thomas Hellmann, *IPOs, Acquisitions and The Use of Convertible Securities in Venture Capital*, 81 J. FIN. ECON. 649 (2006); Broughman and Fried contributed to the literature on VC exit via private sale and found that renegotiation is more likely when governance arrangements, including the firm's choice of corporate law, give common shareholders power to impede the sale. Brian J. Broughman & Jesse M. Fried, *Renegotiation of Cash Flow Rights in the Sale of VC-Backed Firms*, 95 J. FIN. ECON. 384, 387 (2010).

[51] *See* Broughman & Fried, *supra* note 45, at 385, noting that the most common VC exit is private sale. They suggest that "when exiting through a sale, VCs generally have sufficient control to realize their full cash flow rights. However, VCs sometimes need to "bribe" common shareholders to obtain their support for the proposed sale, and the likelihood of such renegotiation is higher when VCs have less control."

[52] *See* Fried & Ganor, *supra* note 24, at 995 ("Liquidity events promise a certain payout, much of which the preferred shareholders can capture through their liquidation preferences. Continuing to operate the firm as an independent company may expose the preferred-owning VCs to risk without sufficient opportunity for gain.").

the "more accurate pricing mechanisms operating in the M&A market relative to those in the IPO market", as well as the ability to mitigate the high costs associated with an IPO.[53]

Traditionally, the preferred stock was also used as a signaling tool to VCs that the entrepreneur believes in the worth of the startup.[54] Therefore, in the past, the VCs made sure that the entrepreneur will not profit from the startup until there was a liquidity event and the proceeds from an IPO or sale are greater than the VC's liquidation preference.[55] There were three exit possibilities. First, the board of directors (usually controlled by VCs) could choose to go public (IPO) as an exit mechanism.[56] Following the IPO, the founders were replaced with professional managers, and the board with an independent board of directors. The capital providers (and employees) were able to cash their investments in the firm.

Second, if instead, the board decided on a sale, and the startup got acquired by another firm, then the capital providers were able to cash out according to their preference. The common shareholders, such as employees, often did not receive much of the profit from the sale, depending on the sale price. Indeed, the employees' unexercised options may have been cancelled without being paid anything. Finally, in the event of a liquidation, the VCs were able to cash out according to their liquidation preference, but, the common shareholders, such as employees, probably were be able to receive much of the liquidation proceeds. Due to the entrance of new market actors and changes to market structures, this dynamic is also changing.

VI. NEW DUAL FIDUCIARIES

What happens when non-traditional players enter the realm of the VCs? Due to differing incentives, AVCs are willing to accept non-traditional structures for their investments. Rather than focusing on efforts to guide and control the startup, AVCs are more focused on liquidation rights and the ability to cash out ahead of everyone else. For

[53] Casimiro A. Nigro & Jörg R. Stahl, *Venture Capital-Backed Firms, Unavoidable Value-Destroying Trade Sales, and Fair Value Protections*, 22 EUROPEAN BUS. ORG. L. REV. 39 (2021).

[54] *See* Fried & Ganor, *supra* note 24.

[55] *See* Fried & Ganor, *supra* note 24, at 983 ("If the firm does poorly, the founder will therefore get less than her pro rata share of the firm's value, and nothing at all if the firm's value is less than the liquidation preference. If the firm does well, and the VCs convert into common, the founder receives her pro rata share of the firm's value. Thus, founders may have a greater incentive to increase startup value than they would under an all-common capital structure.").

[56] For a discussion on the motives to go public, see Richard A. Booth, *The Limited Liability Company and the Search for a Bright Line Between Corporations and Partnerships*, 32 WAKE FOREST L. REV. 79, 89-92 (1977). *See also* James C. Brau & Stanley E. Fawcett, *Initial Public Offerings: An Analysis of Theory and Practice*, 61 J. FIN. 399, 400-36 (2006) (survey on decisions to do an IPO).

them, control is a secondary concern. As a result, the control shifts back to founders, typically using one of the following methods below.

