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Bargaining Inequality: Employee Golden Handcuffs and Asymmetric Information

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BARGAINING INEQUALITY:
EMPLOYEE GOLDEN HANDCUFFS AND ASYMMETRIC INFORMATION

ABSTRACT

Inaccurate unicorn firm valuation is a well-documented problem in the finance literature. Employees of these large, privately held companies do not have access to fair market valuation or financial statements and, in many cases, are denied access to such reports, even when requested. Unicorn employees are granted equity as a substantial part of their compensation, however due to the inferior position of employees in comparison to the start-up founders and other investors, information shedding light on the value of their equity grants has been withheld, as apparent in recent practices.

Start-up founders, investors, and their lawyers have systematically abused equity award information asymmetry to their benefit. This Article sheds light on the latest practice that compels employees, who are not yet stockholders, to waive their stockholder inspection rights under Delaware General Corporation Law ("DGCL") Section 220 as a condition to receiving stock options from the company. Perhaps the clearest indication of this new practice is the recent amendment to the National Venture Capital Association legal forms, which is intended to standardize a contractual "waiver of statutory inspection rights." This waiver is designed to contract around stockholder inspection rights.

This Article puts forward competing arguments and policy considerations for and against such a waiver. It fills the gap in the case law and evaluates whether a contract between the company and its employees, which operates independently and outside the charter or bylaws, can modify or eliminate the mandatory inspection rights expressly set forth in the DGCL. The resolution on this issue will have tremendous influence on corporate law, litigation, and practice.

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I. INTRODUCTION

> *Investors, founders and the law firms they work with systematically & ruthlessly exploit start-up equity information asymmetry to their gain and employees' pain.*
>
> - Chris Zaharias[1]

> *Have you ever wondered about the value of the options and shares that startups issue to employees? If you ask the startup CEO, she tells you they are winning lottery tickets. If you ask your grandmother, she tells you they are worthless.*
>
> - Will Gornall & Ilya Strebulaev[2]

Information is power.[3] Investment in private markets is risky and plagued with information asymmetry. Information asymmetry arises in situations where one party in a transaction has more information regarding the subject of the transaction than the other.[4] Private companies operate in the dark. Information asymmetry

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[1] Nicholas Carlson, *Startup Employees Are Getting Screwed by VCs and CEOs, Says 22-Year Industry Insider*, BUSINESSINSIDER.COM (Mar. 6, 2014), https://www.businessinsider.com/this-22-year-veteran-of-startups-says-employees-are-getting-screwed-by-vcs-and-ceos-2014-3.

[2] Will Gornall & Ilya Strebulaev, VALUATION.VC, http://valuation.vc (last visited Mar. 5, 2021).

[3] Sir Francis Bacon published in his work, Meditationes Sacrae (1597), the saying: "*knowledge itself is power*." FRANCIS BACON, MEDITATIONES SACRAE (1597).

[4] *See* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84(3) Q. J. ECON. 488, 493 (1970)

creates entrepreneurial opportunities for such firms because they are not required to disclose information to the public on their financials, fair market value or strategy. Information asymmetry can also generate a market failure if not managed properly by the firm.[5]

This Article questions the basic allocation of power between boards and stakeholders, which include rank-and-file employees, under U.S. corporate law.[6] Employees of a venture-backed startup can become shareholders in the firms that they work for because they are offered equity as part of their compensation. The high-tech industry predominantly relies on the practice of awarding options to rank-and-file employees.[7] These options commonly require a large out-of-pocket investment on the part of employees to convert to stock.[8] After the employees exercise their options, they become a minority common shareholder.[9]

A shareholder can enjoy several rights associated with ownership, including returns, control over how the business operates (voting and inspection), risk of loss (distribution), duration (terminate or transfer) and the right to sue. These rights are not absolute. Boards, managers and employees will typically bargain over these rights in private agreements. The parties' ability to bargain is subject to several constraints, including state laws, government regulation, information asymmetry, conflict of interest and the incomplete nature of contracts.[10]

This Article sheds light on a new practice designed to limit employees' rights as investors and keep them in the dark.[11] Stock option agreements now contain a new contractual waiver of stockholder inspection rights that prevents employees from accessing

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(Akerlof discusses the "adverse selection" problem, as well as firms' offerings of equity that may be associated with the "lemons" problem).

[5] Pierre Barbaroux, *From Market Failures to Market Opportunities: Managing Innovation Under Asymmetric Information*, 3 J. INNOVATION & ENTREPRENEURSHIP 5 (2014), https://doi.org/10.1186/2192-5372-3-5.

[6] *See infra* Section II.

[7] *See* J. BLASI, D. KRUSE & A. BERNSTEIN, IN THE COMPANY OF OWNERS: THE TRUTH ABOUT STOCK OPTIONS AND WHY EVERY EMPLOYEE SHOULD HAVE THEM 86 (2003). *See* Anat Alon-Beck, *Unicorn Stock Options—Golden Goose or Trojan Horse*, 2019 COLUM. BUS. L. REV. 107 (2019).

[8] *See infra* Section III.

[9] *See infra* Section III discussing the ways in which employees can become stockholders.

[10] *See* William A. Klein, John C. Coffee, Jr. & Frank Partnoy, BUSINESS ORGANIZATIONS AND FINANCE, LEGAL AND ECONOMIC PRINCIPLES 3 (2010).

[11] *See infra* Section V.

information about the value of their stock. This is the latest development in an ongoing trend to deprive tech employees from information about their investment in the firm that they work for. It all started when the social-networking company - Facebook, now Meta, was in violation of our securities laws when it passed the 500 shareholders of record threshold at the end of 2011.[12] Facebook successfully lobbied Capitol Hill and Congress to increase the number of shareholders of record and exclude employees. Prior to the JOBS Act, employees were protected as investors by our securities laws. Start-ups were required to count employees as shareholders and provide them with disclosures on material information. A trend that started with our securities laws is now creeping into our state corporate laws.

Lobbyists convinced regulators that company employees are insiders who don't need protections of mandatory disclosure. This Article rejects this view. Employees in large firms need protection. Employees of a small startup may be privy to information about their firm. Rank-and-file employees of large private firms are not well-positioned to monitor their company's progress.[13] Their economic incentives are not aligned with those of the founders or managers. They are not protected by the bargaining ability of other sophisticated investors, such as VC investors. Sophisticated investors are usually represented and can bargain for the ability to access information.

Inaccurate unicorn firm valuation is extremely severe and well-documented in the finance literature. Unicorn employees cannot value their equity grants, because they do not have access to fair market valuation or financial statements and, in many cases, are denied access to such reports, even if they ask for them. Start-up founders, investors, and their lawyers systematically abuse equity award information asymmetry to their benefit. This Article sheds light on the latest practice that compels employees, who are not yet stockholders, to waive their stockholder inspection rights under Delaware General Corporation Law ("DGCL") Section 220 as a condition to receiving

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[12] *See* Alon-Beck, *supra* note 6; *see also* Paul Sloan, *Three Reasons Facebook Has to Go Public*, CNET.COM (Jan. 31, 2012), https://www.cnet.com/tech/services-and-software/three-reasons-facebook-has-to-go-public/; *see also Capital Formation, Job Creation and Congress: Private Versus Public Markets: Hearing on Government-Business Forum on Small Business Capital Formation Before the Sec. & Exchange Comm'n* (2011) (Testimony of John C. Coffee, Jr., Adolf A. Berle Professor of Law Columbia University Law School and Director of its Center on Corporate Governance, https://www.sec.gov/info/smallbus/sbforum111711-materials-coffee.pdf.

[13] *See infra* Section III.

stock options from the company.[14] The recent amendment to National Venture Capital Association legal forms is intended to standardize the contractual "waiver of statutory inspection rights."[15] The waiver is designed to contract around stockholder inspection rights.

Delaware law is clear that stockholders' inspection right is not without limits. It is less clear to what extent it may be contractually limited and, more importantly, whether employees, as future minority stockholders, can contract away their information rights entirely.[16] DGCL Section 220 was designed to protect stockholders that require information to value their stock holdings, especially in the context of a private corporation, with no access to a liquid market. I argue that *ex ante* efforts to limit employee stockholder inspection rights via private ordering do not fit with the goals of corporate law.

There is a rise in the number of inspection requests under Section 220.[17] Employees can request to value their stock. If companies want to avoid this type of demand, they need to provide information to their employees, as they used to not too long ago.[18] Under common law, shareholders were given access to information to protect their property interest in their investment in the firm. Most states in the United States, including Delaware, have codified common law inspection rights, with variations from state to state.

Inspection rights are one of the few "immutable" mandatory rules of corporate law.[19] In Delaware, stockholder inspection rights

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[14] *See* Roy Shapira, *Corporate Law, Retooled: How Books and Records Revamped Judicial Oversight*, 42 CARDOZO L. REV. 1949 (2021). *See* George S. Geis, *Information Litigation in Corporate Law*, 71 ALA. L. REV. 407, 410, 414 (2019) ("[i]nvoking the right magic words—such as 'I want to value my stock'—should not automatically open the doors to sensitive prospective corporate data").

[15] *See infra* Section III.

[16] *See infra* Section IV.

[17] Edward B. Micheletti & Bonnie W. David, *Recent Trends in Books and Records Litigation*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP (Jan. 21, 2020), https://www.skadden.com/insights/publications/2020/01/recent-trends-in-books-and-records-litigation.

[18] I will not review efforts to limit rights *ex post* in nondislosure agreements.

[19] *See* Jill Fisch, *Stealth Governance: Shareholder Agreements and Private Ordering*, 99 WASH. U. L. REV. (forthcoming 2022); Gabriel Rauterberg & Eric Talley, *Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, 117 COLUM. L. REV. 1075 (2017); Lucian Arye Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U.L. REV. 489, 496 n.16 (2002) (providing "the duty of loyalty of corporate directors" as an example of mandatory corporate governance regulation); Jill E. Fisch, *Picking a*

cannot be eliminated or limited by a provision in a corporation's certificate of incorporation or bylaws.[20] However, there is ambiguity in the case law in regard to the ability to eliminate this right via contract. Unicorn employees are now regularly coerced to waive this inspection right by entering into a contract with the corporation, in the form of a stock option agreement. Their employers, who are unicorn fiduciaries, receive the benefit of operating without oversight from minority common stockholders – their employees.

The Delaware Court of Chancery has yet to answer the question of whether an employee, can waive her rights to inspect books and records under Section 220 by signing an option agreement that contains such a waiver. This practice is new and, in many cases, the employees are putting forth the argument that they signed the waiver without any knowledge. There are even fraud allegations whereby employees had no idea that they were signing on new language that is not "normal" or "customary" for the stock option-type deals that tech companies in Silicon Valley have used for decades. Many employees further complain that they were intentionally misled into signing or not provided copies of the agreements prior to signing.

This Article tracks this new development and presents the following questions: Can statutory stockholder inspection rights be waived? Should Delaware Courts enforce these contractual limits on stockholder rights? Should Delaware Courts extend this protection to certain stakeholders? This issue surrounding stock option awards is

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Winner, 20 J. CORP. L. 451, 458 (1995); Bernard S. Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 551-53 (1990) (citing self-dealing rules as one example of mandatory law); Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1486 (1989) (arguing that self-dealing rules are "largely mandatory, at least for publicly held corporations"); Randall S. Thomas, *What Is Corporate Law's Place in Promoting Societal Welfare?: An Essay in Honor of Professor William Klein*, 2 BERKELEY BUS. L.J. 135, 139 (2005) (stating self-dealing rules are mandatory for public corporations); Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, 89 NW. U. L. REV. 565, 607 n.164 (1995) (claiming that the rules on self-dealing by managers are mandatory). DEL. CODE ANN. tit. 8, § 122(17).

[20] Cochran v. Penn-Beaver Oil Co., 34 Del. 81, 88 (1926) (holding that a charter provision that "permits the directors to deny any examination of the company's records by a stockholder is unauthorized and ineffective"); Rainbow Navigation, Inc. v. Pan Ocean Navigation, Inc., 535 A.2d 1357, 1359 (Del. 1987) (the shareholders' right of inspection "can only be taken away by statutory enactment"); BBC Acquisition Corp. v. Durr-Fillauer Med., Inc., 623 A.2d 85, 90 (1992) (a shareholder's inspection rights "cannot be abridged or abrogated by an act of the corporation"). *See* Geeyoung Min, *Shareholder Voice in Corporate Charter Amendments*, 43 J. CORP. L. 289, 294 (2018).

garnering intense debate and attention in Silicon Valley, especially because of the rise in disputes between venture capital-backed unicorns and their employees.[21]

To illustrate this predicament, this Article will introduce the *Domo* and *JUUL* cases. This new waiver practice became popular following the *Domo* case and its extensive media coverage. Relying on a hand-collected data set consisting of the SEC's public filings, which included tech companies that had filed an Initial Public Offering ("IPO") prior to and following *Domo*, I found that many firms began requiring that their employees sign a waiver clause titled "Waiver of Statutory Information Rights "[22] following *Domo*. I also discovered that the National Venture Capital Association (the "NVCA") recently updated its set of model legal documents to incorporate this waiver clause.[23] Accordingly, many law firms have since updated their clients' stock option restriction agreement templates to include this waiver provision.[24]

It is not clear whether a stockholder waiver of statutory rights would be enforceable by a court, such as Delaware. This Article puts forward the competing arguments and policy considerations for and against enforcing a stockholder inspection rights waiver.[25] It fills the gap in the case law and evaluates whether a contract between the company and its employees, which operates independently and outside the charter or bylaws, can modify or eliminate the mandatory inspection rights expressly set forth in the DGCL. The Delaware Chancery court will have to answer this question soon. The resolution on this issue will have tremendous influence on corporate law, litigation, and practice.

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[21] David Priebe, *Document Inspection Rights for Shareholders of Private Companies*, DLA PIPER, https://www.dlapiperaccelerate.com/knowledge/2017/document-inspection-rights-for-shareholders-of-private-companies.html (last visited Mar. 5, 2021).

[22] The employees waive their inspection rights of the following materials: company stock ledger, a list of its stockholders, other books and records.

[23] *See infra* Section III.

[24] *See infra* Section II.

[25] See analogy to Ingle v. Glamor, 535 N.E.2d 1311 (1989). It allows employee agreements to trump fiduciary duties vis-a-vis employee-shareholders (NY). *See* Stephen Bainbridge, CORPORATE LAW (CONCEPTS AND INSIGHTS TREATISE SERIES) (4th ed. 2020); *see also* Alyse J. Ferraro, Ingle v. Glamore Motor Sales, Inc.*: The Battle Between Ownership and Employment in the Close Corporation*, 8 HOFSTRA LAB. & EMP. L.J. 193 (1990).

This Article proceeds as follows. Section II examines the asymmetry of information between the two major groups of investors in unicorns, the practical effects of it, and the attempts by employees to address it. Section III explains the design of a stock option agreement—its original design and new changes. It considers how the problem of inaccurate unicorn firm valuation affects unicorn employee bargaining power.

Section IV introduces the role of stockholder inspection rights in corporate law. It sheds light on a new practice requiring unicorn employees to sign a waiver clause titled "Waiver of Statutory Information Rights." Section V presents some empirical findings, which reveal that approximately 87% of the unicorn firms in the United States choose to incorporate in Delaware. Section VI calls for the Delaware courts and legislature to provide protection for minority stockholders from oppression and mismanagement by the majority. It also explores amending the DGCL to expand statutory inspection rights under Section 220 to include stock option holders. Section VII concludes by suggesting reforms that could improve governance in unicorn firms.

II. THE ASYMETRIC WORLD

> *Equity compensation makes up more than a quarter (27%) of employees' net worth, on average – and more for Millennials than any other group (41%, versus 21% for Gen X and 20% for Boomers)*[.]
>
> - Schwab Study[26]

Any investor that allocates financial or human capital in private markets deals with information asymmetry. The recent changes to our rules were enacted on the theory that company employees are likely to have intimate knowledge of the business and therefore don't need the

[26] *Schwab Study: Equity Plan Participants Average Nearly $100,000 in Vested Stock; Less Than Half Have Ever Sold or Exercised Their Shares*, BUSINESSWIRE (Nov. 13, 2019), https://www.businesswire.com/news/home/20191113005151/en/Schwab-Study-Equity-Plan-Participants-Average-Nearly-100000-in-Vested-Stock-Less-Than-Half-Have-Ever-Sold-or-Exercised-Their-Shares [hereinafter *Schwab Study*].

protections of mandatory disclosure. But that's not likely to be true of the enormous private companies that exist today.

A. All Shareholders are Not Made Equal

This Article focuses on the information asymmetry between the various groups of investors in unicorn firms: top management (including founders), outside capital and inside capital that is human capital (rank-and-file employees). Employees fulfill unique roles within tech firms as assets and investors at the same time.

This was achieved through contractual innovation. The employee stock option agreement is an example of an extremely popular and prevalent practice among growth companies.[27] Most high-tech start-ups, including Google, Intel, and Microsoft, used this type of contract to provide equity compensation to their employees, which in return helped build their companies.[28] The stock option agreement allows employees to cross over from stakeholder status to shareholder. Tech employees are not only working for the firm but also invest a large part of their equity in it, as stockholders and stock-option-holders.[29]

In the United States, tech founders have a long history of splitting the pie with two types of investors: employees and outside investors.[30] The main differences between these two types of investors are diversification and negotiating power. Outside investors are usually diversified. They provide capital to the firm in return for equity, but also put their eggs in other baskets by investing in other firms. Employees on the other hand, put all of their eggs in one basket – the firm's basket. They are not only employed by the firm but are invested in it. Investors get diversification of risk while employees do not. To sum up, investors put money into the business and get shares of stock to earn a profit. Employees also invest in the company and exchange their creativity and hard work for the sweat equity needed to create the game-changing innovations necessary for American competitiveness in the global marketplace. [31]

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[27] *See infra* Section III.

[28] Joseph Blasi, Douglas Kruse & Richard Freeman, *Having a Stake: Evidence and Implications for Broad-Based Employee Stock Ownership and Profit Sharing*, THIRD WAY (Feb. 1, 2017).

[29] There are other types of equity compensation, but this Article will focus on stock options.

[30] *See* BLASI, KRUSE & A BERNSTEIN, *supra* note 6. .

[31] *See* Saul Levmore, *Puzzling Stock Options and Compensation Norms*, 149 U. PA. L. REV. 1901, 1901 (2001). *See also* Thomas A. Smith, *The*

There are times where employees as investors in the firm may need to make an investment decision, but may not be able to make an informed one.[32] Exercising options is an investment decision, because it requires employees to pay the option exercise price and, in most cases, to pay high income tax on paper profits that may never materialize.[33] This Article is about privately-held firms, which means that investors, including employees, can't simply sell their shares on an exchange and generally have restrictions on transfer or sale. There are new secondary markets, but they are not always available, reliable or efficient.[34]

Unicorn employees maybe rich on paper but need money to exercise their options. They may have to borrow money from outside sources to keep their shares. They don't have the ability to finance their investments by using their options as collateral. If they cannot get financing or decide not to take the risk, they will have to forfeit the right to that equity that may become quite valuable down the road if the company goes public. Many employees simply cannot afford to take this risk. According to a 2019 Charles Schwab survey, more than half of startup employees never exercise or sell the pre-IPO stock options they have earned.[35]

There are several scenarios where employees will be confronted with this investment decision. They may consider the prospect of leaving their jobs, but their options will expire, or their stock will be subject to a mandatory resale.[36] If they received options and worked for the firm for over 10 years, according to our tax laws, employees may need to decide to exercise their options or dispose of their shares. Some may consider selling their stock (or options) into secondary markets,

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Zynga Clawback: Shoring Up the Central Pillar of Innovation, 53 SANTA CLARA L. REV. 577, 580 (2013) (discussing at-will contracts and equity compensation).

[32] *See infra* Section III.

[33] On tax treatment, see Alon-Beck, *supra* note 6.

[34] On secondary markets, see Alon-Beck, *supra* note 6.

[35] *Schwab Study*, *supra* note 21.

[36] See Alon-Beck, *supra* note 6, discussing the example of employees at Good Technology. Good's share value plunged after the company was acquired, but the employee-investors still had paid cumbersome tax bills for profits that never really materialized. Katie Benner, *When a Unicorn Start-Up Stumbles, Its Employees Get Hurt*, N.Y. TIMES (Dec. 23, 2015), https://www.nytimes.com/2015/12/27/technology/when-a-unicorn-start-up-stumbles-its-employees-get-hurt.html.

provided that they are able to do so.[37] Others may find that their options are prohibitively expensive or risky to exercise due to high pre-IPO unicorn valuations, liquidity constraints, or other tax concerns.[38]

Regardless of the decisions they have to make, in nearly every case, employees have little to no negotiating power to obtain information about their investment.[39] Without access to information, they cannot accurately value their holdings and may not understand that the value of their options is likely to diminish if certain types of nontraditional investor groups join the firm in later rounds due to special preferred terms and conditions.[40]

B. The Practical Effects of Asymmetry

There is information asymmetry between the various types of investors in unicorn firms: founders, top management, outside capital and employees, which can lead to market failure if not directed properly.[41] The bargaining power between founders (mangers) and employee-investors is persistently unequal in the unicorn firm context.

The structural inequality in the bargaining power between the unicorn firm, as represented by the founders and managers, and its workers, is referred to in this Article as "bargaining inequality." This

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[37] See Alon-Beck, *supra* note 6, discussing the rise in secondary private markets. See also MICHAEL J. MAUBOUSSIN & DAN CALLAHAN, MORGAN STANLEY, PUBLIC TO PRIVATE EQUITY IN THE UNITED STATES: A LONG-TERM LOOK, 47 (2020); *see also* Matt Levine, *Money Stuff: Boards Have to Pay Attention*, BLOOMBERG (Sept. 13, 2021), https://www.bloomberg.com/news/newsletters/2021-09-13/money-stuff-boards-have-to-pay-attention.

[38] *See infra* Section II.

[39] Allison Herren Lee, Comm'r, U.S. Sec. & Exchange Comm'n, Remarks at The SEC Speaks in 2021 (Oct. 12, 2021), https://www.sec.gov/news/speech/lee-sec-speaks-2021-10-12.

[40] For more on non-traditional investor groups, see Anat Alon-Beck, *Alternative Venture Capital: The New Unicorn Investors*, 87 TENN. L. REV. 983 (2020).

[41] On information asymmetry as a major source of market failures see Akerlof, *supra* note 4; on how individuals anticipate others' intentions see Michael Spence, *Informational Aspects of Market Structure: An Introduction*, 90(4) Q.J. ECON. 591 (1976); on how individuals are incapable of evaluating the quality of services and market failure see Joseph E. Stiglitz, *The Contributions of the Economics of Information to Twentieth Century Economics*, 115(4) Q. J. ECON. 1441 (2000); *see also* Michael Spence, *Signaling in Retrospect and the Informational Structure of Markets*, 92(3) AM. ECON. REV. 434 (2002). , 0

bargaining inequality problem disrupts the process of allocating resources efficiently and the quality of services available on the market.[42] The conflict between the firm, top management, and employees results from new market dynamics and changes to traditional unicorn start-up governance arrangements.[43]

Unicorn founders changed the traditional model of startup funding model and the governance structures of VC-backed firms. Founders push to stay private longer and maintain control over the firm. They are able to do so where VC investment rounds are structured as founder "friendly" financing rounds.[44] In the past, senior managers and employees both received common stock. Historically, VC-backed startups issued two classes of stock: common and preferred.

Unicorn founders have more leverage in their negotiations with VC investors on economic, liquidity and voting rights. Until recently, it was unimaginable that a venture capital (VC)-backed start-up firm could reach an aggressive valuation of more than $1 billion without going public.[45] But today, 925 companies are considered "unicorn" firms[46] simply because they are privately owned and valued at $1 billion or more.[47] The unicorn list keeps growing, and unicorns are no

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[42] Barbaroux, *supra* note 5.

[43] *See* Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473, 474 (1992) (sale of the firm can eliminate managers' positions and their private benefits); 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).

[44] "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." PITCHBOOK, UNICORN REPORT, 2017 ANNUAL (2017) https://pitchbook.com/news/reports/2017-annual-unicorn-report (on file with the *Columbia Business Law Review*).

[45] *See* David Cogman & Alan Lau, *The 'Tech Bubble' Puzzle*, MCKINSEY Q., no. 3, at 103, 104 (2016).

[46] A "unicorn" firm has the following features for the purposes of this article: young but large, privately owned but "quasi-public," invests in research and development (R&D) with intangible assets, venture capital (VC)-backed with concentrated ownership and controlling shareholders and valued at over $1 billion. The term "unicorn" was coined in 2013 by Aileen Lee. *See* Jennifer S. Fan, *Regulating Unicorns: Disclosure and the New Private Economy*, 57 B.C. L. REV. 583, 586 (2016); Abraham J.B. Cable, *Fool's Gold? Equity Compensation & the Mature Startup*, 11 VA. L. & BUS. REV. 613, 615 (2017).