This affects the already fragile status quo with employees as common shareholders. Founders are supposed to represent the interests of the common shareholders on the board. They are often directors and sometimes also controlling shareholders, who are supposed to maximize the value of the corporation for the benefit of the common shareholders. But, thanks to their new bargaining power that allows them to negotiate for founder-friendly terms, they might face conflicts of interest. The following describes the new contractual terms and the ways in which they turn founders into dual fiduciaries. The interests of founders, who hold common and now new types of shares, may diverge from the interests of their employee or other investors, who hold common shares. Who is going to represent the interests of common stockholders? The following developments raise issues on the duty of loyalty and may lead the Delaware court to apply enhanced judicial review.

A. Super-voting Common Stock

Super-voting stock allows the unicorn founders to maintain control over the company for a longer period of time as founder approval will be needed for any future amendments of the charter. Amendments are often required for most rounds of financings, approving liquidation events, and sales.

This structure is designed to give founders control over the company in their capacity as shareholders, even if their ownership stake is diluted in the future through additional rounds of financing. Unicorn founders wishing to use this structure will typically prepare the company's formation documents to provide for two types of common stock (Classes A and B.) Class B will carry multiple votes per share and will be granted to the founders. Class A will carry only one vote per share and will be reserved for issuance under the unicorn's stock option plan, to rank-and-file employees.[57]

B. Super-Voting Common Stock at the Board Level

Super-voting stock at the board level is another use of common stock, which confers a multiple of votes for board seats (such as a multiple of two to five per vote) to its

[57] According to Cytowski & Partners, Facebook, Palantir, Snapchat, Uber, and AirBnB each issued two classes of common stock. The preferred class in each case carries ten votes per share, while Class A carries only one. Cytowksi & Partners, *The Anatomy of a Unicorn*, MEDIUM (Aug. 15, 2018), https://medium.com/@cytlaw/the-anatomy-of-a-unicorn-3298df383e03 [https://perma.cc/35V7-3ZZX].

holder.[58] This type of common stock gives founders the power to elect directors to the board and have control over the board's major decisions. This structure can also have adverse effects on the board's ability to follow its fiduciary duties and take other common stockholder interests into account.

C. FF Preferred Stock

FF preferred stock is a new type of common stock that does not have the traditional lock-in.[59] It is issued to founders, like common stock, but has a special conversion right that allows its holder to cash out prior to a traditional liquidity event such as an IPO or sale. The company will issue a portion of the founder's equity (usually ten to thirty-three percent)[60] in the form of FF preferred stock, and the rest in regular common stock. The FF preferred stock allows the founder to get liquidity with future VC investment. A VC or AVC can buy the FF preferred stock from the founder, and the FF preferred stock is then converted to the investor's preferred stock. It should be noted that this practice can impact the company's option plan (affect the price at which the options are issued,) and have adverse tax consequences for the founder and the company.

D. Limits on VC's Voting Control Blocks

Typically, VCs would negotiate for and get voting-control provisions, which give them voting blocks on liquidation and raising additional capital. By giving common stock-holders the same voting-control provisions, unicorns give founders the freedom to dictate when and whether the company sells or raises capital. VCs will always negotiate for and receive some protections in their investment documents. If founders are able to negotiate for the same protections, then they will be able to limit the VC's control over the decision to liquidate the company.[61]

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[58] *See* Caine Moss & Emma Mann-Meginniss, *5 Founder-Friendly Financing Terms that Give Power to Entrepreneurs*, VENTUREBEAT (Nov. 16, 2014), https://venturebeat.com/2014/11/16/5-founder-friendly-financing-terms-that-give-power-to-entrepreneurs/.

[59] *See id.*

[60] *See* Cytowksi & Partners, *supra* note 54; Moss & Mann-Meginniss, *supra* note 55; *See also* Rolfe Winkler & Maureen Farrell, *In 'Founder Friendly' Era, Star Tech Entrepreneurs Grab Power, Huge Pay*, WALL ST. J. (May 28, 2018),https://www.wsj.com/articles/in-founder-friendly-era-star-tech-entrepreneurs-grab-power-huge-pay-1527539114; Jonathan Axelrad, *Founder Friendly Stock Alternatives I: Keeping Control and Super-Voting Common Stock*, DLA PIPER (last visited Jan. 14, 2022), https://www.dlapiperaccelerate.com/knowledge/2017/founder-friendly-stock-alternatives-keeping-control-and-super-voting-common-stock-.html.