[47] *See The Global Unicorn Club*, CB INSIGHTS (June 24, 2021), https://www.cbinsights.com/research-unicorn-companies.

longer rare.[48] The pandemic has not at all dampened investor interest in these firms.[49] At the same time, unicorn firms continue to attract skepticism about their valuations.[50]

Founder-friendly terms are found in the formation and financing documents.[51] The new structures are designed to give founders control over the company (in their capacity as shareholders),

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[48] *See* Scott Austin, Chris Canip & Sarah Slobin, *The Billion Dollar Startup Club*, WALL ST. J. (last updated December 2018), https://www.wsj.com/graphics/billion-dollar-club/ (on file with the *Columbia Business Law Review*) (showing list and valuation of firms as of December 2018); *The Global Unicorn Club*, CB INSIGHTS, https://www.cbinsights.com/research-unicorn-companies [https://perma.cc/4S6H-TZKB]; *The Unicorn List*, FORTUNE (last updated January 19, 2016), http://fortune.com/unicorns/ [https://perma.cc/F7HC-MX64]; *Unicorns*, CNN TECH (last updated June 29, 2018), https://money.cnn.com/interactive/technology/billion-dollar-startups/ [https://perma.cc/MR2M-7598]. *See also* Ben Zimmer, *How 'Unicorns' Became Silicon Valley Companies*, WALL ST. J. (Mar. 20, 2015), http://www.wsj.com/articles/how-unicorns-became-silicon-valley-companies-1426861606 [https://perma.cc/S3PF-JDL5]. Companies that are valued at over $10 billion are called "decacorns.". *See* Sarah Frier & Eric Newcomer, *The Fuzzy, Insane Math That's Creating So Many Billion-Dollar Tech Companies*, BLOOMBERG: TECH (Mar. 17, 2015, 9:00 AM), https://www.bloomberg.com/news/articles/2015-03-17/the-fuzzy-insane-math-that-s-creating-so-many-billion-dollar-tech-companies (on file with the *Columbia Business Law Review*) (coining the term decacorns); *see also* Jillian D'onfro, *There Are So Many $10 Billion Startups that There's a New Name for Them: 'Decacorns'*, BUS. INSIDER (Mar. 19, 2015, 9:42 AM), http://www.businessinsider.com/decacorn-is-the-new-unicorn-2015-3 [https://perma.cc/8VFS-GDGT].

[49] Eric J. Savitz, *Unicorns Are Proliferating as the Economy Improves*, BARRON'S (June 3, 2021), https://www.barrons.com/articles/unicorns-cb-insights-total-billion-private-51622746686.

[50] *See* Ilya Strabulaev, '*Unicorn' Price Tags Aren't All They're Cracked Up To Be*, TECH CRUNCH (Apr. 10, 2018), https://techcrunch.com/2018/04/10/unicorn-price-tags-arent-all-theyre-cracked-up-to-be/.

[51] For more on these new terms, *see* Anat Alon-Beck, *Dual Fiduciaries* (forthcoming 2022). *See also* Caine Moss & Emma Mann-Meginniss, *5 Founder-Friendly Financing Terms that Give Power to Entrepreneurs*, VENTURE BEAT (Nov. 16, 2014), https://venturebeat.com/2014/11/16/5-founder-friendly-financing-terms-that-give-power-to-entrepreneurs/; *see also* Jonathan Axelrad, *Founder Friendly Stock Alternatives I: Keeping Control And Super-Voting Common Stock*, DLA PIPER, https://www.dlapiperaccelerate.com/knowledge/2017/founder-friendly-stock-alternatives-keeping-control-and-super-voting-common-stock-.html (last visited Aug. 23, 2018); *see* Cytowski & Partners, *The Anatomy of a Unicorn*, MEDIUM (Aug. 15, 2018) (compares certificates of incorporation of five leading unicorns: Facebook prior to its IPO, Palantir, Snapchat, Uber, and AirBnB), https://medium.com/@cytlaw/the-anatomy-of-a-unicorn-3298df383e03.

even if their ownership stake is diluted in the future, with additional rounds of financing. The new structures can have adverse effects on the board of director's fiduciary duty and can also subject the employees as investors to a hold up and abuse by the founders, but this discussion is outside the scope of this paper.[52]

C. Employees Attempt to Seek Recourse in Shareholder Power

There are several economic theories purporting to explain what a firm is. In general, these theories have considered the relationship between employer-employee to be significant to the definition and purpose of the firm.[53] Despite this recognition, unfortunately, corporate governance scholarship neglected to pay attention to the role of employees as "human capital". It mainly focused on the relationship between directors, managers, and outside shareholders.[54] The time is ripe for corporate law to take employees, as stakeholders and shareholders, into account, when defining the legal boundaries of the firm.

The recent developments with regards to keeping tech employees in the dark are not surprising since our traditional corporate law holds the view that the legal relationships between labor, capital, and the firm are very different. While both labor (human capital) and capital (financial) contribute to and invest in the firm, only shareholders that belong to the financial capital group (or their agents) get to decide how the firm is to be governed.

But this is changing. There is a paradigm shift on the role of human capital, culture and purpose in corporate governance. This shift is driven by various influential stakeholders, including activist investors, tech employees, the Global Reporting Initiative, the Embankment Project for Inclusive CAPITALISM, the Business

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[52] *See* Anat Alon-Beck, Unicorns, Corporate Law and the New Frontiers (forthcoming 2022).

[53] Matthew T. Bodie, *Employees and the Boundaries of the Corporation*, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW (Claire A. Hill & Brett H. McDonnell eds., 2012); *see* Ronald Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937); *see also* Kent Greenfield, *The Place of Workers in Corporate Law*, 39 B.C. L. REV. 283 (1998).

[54] *See* Anat Alon-Beck, *Times They Are a-Changin': When Tech Employees Revolt!*, 80 MD. L. REV. 120 (2021).

Roundtable, the Sustainability Accounting Standards Board ("SASB"), and the U.S. Securities and Exchange Commission ("SEC").[55]

Delaware courts also changed their approach in the startup firm context. They 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.[56] In 2013, the Delaware Chancery Court issued an opinion *In re Trados Inc*.[57] The case involved a "fire sale", which 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. Historically, board of directors of tech companies were controlled by venture capital investors. It was very common that fire sales resulted in payouts only to the preferred shareholders (due to liquidation preferences), i.e., the venture capital funds. The directors who are common shareholders and hold senior management positions get bonuses. But, the other common shareholders, such as employees, usually don't get anything from the sale. 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."[58]

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[55] For more on the paradigm shift, see Alon-Beck, *supra* note 50; *see also* Stephen Klemash, Jennifer Lee & Jamie Smith, *Human Capital: Key Findings from a Survey of Public Company Directors*, Harv. L. Sch. F. On Corp. Governance (May 24, 2020), https://corpgov.law.harvard.edu/2020/05/24/human-capital-key-findings-from-a-survey-of-public- company-directors/.

[56] For more on this rule, see Abraham Cable, *Does* Trados *Matter?*, 45 J. CORP. L. 311 (2020).

[57] *See In re* Trados Inc. S'holder Litig., 73 A.3d 17, 78 (2013). Several legal scholars analyzed the *Trados* decision. *See* Cable, *supra* note 52; *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); William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815, 1874–900 (2013) (discussing *Trados* in articulating an over-arching "theory of preferred stock"); Charles R. Korsmo, *Venture Capital and Preferred Stock*, 78 BROOK. 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).

[58] *See* Abraham Cable, *Does* Trados *Matter?*, 45 J. CORP. L. 311 (2020).

The *Trados* decision is very important because the court specifically recognized the fact that the *Trados* board failed to consider the effects of the transaction in question on common stockholders. Not only did the board fail to do so, but it made an informed decision that purposefully ignored the conflict of interest between the different parties involved.[59] Unfortunately, despite the fact that *Trados* appeared on numerous blogs and caught the attention of many lawyers, according to research by Abraham Cable, *Trados* has not had a substaintial effect on venture capital financing terms.[60]

In light of the other developments described above and the power struggles between the different stakeholders in large startup firms, this is not surprising that the corporate practice has not changed significantly. However, it is my view that *Trados* is important in perhaps signeling how the Delaware court may treat cases that involve common shareholders in the furure. One of the largest groups of common shareholders in a startup are the employees.

Tech employees are different than employees in other industries. Tech employees are not merely stakeholders but are usually also equity holders (shareholders) in their firm, as I explain in my paper, *Unicorn Stock Options*. Moreover, and more importantly, as noted by Gorga and Halberstam,[61] and later, by Yifat Aran,[62] tech firms use equity compensation to avoid the high costs associated with employee turnover. Such arrangement not only helps prevent employee turnover, but also make it possible for employees to participate in the growth of the business and sharing in the risk.

As discussed in further detail below, only stockholders, not stock-option-holders can make a demand on the company (board of directors) to inspect books and records to find out what is the value of their stock.[63] Employees who wanted access to information became

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[59] *See id*; *See in re Trados*, 73 A.3d at 62.

[60] According to Cable, *Trados* "lawyers now advise boards to more systematically consider continuation value and, in some cases, push consideration to common shareholders in excess of their baseline entitlements." *See id*.

[61] *See* Érica Gorga & Michael Halberstam, *Knowledge Inputs, Legal Institutions and Firm Structure: Towards a Knowledge-Based Theory of the Firm*, 101 NW. U. L. REV. 1123, 1185, 1192 (2007).

[62] Yifat Aran, Note, *Beyond Covenants Not to Compete: Equilibrium in High-Tech Startup Labor Markets*, 70 STAN. L. REV. 1235 (2018); Yifat Aran, *Making Disclosure Work for Start-Up Employees*, 2019(3) COLUM. BUS. L. REV. 867 (2019).

[63] *See infra* Section IV.

shareholders of record and in their capacity as shareholders started making demands on the companies that they work for. To deal with the rise in demands and the desire to not disclose material information about the firm, some start-ups adopted new contractual mechanisms to get around this. They require employees to waive their stockholder inspection rights under DGCL Section 220 as a condition to receiving stock options from the company.[64] This is despite the fact that inspection rights are especially important in the context of a private corporation, where stockholders do not have access to a liquid market.[65]

This latest contractual innovation, however, which compels employee-stockholders to waive their inspection rights as a condition to receiving stock options from their company, is very significant.[66] Many tech firms, including unicorns, are taking advantage of this new disclosure arbitrage that was created by changes to our securities laws, by adopting a new practice that contracts around stockholder inspection rights and compels employees to waive their rights as stockholders under Delaware General Corporation Law ("DGCL") Section 220.[67]

This is accomplished through private ordering, whereby the firm requires the employees to waive the right *ex ante*, by entering into a separate contract with the employee. Enter the stock option agreement.[68] The employee signs the stock option agreement, which contains a waiver clause titled "Waiver of Statutory Information Rights."[69] By signing this waiver, the employee relinquishes her stockholder rights to inspect the firm's books and records under Section

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[64] There is analogy to be drawn between this issue and section 115 of DGCL. In *Bonanno v. VTB Holdings Inc.*, the Chancery Court drew an important distinction between forum selection clauses contained in a corporation's articles or bylaws, and those contained in external contracts such as a shareholders' agreement. 2016 WL 614412 (Del. Ch. Feb. 8, 2016). Obviously, the two issues are not identical, but based on *Bonanno* – does Delaware have "an overarching public policy" that prevents stockholders of Delaware corporations from waiving their stockholder inspection rights? For comparison, see *Havlicek v. Coast-to-Coast Analytical Servs, Inc*., 46 Cal. Rptr. 2d 696, 699 (Cal. App. 2d Dist. 1995) ("California has a public policy favoring broad inspection rights for the directors.").

[65] *See infra* Section IV.

[66] *See* Shapira, *supra* note 11. *See* Geis, *supra* note 11, at 414.

[67] *See, e.g.,* DEL. CODE ANN. tit. 8, § 220 (2006); compare to MODEL BUS. CORP. ACT §§ 16.02-16.03 (requires corporations to provide shareholders with annual financial statements).

[68] *See infra* Section V.G on private ordering.

[69] The employees waive their inspection rights of the following materials: company stock ledger, a list of its stockholders, other books and records, and the books and records of subsidiaries of the company. The waiver is in effect until the first sale of common stock of the company to the public.

220 of the DGCL thus losing their last avenue of access for information.[70]

Stockholder inspection rights are one of the most powerful fundamental rights in corporate law because they allow stockholders to inspect nonpublic company information. Inspection rights address the problem of information asymmetry, which is inherent in all companies, especially privately held start-up firms.[71] These rights were designed to allow a stockholder to gain access to nonpublic information so the stockholder can protect her economic interests, make informed decisions, and hold the company fiduciaries accountable by subjecting them to oversight, particularly in scenarios like *Trados*.[72]

Section 220 of the DGCL not only provides an important protection to a stockholder by allowing her to seek inspection of the books and records of a Delaware corporation to investigate potential wrongdoings but also is used as an important tool in litigation for pre-filing investigations. In recent years, we've seen a sharp increase in the general use of Section 220 by the plaintiff's bar.[73] This rise is partly attributed to Delaware courts' decisions such as *Corwin*,[74] which raised the pleading standard for stockholder plaintiffs in stockholder derivative or post-merger damages suits.

Inspection rights under Section 220 can be an important tool for hundreds or thousands of tech workers around the country who received equity awards from unicorns (or other tech firms) in return for their sweat labor and are now questioning the worth of their shares.[75] Unicorn firms raise money at a billion dollar valuation but are not required to be audited by an independent auditor before issuing equity compensation to unaccredited or unsophisticated purchasers, namely, their employees. [76] The problem of inaccurate unicorn firm valuation is

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[70] *See* Shapira, *supra* note 11; Geis, *supra* note 11.

[71] *See infra* Section V.

[72] *See infra* Section IV on stockholder inspection rights.

[73] *See* William Gornall & Ilya Strebulaev, *Squaring Venture Capital Valuations with Reality* 2 (Nat'l Bureau of Econ. Research, Working Paper No. 23895, 2017). *See also* Robert P. Bartlett, III, *A Founder's Guide to Unicorn Creation: How Liquidation Preferences in M&A Transactions Affect Start-up Valuation*, *in* RESEARCH HANDBOOK ON MERGERS & ACQUISITIONS 123 (Claire A. Hill & Steven D. Solomon eds., 2016).

[74] Corwin v. KKR Fin. Holdings, LLC, 125 A.3d 304 (Del. 2015).

[75] *See infra* Section IV.D on unicorn valuation.

[76] *See infra* Section IV.

quite severe and greatly limit the ability of employees to understand the true value of their equity compensation.[77]

With the rise in the number of unicorn firms in the United States, there is a need for greater certainty in the exercise of this inspection right. The employees do not have access to financial reports and, in many cases, are denied access to such reports even if they ask for them. Some start-up founders, investors, and their lawyers recently systematically abused equity award information asymmetry to their personal benefit. They were able to do so thanks to a change in our securities laws, one that limits the type of information employees receive as stockholders. Unicorn employees are left with no choice but to turn to the courts for help to gain access to such information.[78] As a result, the country may witness a wave of litigation concerning books and records demands by unicorn employees.[79]

D. The Black Box of Unicorn Valuation

Unicorns are private start-up firms, which means they generally focus on fast scale and large growth and are unprofitable in their early years. The problem of inflated post-money valuations of unicorn firms is well-documented in the finance literature.[80] Unsophisticated investors or the press might simply apply the latest series' share price to all these investors to determine the valuation of the firm, but this practice is simply not accurate.

According to Gornall and Strabulaev, unicorns often report values that are on average about 51% to more than 200% above their fair market value. To help tech employees figure out the black box of their unicorn employer's valuation, Gornall and Strabulaev also created a new online tool, allowing unicorn employees to properly value their

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[77] *See infra* Section III.

[78] *See infra* Section IV.A. The JOBS Act and subsequent legislation leave employees vulnerable (as investors in their companies) and subject them to the discretion of majority shareholders.

[79] Corporate law is governed by state law, and changes from state to state in the United States. Generally, Delaware courts are typically more management friendly, whereas New York and California courts protect shareholders.

[80] Post-money valuation means a company's estimated worth after outside financing is added to its balance sheet. It is the market value given to a start-up firm after a round of financing. *See* Gornall & Strabualev, *supra* note 66. Their research indicates that over 90 percent of mutual funds used inflated post-money valuations.

stock. It should be noted, however, that Gornall and Strabulaev's tool only covers firms they were able to gather information on from various sources. This is a great initiative, but again, it does not fully solve the problem of lack of information on these companies.

Start-ups, including unicorns, typically sell shares to private investors to raise money. They often raise capital in multiple rounds. Each financing round is unique. Unicorns are different from traditional start-ups because they are able to stay private longer by raising large amounts of money from nontraditional investors (i.e., alternative venture capital).[81] Therefore, unicorns have a complex capital structure. They sell shares to venture capitalists, institutional investors, hedge funds, mutual funds, corporate venture capitalists, sovereign wealth funds, Softbank, and other investors. Each of these investors usually negotiates different terms at each round of financing. Unicorns can have up to eight classes of stock, or perhaps even more.

Investors typically look at the latest round of financing to try to determine the exact market value (valuation) of the unicorn. They usually take the latest stock purchase price and apply that number to all the outstanding shares. For example, let's consider the unicorn, Square. At the last round of financing, Square was able to raise $15.46 a share for its Series E shares. After the financing round, Square was valued at $6 billion using the following formula:

> *"$15.46 Series E shares x ALL outstanding shares and unissued options = $6 billion"*[82]

Several problems exist with valuing a company this way, as Gornall and Strabulaev correctly illustrate. This sort of valuation does not factor in the different contractual terms, such as liquidation preferences the various investors negotiated for, which were associated with the Series E stock. Additionally, the investors can negotiate for different economic rights, such as full ratchet or weighted average protections. Full ratchet and weighted average are examples of anti-dilution protections that sophisticated investors negotiate for in the event of liquidation or failure. These protect early investors by compensating them in the event of a future dilution in their ownership. Common and preferred stock do not typically receive the same protections, which means that common stockholders are likely to get far less for their shares.

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[81] *See* Alon-Beck, *supra* note 35.

[82] *See* Gornall & Strabulaev, *supra* note 66 (Post-money valuations treat all shares equally in this calculation, but they aren't equal. Depending on the type and round of funding, the shares issued can potentially have different rights and protections).

If we were to use Gornall and Strebulaev's valuation model, which considers the different rights and protections of the various investors' groups, then a unicorn like Square would not be valued at $6 billion but rather at only $2.2 billion. Note that when Square did eventually go public, its pre-IPO valuation was set at $2.66 billion.[83] Thus Gornall and Strabulaev were spot on with their calculations of Square's valuation.

E. Bargaining under Asymetric Information

The issue of valuation and the ability to make informed investment decisions is critical for unicorn firm employees as minority shareholders. A central issue for unicorn employees, who are also stock option holders, is that they are uninformed about their rights, the *true* or *accurate* valuation of company stock, and the overall financial stability of the company. They might have access to public information to *some* valuation details, but that valuation is wildly inflated. To make an informed investment decision on whether to exercise or forfeit their options, they need disclosure and access to appropriate information.[84]

An investment in a unicorn firm is an investment in private equity markets, which are categorized by greater information asymmetries[85] when compared with public markets. Therefore, the variation in investment strategy among the various investors affects the stock price, which is difficult to ascertain if the investor-employees do not have information such as the list of shareholders and the various terms of the financing rounds.

This Article rejects the view that employees are simply insiders who already have financial information about the firm and its viability. Some scholars[86] consider employees of start-ups insiders (sometimes

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[83] *See* Gornall & Strabulaev, *supra* note 66.

[84] The U.S. Supreme Court made it clear in *Ralston Purina* that employee status, taken alone, does not guarantee access to material information. SEC v. Ralston Purina Co., 346 U.S. 119, 126 (1953).

[85] *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,* 3 J. FIN. ECON. 305, 309 (1976). For further discussion on agency problems and strategies to reduce them, see also Henry Hansmann & Reinier Kraakman, *Agency Problems and Legal Strategies*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH (Reinier H. Kraakman et al. eds., Oxford Univ. Press 2d ed. 2009).

[86] For a further discussion on employee incentives, see generally Robert Anderson IV, *Employee Incentives and the Federal Securities Laws*, 57 U.

they go so far as to consider these employees successful gamblers or lottery winners) who are well-positioned to monitor their company's progress. Such scholars presume that the employees' economic incentives are aligned with the those of the founders. Moreover, these scholars assume that the employees are protected by the bargaining ability of other sophisticated investors, such as VC investors, who can sanction the founders for bad behavior. Even if this is true in limited circumstances (perhaps this theory could work for employees of small or medium-sized start-ups), it certainly is not true for unicorn employees.[87]

There is a conflict of interest between the founders, senior management and employees. Until recently, the founders of tech firms were usually diluted (i.e., they had to give up voting control and economic rights). VC firms negotiated for control over the board of directors and for the power to fire the founders. Fried and Broughman showed that Mark Zuckerberg's example (of a founder maintaining control over a firm after an IPO) is an exception and not the rule.[88]

Unicorns are different from small or medium-size start-ups because they raise large amounts of capital in private mega deals of $100 million or more from a mixed group of investors, including non-traditional investors. The mega deals allow unicorn founders to prolong the timeline to IPO or trade sale. These offerings are not registered with the Securities and Exchange Commission (SEC). Alternative venture capital investors play a major role in contributing to the transition in equity ownership and capital formation in the U.S. toward models of private ownership.[89] The changes in the incentives and the composition

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MIAMI L. REV. 1195, 1217–52 (2003) (discussing the status of employee options as securities); Matthew T. Bodie, *Aligning Incentives with Equity: Employee Stock Options and Rule 10b-5*, 88 IOWA L. REV. 539 (2003) (focusing on the availability of Rule 10b-5 actions); Smith, *supra* note 26, at 589-606 (focusing on the law and economics of equity compensation as private ordering); Michael C. Jensen & Kevin Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, HARV. BUS. REV., May–June 1990, at 138 (advocating for equity compensation as a form of incentive-based executive pay); *see also* Elizabeth Pollman, *Private Company Lies*, 109 GEO. L.J. 353, 353 (2020) ("[T]he explosive growth of private markets has left huge portions of U.S. capital markets with relatively light securities fraud scrutiny and enforcement.").

[87] *See also* Cable, *supra* note 41, at 616-17.

[88] *See* Jesse M. Fried & Brian J. Broughman, *Do Founders Control Start-Up Firms that Go Public?*, 10 HARV. BUS. REV. 50, 51 (2020).

[89] "Capital formation in the United States is currently in the midst of a significant transition . . . ." IRA M. MILLSTEIN CENTER, COLUMBIA LAW SCHOOL, PRIVATE OWNERSHIP AT A PUBLIC CROSSROADS: STUDYING THE RAPIDLY EVOLVING WORLD OF CORPORATE OWNERSHIP (2019).

of the investor groups give unicorn founders greater power vis-à-vis preferred shareholders and minority common shareholders to oppose a sale to keep the company private longer.[90] This also means that employees can no longer be protected by traditional investors who had the power to sanction the founders for bad behavior.[91]

With employees having no access to accurate information about the company, the mere reported but unconfirmed firm valuation can lead them to take on more risk than anticipated and to pay large amounts of taxes (for example, on profits that may never materialize). Moreover, in some cases, employees may be systematically misled by founders to think that they are rich but in reality might only be rich on paper. This could result in the employee-investor making the wrong investment decisions, such as exercising their options prematurely. There is also always a chance that the value of the unicorn's common stock will drop below the strike price, which renders the employee's options practically worthless. The employees could end up paying to work for their company when their stock option profits do not materialize.[92]

Employees only benefit from their vested options if their company goes public. If the company goes public, then they are able to sell the stock and realize the upside value they helped create.[93] But, as noted, today many unicorn companies remain private while their employees must pay large sums of money out-of-pocket for the exercise price and taxes[94] on profit that might never in fact

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[90] *See* Alon-Beck, *supra* note 35.

[91] *See also* Cable, *supra* note 41, at 616-17.

[92] *See infra* Section V.

[93] *See* BAGLEY & SAVAGE, *supra* note 76.

[94] Federal and state taxes are imposed on exercise of equity options, even when there is no active market to sell them and such a market might never materialize. *See* Richard Lieberman, *2017 Tax Act Impact on Employee Benefits and Executive Compensation*, LEXIS PRAC. ADVISOR J. (Apr. 18, 2018), https://www.lexisnexis.com/lexis-practice-advisor/the-journal/b/lpa/archive/2018/04/18/2017-tax-act-impact-on-employee-benefits-and-executivecompensation.aspx; *see also* Client Memorandum, *New Tax Act Provides Tax Deferral Opportunity for Private Company Equity Compensation Awards*, DAVIS POLK & WARDWELL LLP (Jan. 8, 2018), https://www.davispolk.com/files/2018-01-08_tax_act_provides_deferral_opportunity_private_company_equity_compensation_awards.pdfhttps://www.davispolk.com/files/2018-01-08_tax_act_provides_deferral_opportunity_private_company_equity_compensation_awards.pdf [perma.cc/378N-FK2V]; Kathleen Pender, *Bills Would Ease Tax Burden of Private-Company Stock Options*, S.F. CHRON. (Aug. 17, 2016, 5:11 PM), https://www.sfchronicle.com/business/networth/article/Bills-would-ease-tax-burden-of-private-company-9157182.php [perma.cc/7GDT-JMTY];

materialize.[95] The value of equity options to employees is diminished—helping explain why unicorn firms are experiencing difficulties with attracting, engaging, and retaining talent.[96] The longer the unicorn stays private, the longer the employees are locked in.