[61] For example, Snapchat does not give its series C, D, E, or F preferred shareholders any voting rights or anti-dilution protection, "essentially allowing them to just invest and tag along for the ride." Cytowski & Partners, *supra* note 54.

E. Aggressive Founder Vesting

Founders are now also able to negotiate and receive aggressive founder vesting provisions.[62] As noted above, the traditional vesting schedule is four-year with a one-year cliff vesting. Founders can negotiate for an accelerated vesting time frame of three years or less, sometimes without the cliff vesting. The new terms for acceleration become effective in the event of a change of control provisions or involuntary terminations of the founders without cause. These structures can, like super-voting stock at the board level, have adverse effects on the board's fiduciary duties and can also subject the investors to a hold up and abuse by the founders.

All of these new developments are also affecting employees of unicorn firms. In *Unicorn Stock Options*,[63] I demonstrate that traditional employee equity contracts were not designed to prevent the heretofore unforeseen contingency that startups remained private for eleven years rather than four. Nevertheless, this delayed timeline before an IPO affects employee equity contracts and triggers conflicts between employees and employers. According to incomplete contracting theory, this conflict, which results from new market dynamics and changes to unicorn startup governance arrangements, leads to renegotiation of employee equity compensation agreements.

VII. CONCLUSION

The world of capital formation is changing. There are new sources of funding and various multi class structures, both of which, when implemented, may change the parties' fiduciary duties.[64] These changes contribute to incentive misalignment between the various

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[62] Moss & Mann-Meginniss, *supra* note 55.

[63] Anat Alon-Beck, *Unicorn Stock Options – Golden Goose or Trojan Horse?*, 2019 COLUM. BUS. L. REV. 107 (2019).

[64] Les Brorsen, *Looking Behind the Declining Number of Public Companies*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 18, 2017), https://corpgov.law.harvard.edu/2017/05/18/looking-behind-the-declining-number-of-public-companies/; *see* Josh Lerner et al., *Mutual Funds as Venture Capitalists? Evidence from Unicorns* (Euro. Corp. Governance Inst., Working Paper No. 675, 2020), https://ssrn.com/abstract=2897254; MCKINSEY & CO., MCKINSEY GLOBAL PRIVATE MARKET REVIEW 2018, THE RISE AND RISE OF PRIVATE MARKETS, https://www.mckinsey.com/~/media/McKinsey/Industries/Private%20Equity%20and%20Principal%20Investors/Our%20Insights/The%20rise%20and%20rise%20of%20private%20equity/The-rise-and-rise-of-private-markets-McKinsey-Global-Private-Markets-Review-2018.ashx (Feb. 2018); Matt Levine, *Unicorns Take Different Paths to Being Public*, BLOOMBERG (Mar. 27, 2018, 10:13 AM), https://www.bloomberg.com/opinion/articles/2018-03-27/unicorns-take-different-paths-to-being-public [https://perma.cc/2V8M-KRFZ]; *see also* Andrew Nussbaum et al., *Private Equity—Year in Review and 2020*

groups of investors, founders and management. As a result, VC investment rounds are now structured as "founder-friendly" financing rounds.

The contractual mechanism that VC investors traditionally used to avoid opportunism by founders are disappearing. AVC investors invest in late stages and bargain for different contractual provisions that focus on exit, such as redemptions and anti-dilutive IPO ratchets, rather than monitoring rights. The changes give unicorn founders greater power, allowing them to negotiate for "founder friendly" terms, control the board of directors and keep the company private longer.

Investors, board of directors, founders and management teams need to carefully consider their fiduciary duties and the ramifications for the structure that they choose. These new structures can be subject to stockholder litigation and scrutiny. These changes, not only affect the actions of unicorn founders and their management teams but can have serious effects on economic activity.

Monitoring founders and management is extremely important, not only to ensure effective corporate governance outcomes, but also to maximize the incentives and opportunities to invest in innovation in the future. Unicorns are not going away anytime soon. Therefore, we must learn to adapt our corporate law to ensure proper outcomes, protect minority shareholders, and address misaligned incentives.

Outlook, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 8, 2020), https://corpgov.law.harvard.edu/2020/02/08/private-equity-year-in-review-and-2020-outlook/.