III. THE ROLE OF STOCKHOLDER INSPECTION RIGHTS IN CORPORATE LAW

Stockholder inspection rights are one of the most powerful fundamental rights in corporate law. They allow stockholders to inspect nonpublic company information to mitigate agency problems and asymmetry of information. Access to nonpublic information allows the stockholder to protect her economic interests, by making informed decisions, holding the company fiduciaries accountable and subjecting them to oversight.

A. Bargaining Inequality, Asymmetric Information and Agency Costs

Employees who are stockholders or stock-option holders experience inequality in bargaining power, which is why the mandatory inspection rights rules of corporate law are so important and should not be waived easily. Their firm, employer, has more negotiation power and can bargain for more favorable terms.[97]

Tax "Reform" And Its Impact On Stock Compensation, MY STOCK OPTIONS BLOG (Dec. 20, 2017), http://mystockoptions.typepad.com/blog/2017/12/tax-reform-and-its-impact-on-stock-compensation.html [perma.cc/2RSG-FFZ4].

[95] This can also lead to a cash-flow issue for the unicorn firm. The firm is required to withhold and remit income and employment taxes at the time of the exercise (NSOs) or vesting (RSUs), but it is not transferring any cash to the grantee from which it can withhold those amounts. *See* Scott Belsky, *Don't Get Trampled: The Puzzle For "Unicorn" Employees*, MEDIUM (Jan. 2, 2017), https://medium.com/positiveslope/dont-get-trampled-the-puzzle-for-unicorn-employees-8f00f33c784fhttps://medium.com/positiveslope/dont-get-trampled-the-puzzle-for-unicorn-employees-8f00f33c784f [perma.cc/76C3-E9CE].

[96] *See* Andrew Ross Sorkin, *How Valuable Is a Unicorn? Maybe Not as Much as It Claims to Be*, N.Y. TIMES (Oct. 17, 2017), https://nyti.ms/2yvpuyk [perma.cc/4Y7C-3KAA].

[97] *How Technology Changes The Balance of Power in The Labor Market*, GROUNDWORK COLLABORATIVE (Oct. 24, 2019), https://groundworkcollaborative.org/resource/how-technology-changes-the-balance-of-power-in-the-labor-market/; *Unequal Power[:] How the Assumption of Equal Bargaining Power in The Workplace Undermines Freedom, Fairness, and Democracy*, ECON. POLICY INST.,

Inspection rights are an important tool for stockholders in privately-held firms for the following reasons. Employees who invest in their firms and become stockholders, usually experience fundamental information inadequacies when compared to the founder (or management) of the firm. There is always uncertainty concerning the potential or success of the entrepreneur's product, impact or research.[98] Investment in private firms inherently involves information asymmetry[99] and uncertainty, as well agency problem,[100] which contribute to "adverse selection," where investors have difficulty with screening and selecting entrepreneurs.[101] The markets for allocating risk capital to private startups are inefficient.[102] Therefore, access to private nonpublic information is incredibly important to protect stockholders.

Note that we do not have a separate corporate law for private or public firms. However, there are fundamental differences between an owning stock in a publicly-held versus a closely-held corporation. In

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https://www.epi.org/unequalpower/home/ (last accessed July 28, 2021); *see* Jennifer Riggins, *Alphabet Workers Union Tests Tech Industry Appetite for Unionization,* NEWSTACK (Feb. 8, 2021), https://thenewstack.io/alphabet-workers-union-tests-the-appetite-for-tech-industry-unionization/.

[98] *See* PAUL A. GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 127 (1999).

[99] Laura Lindsey, *Blurring Firm Boundaries: The Role of Venture Capital in Strategic Alliances*, 63 J. FIN. 1137 (2008); *see also* GOMPERS & LERNER, *supra* note 132, at 128 (discussing the asymmetric information problem).

[100] *See* Jensen & Meckling, *supra* note 107, at 309.

[101] *See* Akerlof, *supra* note 4; *see also* Manuel Utset, *Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital Financed Firms*, 2002(1) WIS. L. REV. 45, 56 (2002); *see also* GOMPERS & LERNER, *supra* note 132, at 129.

[102] *See* GEORGE S. FORD, THOMAS M. KOUTSKY & LAWRENCE J. SPIWAK, PHOENIX CTR., DISCUSSION PAPER, AN ECONOMIC INVESTIGATION OF THE VALLEY OF DEATH IN THE INNOVATION SEQUENCE (Aug. 2007) http://www.osec.doc.gov/Report-Valley%20of%20Death%20Funding%20Gap.pdf; *see* BRANSCOMB & AUERSWALD, *supra* note 78; *see also* AUERSWALD ET AL., *supra* note 78; *see also* Ederyn Williams, *Crossing the Valley of Death*, INGENGIA, Dec. 30, 2004, at 21, http://www2.warwick.ac.uk/services/ventures/valley.pdf (discussing valley of death in the U.K.); *see also* Philipp Marxgut, *Interview with Charles Wessner, Director of the Program on Technology, Innovation, and Entrepreneurship at the National Academy of Sciences*, BRIDGES, Oct. 16, 2008, at 19, http://ostaustria.org/bridges-magazine/volume-19-october-16-2008/item/3585-innovation-policy-in-the-us-an-interview-with-charles-wessner.

the public corporation context, if a stockholder is dissatisfied with the ways in which the firm is managed or with the value of her stock, she can simply call her stockbroker, or use an app, and sell her stock on the market. In the private (closely-held) corporation context, the stockholder is "locked-in" and will typically find it very hard, if not forbidden by contract, to sell her stock and get liquidity.[103] Capital lock-in refers to a situation where a stockholder is not able to withdraw or "redeem" the capital that she contributed to the firm freely.[104] She cannot force the firm to distribute assets or buy back her shares.[105]

An investment in a private firm is therefore inherently risky. Inspection rights are designed to mitigate some of these information asymmetry and agency problems. In return for investment capital, the entrepreneur agrees to disclose credible information about her firm to the investor, and to continue to disclose such information following the initial investment, so that the investor will be motivated to remain invested in the company. This reduces costs. Inspection rights provide the stockholder with a way to access valuable information about the private company's operations and financial performance. An investor may not have an economic incentive to invest in a private firm, if she did not have the ability to monitor the entrepreneur and value her interest in the company.

Employees do not have the same protections or bargaining powers, such as typical sophisticated investors in startups. VCs can negotiate for and get voting-control provisions and other inspection rights. They are represented by lawyers that will probably flag such a waiver, and not allow their clients to sign such a provision, without negotiations. Employees typically are not able to negotiate for the same protections. As explained in greater detail below, the stock option agreement that employees sign ties them with "golden handcuffs" to the firm.[106] The agreement is designed to attract, engage and retain

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[103] *See* Alon-Beck, *supra* note 6.

[104] *See* Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1, 6 (2012). *See also* Margaret M. Blair, *Reforming Corporate Governance: What History Can Teach Us*, 1 BERKELEY BUS. L.J. 1, 26 (2004).

[105] *See* Ibrahim, *supra* note 138. *See also* Blair, *supra* note 138, at 14, 26 (citing early corporate charters and statutes that limited withdrawals to formal corporate dissolution).

[106] "Golden handcuffs" refer to benefits that an employer provides to employees to discourage the employee from taking employment elsewhere. It should be noted that there is a difference between early and late hires. These handcuffs do not work for late hires. For more on this, see Alon-Beck, *supra* note 6. For turnover in the tech industry, see *The Ugly Truth About Employee Turnover in Silicon Valley*, MENLO PARTNERS STAFFING,

employees. Most employees would not be able to bargain away from the predominant practice of equity incentive plans, because to do so might send a hostile signal to the market and to their employer, which they would like to avoid.[107]

Many employees probably do not understand the risks associated of owning their company stock (or more accurately, options), as compared to other types of diversified investment alternatives. The Zuber example bellow illustrates the risks associated with exercising stock options while the company is still private, and moreover the adverse tax effects of such an investment decision. It is risky to extrapolate past performance into the future, even when employees work for a large private company that has historically done well.

Moreover, and more importantly, the problem of inaccurate unicorn firm valuation is a well-known and documented problem in the finance literature. This information asymmetry problem is very severe because it prevents unicorn employees from accurately valuing their stock options and making informed investment decisions. A decision on whether to exercise the stock option in order to gain standing in a potential lawsuit or be able to file a demand with a company to access stockholder information rights is a financial investment decision. The unicorn employee does not know if her stock options are worth anything without access to information.

B. *Zuber* Example

To illustrate this predicament imagine you just received a job offer from a unicorn firm—Zuber. If you accept the offer, you will receive an annual salary of $200,000 and 100,000 stock options. You need to figure out exactly how much the Zuber stock options are worth because a stock option award is different from a straightforward stock award. Note that as a stock-option-holder, you are not a shareholder yet. A stock-option-holder merely has an option, which is a contractual right to purchase a set number of shares in the future. If you accept this offer, then later on you will need to make an investment decision—i.e., a decision to exercise the options and purchase the stock or not.

If Zuber was a publicly-traded company, this decision on whether to exercise Zuber options would be easy, all you would have

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https://mpstaff.com/the-ugly-truth-about-employee-turnover-in-silicon-valley/.

[107] *See* Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms and the Self Governing Corporation*, 149 U. PA. L. REV. 1619 (2001).

to do is look at Zuber's stock trading price and decide. But remember, Zuber is not a publicly-traded firm. Instead, because it is a unicorn, a privately-held firm, you will not find accurate public information about Zuber's share price.

There is always a risk associated with exercising stock options when the company is private because the stock can be "underwater." Underwater means that you paid more for the stock than it is worth (according to current market price). If the purchase price (the "exercise") for the stock option is higher than the market price for the stock after the company goes public or is acquired, then you will lose on your investment in the company.

To illustrate this point, let's return to our hypothetical: if you received stock options with an exercise price of $6 per share, then you will pay the company (Zuber) $6 per share to purchase the shares. So, you will pay $600,000 for 100,000 shares of Zuber. But what if Zuber decides to go public and, unfortunately for you, the Zuber stock only trades for $2 per share following the IPO. In this scenario, you paid more for the shares ($600,000) than they are worth because the market price is lower ($200,000) than you anticipated. Note that exercising options will not generate a tax loss (of $400,000). Therefore, as an employee, you cannot apply this loss against your income. In this scenario, you basically paid for the privilege of working for Zuber.

Unfortunately, this is not the only or main problem associated with exercising the options. There are also important and detrimental tax issues. If you work for Zuber and decide to exercise your options (or settle your RSUs), then you will have an immediate tax liability. You will have to pay taxes on profit that might never materialize. It means that you have to pay out of pocket for both the strike price and the tax. Many unicorn employees may not be able to raise enough cash to pay for these expenses because of the high valuations of their firms.[108]

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[108] Exercising incentive stock options can trigger the alternative minimum tax. *See Fundamentals of Equity Compensation*, PAYSA, https://www.paysa.com/resources/fundamentals-of-equity-compensation [https://perma.cc/DKW3-X9J8] (last visited Aug. 2, 2018). Although Congress did not repeal the alternative minimum tax, it significantly increased the income exemption and phase-out amounts, leaving fewer startup employees who receive stock options subject to the tax. *See Six Ways Tax Reform Affects Your Stock Compensation and Financial Planning*, MYSTOCKOPTIONS.COM, https://www.mystockoptions.com/articles/index.cfm/ObjectID/22615723-D31E-CCDF-68284D3C456C3E3A [https://perma.cc/HJ6Z-ANGT]. There is a new Internal Revenue Code § 83(i), which allows certain individuals, if certain conditions are met (such as the underlying stock is eligible stock and

Unicorns are private firms, and no one really knows what the future will bring. Their past performance, even if is a solid one, is not necessarily a good predictor of their future performance. Most rank and file employees are naïve and should not be considered as insiders for the purposes of making such an investment decision.[109] They do not have inside information on the firm's long-term prospects. At some point, as explain in further detail below, they will need to decide on whether to exercise or forfeit their options, without a guarantee that there will be an IPO in the future. Furthermore, unicorn employees do not have downside protection as common shareholders.

Unicorn employees become common shareholders when they exercise their options. There are different types of stock, including common and preferred. What it means to own common shares is that the Zuber employee, as a common stockholder will be last in line to be paid in the event of a sale or other types of distribution.[110] If Zuber is sold to another in a fire sale in the future, then it is probable that Zuber employees will end up with nothing.[111] The case of *Good Technology* ("Good") explain this problem of lack of downside protection.[112]

Good was a successful unicorn firm that ultimately sold in a fire sale for almost half this value after running into financial distress. News of the fire sale came as a shock to Good's employees. One day the employees, who were common shareholders, basically discovered that the value of their stock in the firm went down substantially from $4.32 to 44 cents a share.[113] The investors, on the other hand, who held onto

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the corporation is an eligible corporation), to defer tax liability on the income earned from exercising options (or settlement of RSUs) for up to five years. This is intended to mitigate the problem described above concerning NSOs (and RSUs). For more on this, see Alon-Beck, *supra* note 6.

[109] For more on naïve employees, see Bubb, Corrigan and Warren, who are criticizing federal retirement plans policy. *See* Ryan Bubb, Patrick Corrigan & Patrick L. Warren, *A Behavioral Contract Theory Perspective on Retirement Savings*, 47 CONN. L. REV. 1317, 1323 (2015).

[110] A sale of a startup is more likely to happen today than an IPO. See empirical research on this below.

[111] For more on the drivers behind value-destroying trade sales, see Casimiro Nigro & Jörg Stahl, *Venture Capital-Backed Firms, Unavoidable Value-Destroying Trade Sales, and Fair Value Protections* (June 1, 2020), LawFin Working Paper No. 1, https://ssrn.com/abstract=3662441 (they also suggest an optimal design of a standard corporate contract).

[112] *See* Cable, *supra* note 41, at 614-16.

[113] Matt Levine, *Good Technology Wasn't So Good for Employees*, BLOOMBERG OPINION (Dec. 23, 2015, 5:35 PM), https://www.bloomberg.com/opinion/articles/2015-12-23/good-technology-wasn-t-so-good-for-employees.

Good's preferred share, were able to recover their investment in the firm and get paid from the sale.[114]

Prior to the fire sale, several Good employees took on loans to pay for the taxes to exercise their stock options. These employees never profited from their investment in the firm because the loan amounts (to pay for the tax bills) were much larger than what their stock was worth after the sale. Good is a cautionary tale concerning employees as investors, who believed in the company and had no idea about its financial distress.[115]

To summarize, unicorn employees need access to information in order to make an informed decision, especially due to the fact that pre-IPO unicorn valuations are very high. Companies design stock option plans to allow the company to conserve cash while sharing ownership with employees and increasing the productivity of the employees. Additionally, in a recent Delaware case, ***Riker v. Teucrum Trading, LLC***,[116] the Delaware Court of Chancery addressed a demand for books-and-records by an LLC member, and specifically recognized that valuation is a well-established statutory proper purpose. Rather, the focus in the case was on whether the documents requested were necessary in order to perform a valuation. However, there is still a lot of uncertainty in this area.

In *JUUL*, the Delaware Court decided not to decide on whether a waiver of DGCL Section 220 rights would be enforceable or not. There is a lot of ambiguity in the case about a potential resolution on this issue, as noted correctly by a prominent Delaware litigator and commentator Francis G.X. Pileggi.[117] On the one hand, at footnote 14, the Court provides citations to many Delaware cases that sowed doubt about the viability of that position–but then the Court also cited cases at footnote 15 that more generally recognized the ability to waive even constitutional rights.

This Article highlights the fact that there are important differences between stock-holders and stock-option-holders concerning information rights. Only a stockholder in a private company has a statutory and common law right to access information about the

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[114] *Id.*

[115] Tania Babina, Paige Ouimet & Rebecca Zarutskie, *Going Entrepreneurial? IPOs and New Firm Creation* (FEDS, Working Paper No. 2017-022), https://ssrn.com/abstract=2940133. Babina et al.'s results suggest a new potential cost of the IPO that firms should factor into their IPO decision: losing entrepreneurial-minded employees.

[116] Riker v. Teucrum Trading, LLC, C.A. No. 2019-0314-AGB (Del. Ch. May 12, 2020).

[117] *See infra* Section IV.

company. If a stockholder demands information (i.e., accessing books and records) but is refused by the company, then it is considered a violation of the stockholder's information right, which can be the basis of a stockholder oppression lawsuit. The stockholder can thus turn to the courts and seek judicial remedies that were designed specifically to enforce a stockholder's information rights.

But, what about stock-option-holders? They do not have this right or any protection. Therefore, this Article is proposing below an amendment to the Delaware General Corporation Law, which would expand the statutory inspection rights under Section 220 to specifically include stock-option-holders.

C. The Statutory Design of Stockholder Inspection Rights

Stockholder inspection right originated from the common law of England. The right was recognized in England as early as 1745.[118] The right under English rule was not absolute, but rather had several restrictions, such as that the shareholder had the right to inspect the books of the corporation at reasonable times, the inspection had to be in good faith and for a proper purpose.[119] The idea behind this right was to provide shareholders with disclosures, which can improve efficiency and reduce information asymmetries.

Many states in the U.S. followed the English courts and codified this rule in their own statutes and applied it in their case law.[120] Twenty four (24) states adopted the Model Business Corporation Act ("MBCA"), which is a model act prepared by the Committee on Corporate Laws of the Section of Business Law of the American Bar Association. According to Section 16.02 of the MBCA, inspection rights are mandatory immutable rules of law, which means that they cannot be waived by the parties like default rules.[121]

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[118] *See* Dominus Rex v. Fraternity of Hostmen in Newcastle-Upon-Tyne 2 Str. 1223, 93 Eng. Rep. 1144 (K.B. 1745). The early English case of Dominus Rex was one of the first cases to recognize the right of stockholders to inspect corporate books. *See* William T. Blackburn, *Shareholder Inspection Rights*, 12 SW. L.J. 61 (1958).

[119] *See* Blackburn, *supra* note 152.

[120] *See* JONES DAY, THE TOOLS AT HAND: INSPECTION OF CORPORATE RECORDS, https://www.jonesday.com/files/Publication/70e4b38e-e3e9-4718-b4c9-a04247277901/Presentation/PublicationAttachment/f4507208-1c42-4add-a976-1dd7735d526e/ToolsAtHand.pdf

[121] *See also* Geis, *supra* note 11, at 429 (questioning the ability of states that adopted the MBCA to allow parties to contact around this provision).

The Model Business Corporation Act (MBCA) Section 16.02 includes the following language on shareholder inspection:[122]

> "The right of inspection granted by this section may not be abolished or limited by a corporation's articles of incorporation or bylaws."[123]

Not surprisingly, Delaware did not adopt the MBCA, but rather codified its own comparable version of inspection rights. Many courts today look to Delaware case law when they are required to interpret inspection rights according to their own statutes.[124]

Section 220 of the Delaware General Corporation Law ("DGCL") also balances the rights of stockholders and management. On the one hand, it provides important protections to stockholders by allowing them to exercise their ownership rights and inspect the books and records of a Delaware corporation. On the other, it also protects the firm and management. DGCL Section 220 is not an absolute right. There are hurdles. A shareholder that wants access to information must have standing and proper purpose.

The inspection right is not absolute due to the understanding that there is a need to protect the firm from frivolous or meritorious lawsuits, and to protect the firm's proprietary information. To have standing in court, the employee, as a shareholder, must first overcome the following hurdles.

1. Standing - Shareholder of Record Requirement

To have standing in court, the employee has to be a shareholder of record. As noted, owning stock options does not qualify the employee as a shareholder. Rather, the employee must first exercise her

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[122] MODEL BUS. CORP. ACT § 16.02(F) (AM. BAR ASS'N 2016).

[123] It should be noted that according to comment 1 to MBCA § 7.32, "a provision of a shareholder agreement that limited inspection rights under section 16.02 or the right to financial statements under section 16.20 might, as a general matter, be valid." There are situations where shareholders can waive inspection rights in shareholder agreements according to this provision, as long as it is not against public policy. This Article supports the view that do so in a stock option agreement, where the option holder is not yet a shareholder and might not be aware this waiver is against public policy. *See also* Fisch, *supra* note 14.

[124] *See* JONES DAY, *supra* note 154. *See* Arctic Fin. Corp. v. OTR Express, Inc., 72 Kan. 1326, 1331, 38 P.3d 701, 703 (Kan. 2002); *see also* Danzinger v. Luse, 815 N.E.2d 658 (Ohio 2004).

options (after they vest), buy the shares and only then she becomes a shareholder (and thus become eligible to demand to inspect her employer's books and records). Founders and investors usually get outright stock in the company, whereas startup employees get stock options.

Stock-option-holders do not have standing under Section 220, unless they become shareholders. The decision to exercise the options and become a stockholder is problematic without access to information for the following reasons. There is always a great economic risk associated with exercising stock options when the company is private. This risk arises because of asymmetry of information and uncertainty.

Unicorn employees at many of the largest private (but secretive) startups across the country are uninformed about their rights, their firm's equity structure, or its overall finances, and thus should not be treated as traditional insiders.[125] In the economic literature, employees who are insiders are compared to gamblers or lottery winners, who have access to information and are well-positioned to monitor their company's progress.[126] Under these theories, the insiders' economic incentives are aligned with those of the founders', which is not the case for unicorn employees, as illustrated below.

Employees that work for a small sized startup can very well be regarded as insiders who have information on the operations and status of the firm. Unicorn employees, on the hand, work for very large, even quasi-public companies with thousands of employees.[127] They are not necessarily privy to nonpublic information on the firm's performance. Additionally, as investors in private firms, they are locked-in and do not have a way of disciplining the firm's managers by threatening to withdraw their capital from the firm, which further contributes to governance problems within the firm.[128]

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[125] A unicorn is a large privately held venture-capital ("VC") backed company that is valued at over $1 billion (a "unicorn"). For more on naïve employees, see Bubb, Corrigan and Warren, *supra* note 143, who criticize federal retirement plans policy.

[126] For a further discussion on employee incentives, see generally Anderson, *supra* note 108 (discussing the status of employee options as securities); Bodie, *supra* note 108 (focusing on the availability of Rule 10b-5 actions); Smith, *supra* note 26 (focusing on the law and economics of equity compensation as private ordering); and Jensen & Murphy, *supra* note 108 (advocating for equity compensation as a form of incentive-based executive pay).

[127] *See also* Cable, *supra* note 41, at 616-17.

[128] *See* Larry E. Ribstein, *Should History Lock in Lock-in?*, 41 TULSA L. REV. 523, 524–25 (2006); *see also* Darian M. Ibrahim, *supra* note 138, at 6-7.

2. Proper Purpose - The "Demonstration" Requirement

Proper purpose is another hurdle that is rooted in common law tradition. Even if the employee becomes a shareholder of record after exercising her stock options, the inspection right is not absolute but rather conditional. After exercising her options, the employee who became a new shareholder must "demonstrate a proper purpose for making such a demand." The DGCL statute defines a "proper purpose" as "a purpose reasonably related to such person's interest as a stockholder."

Until recently, it was not clear whether an employee-shareholder could establish a proper purpose when that purpose is to ascertain the value of her stock. However, Delaware Vice Chancellor Travis Laster in *Woods v. Sahara Enterprises, Inc.*, clarified that a stockholder demanding corporate records under Section 220 is not required to explain *why* the stockholder wants to value her interest in the company to satisfy the recognized proper purpose of valuation.[129]

The court also provided a list of "proper purposes" that can be shown to satisfy Section 220 which included "to ascertain the value of his stock".[130] The Delaware Supreme Court in *Lebanon Cnty. Emps. Ret. Fund v. Amerisource Bergen Corp.*, clarified the circumstances in which stockholders are entitled to demand books and records.[131] This decision further suggests an inclination by Delaware courts to permit plaintiffs (who are stockholders) to use Section 220 to get "pre-lawsuit" discovery, even if it seems that there is no credible basis to believe there are actionable claims.[132] While *Amerisource* involved attempts to investigate allegations of mismanagement, the usage as "pre-lawsuit" discovery was not limited to such a purpose.

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[129] *See* Woods v. Sahara Enters., Inc., C.A. No. 2020-0153-JTL, slip op. at 11, 14-15 (Del. Ch. July 22, 2020). Additionally, according to the decision in *Amerisource*, stockholders may state broader purposes for investigations under section 220. Lebanon Cnty. Emps' Ret. Fund v. AmerisourceBergen Corp., C.A. No. 2019-0527, 2020 WL 132752 (Del. Ch. 2020).

[130] *See Woods*, slip op. at 8-9.

[131] If a stockholder seeks to investigate credible allegations of mismanagement, they have to meet a low bar.

[132] Roger A. Cooper, Mark E. McDonald, Pascale Bibi & Kal Blassberger, *Delaware Supreme Court Clarifies Section 220's "Proper Purpose" Test*, CLEARY GOTTLIEB (Dec. 16, 2020), https://www.clearymawatch.com/2020/12/delaware-supreme-court-clarifies-section-220s-proper-purpose-test/.

Additionally, there are new Delaware court decisions that have clarified the different types of documents that may be obtained under a Section 220 demand, which include, in limited circumstances, even communications such as personal emails or text messages.[133] No surprisingly, these is an increase in the number of Section 220 demands in recent years. The more stockholders use this investigation tool, the more potential for stockholders to file derivative lawsuits against directors and officers.

These developments perhaps encourage corporate attorneys to innovate, take advantage of bargaining inequality and put limits on information rights of certain stockholders - employees. Lawyers are paid to come up with new ways and practices to protect their clients, which are the firm and its management team. Thanks to cases like *Domo* and *Woods*, corporate lawyers who represent unicorn firms, decided to innovate with a new practice—one that compels employees to waive their inspection rights under Section 220 as a condition to receiving stock options from the company.

D. Exploitation and Market Power

There are benefits and costs associated with disclosure, which affect the cost of capital when there is information assymetry.[134] If private firms choose to disclose information to their stockholders generally, it reduces the information assymetry between the stockholders (investors) and managers, which also reduces the cost of capital. It improves the liquidity of the stock and contributes to more demand from other investor groups.

Information is power and disclosure is very important to unicorn firms. Our intellectual property laws do not protect valuable tacit knowledge (as opposed to formal, codified or explicit knowledge). Tech companies cannot easily use patent or trade secret, for example, in a way to prevent or deter imitation of tacit knowledge. Additionally, the current market dynamics lead to concentration in the economy (in tech digital industry). There is a decline in competition in the technology sector. Both public and private larger tech firms, are taking advange of these market conditions to weaken competition and leverage their dominant position to strengthen their hold on the market.

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[133] *See* KT4 Partners LLC v. Palantir Techs. Inc., No. 281, 2018, C.A. No. 2017-0177-JRS (Del. Jan. 29, 2019).

[134] Douglas W. Diamond & Robert E. Verrecchia, *Disclosure, Liquidity, and the Cost of Capital,* 46(4) J. FIN. 1325 (1991).

Unicorns are spending a lot of resources to keep information private. Leakage of proprietary information about the firm can be used by the firm's competitors and hurt the firm's competitive advantage. Unicorn firms, which are leading large tech companies, spend a lot of resources on innovation, new technology and secrecy to maintain their market dominance. Such firms are very protective of financial and other proprietary information about their business affairs. Unicorns generally do not disclose this sort of information to anyone except for major stockholders, who are able to protect their interests and specifically negotiate for contractual provisions such as for exit or voice.

Tech employees are the human capital that contributes to the knowledge in the firm. Tech firms have an incentive to protect their knowledge resources from imitation by others, because it helps the firm to generate rents from this valuable knowledge. One of the most common ways for leakage to competitors is through employee mobility across firms.[135]

There are several ways to protect knowledge leakage when employees leave to go work for a competing firm, such as non-disclosure agreements (NDAs) and non-compete agreements (NCAs).[136] However, in practice, the enforcements of these contractual arrangements depend on the geographic location and the court's willingness. It is also very hard to enforce and detect knowledge spillover using these contractual arrangements, especially in innovation clusters, such as Silicon Valley, where a court might not be willing to enforce these arrangements. Therefore, corporate lawyers had to innovate and come up with another mechanism. The stock option agreement is designed to retain the employee, so that the employee does not have an incentive to compete with the firm or leave for a competitor.

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[135] Almeida, 1996; Almeida and Kogut, 1999; Rosenkopf and Almeida, 2003.

[136] ALAN HYDE, WORKING IN SILICON VALLEY: ECONOMIC AND LEGAL ANALYSIS OF A HIGH-VELOCITY LABOR MARKET (2003); KANNAN SRIKANTH, ANAND NANDKUMAR, PRASHANT KALE & DEEPA MANI, THE ROLE OF ORGANIZATIONAL MECHANISMS IN PREVENTING LEAKAGE OF UNPATENTED KNOWLEDGE (2015); M. Marx, *The Firm Strikes Back: Non-Compete Agreements and the Mobility of Technical Professionals*, 76(5) AM. SOCIO. REV. 695 (2011); M. Marx, D. Strumsky & L. Fleming, *Mobility, Skills, and the Michigan Non-Compete Experiment*, 55(6) MGMT. SCI. 875 (2009); *see* ANNALEE SAXENIAN, REGIONAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE 128 (1996).

There is a difference between insider and outside investor groups. It is not clear if unicorn founders trust major stockholders (preferred stockholders) to protect information. It is more likely that founders are compelled to disclose some information in order to induce investment in the firm. It all depends on the bargaining power of the founders and investors. Sophisticated accredited investors, such as VCs or alternative VCs, have bargaining power, conduct due-diligence (investigation) prior to investment, and hence decide on whether to use "voice" (voting rights) or demand exit (aggressive redemption rights) when investing in unicorns. They are not only sophisticated players, but also likely represented by lawyers. They can use their power to engage with the management to try to institute change.[137]

Depending on the group of outside investors in question, there are different contractual provisions associated with the investments in the unicorns. The parties' incentives can vary and are depended on timing of financing round, participating investors and performance of the startup.[138] VC investors typically invest in earlier rounds than other alternative VC investors, and bargain for preferred stock, extensive control rights and control of the start-up's board of directors.[139] I find it hard to believe that such sophisticated investors would be willing to sign a waiver of statutory inspection rights. I was not able to find any evidence of such practice.

Employees are not sophisticated represented investors. Startup founders and their lawyers have found a new way to abuse equity award information asymmetry to their benefit when dealing with employees – waiver of inspection rights. Inspection rights waivers are especially detrimental to minority common stockholders, such as employees, who are usually not represented, but still required to make an investment decision, such as exercise their stock, or leave and compete with the firm. Since employees are minority shareholders, there are not only serious agency problem, but also a conflict of interest between majority

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[137] See Alon Brav, Wei Jiang & Hyunseob Kim, *Hedge Fund Activism: A Review* 2 (Working Paper, 2010), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1947049&download=yes, on institutional engagement. *See* Alex Edmans & Clifford Holderness, *Blockholders: A Survey of Theory and Evidence*, *in* HANDBOOK OF CORPORATE GOVERNANCE (Benjamin Hermalin & Mike Weisbach eds., 2017); *see also* Joseph McCahery, Zacharias Sautner & Laura Starks, *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 J. FIN. 2905 (2016).

[138] Alon-Beck, *supra* note 35.

[139] Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 970 n.9 (2006) ("preferred stock offers investors more senior rights than does common stock. Most importantly, preferred stockholders have a 'liquidation preference").

and minority common shareholders, which now plagues the corporate governance system in unicorn firms.

In the past, both startup founders and rank and file employees used to belong to the same class of common shareholders. Their incentives were aligned. These days, however, founders of unicorn firms are able to negotiate for other, more powerful, contractual arrangements thanks to market changes and investments from alternative and VC investors. For example, in *Unicorn Stock Options*, and *Alternative Venture Capital*, I shed light on these new practices. Founders are able to control the board of directors thanks to super voting rights and other types of contractual arrangements. These new arrangements enhance the power of founders within the firm at the expense of other employees. As a direct result of these developments, the interests of the employees and founders as common shareholders are not aligned anymore.

Unicorn founders choose to stay private to have more control over the firm, protect their proprietary information, keep it secret, and prevent leakages to competitors.[140] Founders also have an incentive to avoid the high costs associated with employee turnover. Tech employees are skilled labor, and as such, they are in high demand. There is currently a shortage in talent in the global markets. This shortage in talented employees is expected to become more acute in coming years.[141]

Tech companies limit leakage of information, so that they can continue to maintain their market power, dominance and crush competition, which raises the barriers to entry for small firms. There are several geographic tech regions in the United States, but the most known ones are Silicon Valley around San Francisco and Route 128 in Boston. These areas enjoy concentrated technology development and access to capital. This success can be attributed to several factors,

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[140] *See* Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision,* 125 YALE L.J. 563 (2016) ("entrepreneurs value corporate control because it allows them to pursue their vision"). *See also* Zohar Goshen & Assaf Hamdani, *Corporate Control, Dual Class, and the Limits of Judicial Review*, 120(4) COLUMBIA L.R. 941 (2020) (they show that "reallocation of control rights raises an inevitable tradeoff between investors' protection from agency costs and the controller's ability to pursue its idiosyncratic vision, making the value of different allocations of control rights both firm-specific and individual-specific.").

[141] Pedro Nicolaci da Costa, *Tech Talent Scramble*, *Global Competition for a Limited Pool of Technology Workers Is Heating Up,* INT'L MONEY FUND (Mar. 2019), https://www.imf.org/external/pubs/ft/fandd/2019/03/global-competition-for-technology-workers-costa.htm.

including robust investment in research and development efforts, availability of government funding, strong linkages between academic institutions and industry, developed risk-capital networks, complementary infrastructure of suppliers (for example specialized law firms), and last but not least – a ruthless code of secrecy.[142] There are many urban legends about retribution for employees who break the code of secrecy.[143]

It is not surprising that unicorn firms have come up with this new practice to limit stockholder inspection rights. The following is a description of the rise in use of this new contractual innovation, its wide adoption and practice.

IV. THE INVENTION OF STOCKHOLDER INSPECTION WAIVERS

Tech founders may claim that keeping their financial information private—even from their own minority stockholders—prevents the information from falling into rival hands. They may also claim that the lack of public scrutiny also gives them freedom to invest for the long-term. However, with regards to employees, employees used to have a right to information under our securities laws. Today, unicorns rely on regulatory arbitrage, a new exemption under our securities laws, specifically Rule 701, to avoid providing their employees with disclosure of information.[144]

The following is an investigation of the factors that contributed the rise in the use of waivers.

A. SEC Continues to Ease Disclosure Obligations

Initially, our securities laws were designed to protect all investors, including employees as investors. That meant that all the companies in the U.S. were required to disclose financial and other

[142] *See* BRANSCOMB & AUERSWALD, *supra* note 78.

[143] Olivia Solon, *'They'll Squash You Like a Bug': How Silicon Valley Keeps a Lid on Leakers*, GUARDIAN (Mar. 16, 2018), https://www.theguardian.com/technology/2018/mar/16/silicon-valley-internal-work-spying-surveillance-leakers.

[144] Thanks to Rule 701, unicorns are not required to provide employees with enhanced information, especially concerning the risks associated with investing in illiquid securities of a high-risk venture that is often controlled by founders who lack management experience.

information about the offering firm, prior to offering securities to the public. Our laws, specifically the Securities Act of 1933 (the "Securities Act"), required that a company that offers to sell its securities must first register the securities with the SEC. During the registration process, the issuing company disclosed certain facts, including certified financial statements, a description of its assets and business operations, management composition and more.

Things changed. Startups today enjoy several exemptions from registration. Thanks to a series of reforms to the federal securities laws, which began in 1988.[145] What should private companies disclose? There are several approaches to disclosure. There is consensus that there is a need for more disclosure. According to Yifat Aran, they include a maximalist, minimalist, and intermediate approach.[146]

We need a better disclosure regime to "prevent the market for equity-based compensation from becoming a market for lemons."[147] Aran warns that employees will lose trust in equity compensation arrangements. This is already happening, as evident from employees complaining on public platforms such as Glassdoors and PaySa.[148] Some employees as shareholders turn to the courts for help.

B. Workers Go to Court

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[145] *See* Renee M. Jones, Professor of Law and Associate Dean for Academic Affairs, Boston College Law School, Written Testimony Before the H. Fin. Servs. Comm., Subcomm. on Inv. Prot., Entrepreneurship, and Cap. Mkts. (Sept. 11, 2019), https://financialservices.house.gov/uploadedfiles/hhrg-116-ba16-wstate-jonesr-20190911.pdf (citing Alon-Beck, *supra* note 6).

[146] It should be noted that there are several views in academia and practice on the type of information that should be provided to employees. According to Aran, I represent the maximalist approach (for more, see Alon-Beck, *supra* note 6), practitioners represent a minimalist one, and Aran proposes an intermediate approach to the regulation of disclosures to start-up employees. *See* Aran, *supra* note 55, *Making Disclosure Work for Start-Up Employees*.

[147] *See* Anat Alon-Beck, Unicorn Stock Options; *See also* Aran, *supra* note 55, *Making Disclosure Work for Start-Up Employees*.

[148] These sites rank the "Best Companies to Work For" and employees pay "careful attention . . . to Employee Engagement Scores that link corporate reputation, employee motivation, and productivity." Samuelson, *supra* note 101. Unicorn employee complaints are not private anymore, as the "conversation has moved to employee hangouts, both virtual and real, to interview rooms on college campuses, and to public conversations about Board diversity, the glass ceiling, and in the talent pool." *Id.*

Employees are now turning to the courts to gain access to information on their company. Why courts? To invoke their statutory shareholder inspection rights.[149] Lawyers are familiar with a little secret—shareholders can make a demand on the company to inspect the books and records, and when the company refuses, they turn to courts.

In Delaware, DGCL Section 220 provides protection to stockholders by allowing them to exercise their ownership rights and inspect the books and records of a Delaware corporation. In *Cedarview Opportunities Master Fund v. Spanish Broad. Sys., Inc*., Delaware court held that this ownership right "cannot be eliminated or limited by a provision in a corporation's certificate of incorporation." But, there is ambiguity in the case law about waiving these rights by contract.

Can employees (who are not yet stockholders) waive this right by entering into a contract with the corporation such as a stock option agreement? And, in the event of litigation, would a Delaware court side with management or employees? The Delaware Court of Chancery has yet to answer these questions.

One of the first cases before the Delaware Chancery was *Biederman vs. Domo* ("Domo"). Domo is a business intelligence and data visualization company, which was private at the time. On January 26, 2017, the *Wall Street Journal* reported that Jay Biederman—a former employee and minority shareholder—finally compelled the company to open up its books.[150] Biederman used an "obscure" Delaware law, Section 220, to inspect Domo's books and records.[151]

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[149] *See* James D. Cox, Kenneth J. Martin & Randall S. Thomas, *The Paradox of Delaware's 'Tools at Hand' Doctrine: An Empirical Investigation* (Duke Law School Public Law & Legal Theory Series No. 2019-20 (2019); Vanderbilt Law Research Paper No. 19-10 (2019); European Corporate Governance Institute – Law Working Paper No 498/2020 (2019)), https://ssrn.com/abstract=3355662.

[150] *See* BLASI, KRUSE & BERNSTEIN, *supra* note 6. *See* Sean Kelly, *Start-Up Hauled to Court over Secret Stock Value*, COURTHOUSE NEWS SERV. (Aug. 18 2016), https://www.courthousenews.com/start-up-hauled-to-court-over-secret-stock-value/

("According to a complaint filed August 15 in Delaware state court, Biederman owns over 64,000 shares of Domo Inc. after his stock options vested and he purchased the options under an employee incentive plan for 32 cents per share. But Biederman says just days after he requested information about the stock's worth, he was fired. And then the stonewalling began, the complaint says.").

[151] Rolfe Winkler, *Former Employee Wins Legal Feud to Open Up Startup's Books,* WALL ST. J. (Jan. 26, 2017),

Biederman wanted information to value of his holdings. He was refused, laid off, and had to litigate with Domo for over a year. Biederman received stock options under his company's employee stock incentive plan. He exercised those options, and became a shareholder, by purchasing over 64,000 shares after his options vested. Therefore, Biederman was both a shareholder and stock-option-holder. He wanted to review Domo's financial statements to value his position in the company. Domo was a private company at the time and was not required to disclose its financial information to the public. Despite the fact that it raised over $1 billion dollars and joined the unicorn club, it is not clear whether its valuation was aggressive or justified.[152]

Domo was a unicorn firm that stayed private for long periods of time while avoiding public disclosures that would reveal its financial conditions and fair market value. Domo, like other unicorn firms, is also known for its "exaggerated valuations."[153] Prior to its IPO, Domo was valued as high as $2 billion, which means that immediately following the IPO, about 75 percent of that value (compared to the valuation) was erased.[154] According to Gornall & Strabulaev, Domo was overvalued by 16-17%.[155] This example illustrates why it is critical

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https://www.wsj.com/articles/former-employee-wins-legal-feud-to-open-up-startups-books-1485435602.

[152] David Trainer, *Domo Richly Priced at Post-IPO Market Value*, FORBES (July 3, 2018), https://www.forbes.com/sites/greatspeculations/2018/07/03/domo-richly-priced-at-current-market-value-after-ipo/#36a9a78f4da8.

[153] There are new research studies that examine the fair market value of startups worth over $1 billion. Gornall & Strebulaev find huge discrepancies in their purported worth. *See* Gornall & Strebulaev, *supra* note 66. On the skepticism about unicorn reported valuations, see also Robert P. Bartlett, III, *A Founder's Guide to Unicorn Creation: How Liquidation Preferences in M&A Transactions Affect Start-up Valuation*, *in* RESEARCH HANDBOOK ON MERGERS & ACQUISITIONS 123 (Claire A. Hill & Steven D. Solomon eds., 2016) ("achieving unicorn status provides a firm with added visibility to prospective employees and customers, giving it a potential competitive advantage over rival firms."); *see also* Sarah Frier & Eric Newcomer, *The Fuzzy, Insane Math That's Creating So Many Billion-Dollar Tech Companies*, BLOOMBERG TECH. (Mar. 17, 2015), 9:00 AM), https://www.bloomberg.com/news/articles/2015-03-17/the-fuzzy-insane-math-that-s-creating-so-many-billion-dollar-tech-companies ("investors agree to grant higher valuations, which help the companies with recruitment and building credibility"); Fan, *supra* note 41; Cable, *supra* note 41.

[154] TechCrunch, https://techcrunch.com/2018/06/29/domo-opens-at-23-80-share-a-pop-of-13-after-raising-193m-valuing-the-company-at-around-510m/

[155] *See* Gornall & Strebulaev, *supra* note 66.

that employees have access to real data, not just exaggerated valuations put out by company leadership.[156]

During the *Domo* litigation, Vice Chancellor Sam Glasscock III of the Delaware Court of Chancery ruled against the company and ordered Domo to provide Biederman with audited financial reports.

> The Court stated: "There is no question that valuation is a proper purpose under Section 220, particularly in a corporation like this which is not particularly transparent. A stockholder is entitled to value his shares." The Court ordered that "three years of audited financials" was sufficient to this proper purpose.

The decision came after many months of media scrutiny in which *The Wall Street Journal* repeatedly reported on Domo's refusal to provide Biederman with financial records. The Domo case was celebrated by the press as a win to employees.

The publicity of this case and other cases mentioned below inspired a wave of articles, law-firm memos and client alerts on the ability to waive inspection rights.[157] Moreover, leading law firms, acting through the National Venture Capital Association ("NVCA"), added provisions to existing contracts to thwart the Domo effects.[158]

C. Contractual Innovation

Despite its initial promise, *Domo* had an unintended consequence for employee stock-option-holders and employee stockholders. In order to avoid disclosing information to employees, unicorns adopted a waiver of statutory stockholder inspection rights.

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[156] *See* Gornall & Strebulaev, *supra* note 66.

[157] https://www.hg.org/legal-articles/shareholder-litigation-to-obtain-corporate-books-and-records-to-value-company-and-investigate-wrongdoing-53037; https://www.foundersworkbench.com/founders-alert-be-aware-of-stockholder-inspection-rights/; https://ma-litigation.sidley.com/2021/03/can-inspection-rights-be-waived-some-observations-on-delaware-law/; https://www.deallawyers.com/blog/2021/03/books-records-can-inspection-rights-be-waived-in-delaware.html; https://danashultz.com/2018/11/05/delaware-stockholders-waive-inspection/; https://www.dlapiper.com/en/us/insights/publications/2020/08/delaware-court-of-chancery-internal-affairs-doctrine-bars-stockholder/;

[158] See infra … Section …

Many tech companies are now requiring their employees to sign a waiver provision entitled, "Waiver of Statutory Information Rights," which states:

> **Waiver of Statutory Information Rights**. Purchaser acknowledges and understands that, but for the waiver made herein, Purchaser would be entitled, upon written demand under oath stating the purpose thereof, to inspect for any proper purpose, and to make copies and extracts from, the Company's stock ledger, a list of its stockholders, and its other books and records, and the books and records of subsidiaries of the Company, if any, under the circumstances and in the manner provided in Section 220 of the Delaware General Corporation Law (any and all such rights, and any and all such other rights of Purchaser as may be provided for in Section 220, the "Inspection Rights"). In light of the foregoing, until the first sale of Common Stock of the Company to the general public pursuant to a registration statement filed with and declared effective by the Securities and Exchange Commission under the Securities Act of 1933, as amended, Purchaser hereby unconditionally and irrevocably waives the Inspection Rights, whether such Inspection Rights would be exercised or pursued directly or indirectly pursuant to Section 220 or otherwise, and covenants and agrees never to directly or indirectly commence, voluntarily aid in any way, prosecute, assign, transfer, or cause to be commenced any claim, action, cause of action, or other proceeding to pursue or exercise the Inspection Rights. The foregoing waiver applies to the Inspection Rights of Purchaser in Purchaser's capacity as a stockholder and shall not affect any rights of a director, in his or her capacity as such, under Section 220. The foregoing waiver shall not apply to any contractual inspection rights of Purchaser under any written agreement with the Company.

This waiver illustrates that unicorn employees who sign this waiver are oppressed because they do not have access to information about the risk of exercising their stock options or the valuation of their company, even if they later exercise their options and become stockholders. This is true until and unless the company decides to go public.

Most employees are unable to bargain away from this practice. If they wanted to do so, most employees would have to refuse equity incentive plans altogether, and to do so might send a hostile signal to

the market and to their employer that they would probably like to avoid.[159]

This practice is gaining momentum. Relying on a data set of the SEC's public filings for companies that filed an IPO prior to and following *Domo*, I found many examples of companies that are using this new language. That is why the results in Table 2 below are not surprising. I also found that a few companies started using the "Waiver of Statutory Information Rights," immediately after the enactment of the JOBS Act in 2012. The following findings make note of the timing following the 2012 JOBS Act and *Domo*.

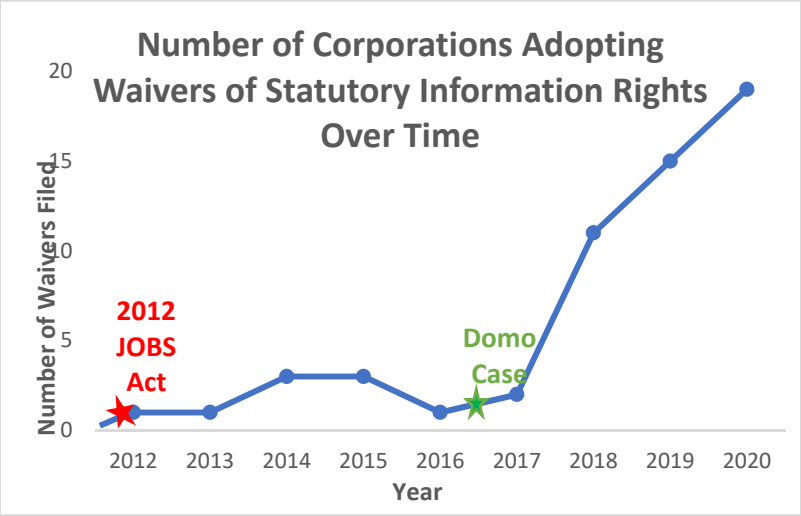

Table 2. The Number of Corporations Adopting Waivers of Statutory Information Rights Over Time.

The line graph shows the yearly number of filings that included a waiver between 2012 (when the waiver first appeared) and 2020. The line graph also notes the timing between the 2012 JOBS Act and the *Domo* case to show the change over time. I found that the waiver became popular following the *Domo* case, possibly due to all the financial press coverage, and the publication of client alerts by large law firms.

Delaware has to make a decision on this issue soon. In a recent case, *JUUL Labs, Inc. v. Grove* ("JUUL"), the Delaware court noted that it was not deciding whether waivers of a stockholder's statutory inspection rights under Section 220 in JUUL Labs' form agreements would be enforceable. That being said, the court almost deliberately left this question open for further deliberation.

[159] *See* Rock & Wachter, *supra* note 141; *Also*, *see Schwab Study*, *supra* note 21.

There is perhaps a plausible reason for this "uncertainty." On the one hand, we have, in my opinion, a very clear situation of a mandatory law that should not be contracted around.[160] On the other hand, in recent years, Delaware courts and the legislature have been recognizing the ability to waive statutory and even constitutional rights.[161]

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[160] JUUL Labs, Inc. v. Grove, No. 2020-005-JTL (Del. Ch. Aug. 13, 2020). The Delaware Court in footnote 14 of the JUUL case cited the following cases that state that the parties cannot waive inspection rights: "*See State v. Penn-Beaver Oil Co.*, 143 A. 257, 260 (Del. 1926) ("[T]he provision in defendant's charter which permits the directors to deny any examination of the company's records by a stockholder is unauthorized and ineffective."); *Marmon v. Arbinet-Thexchange, Inc*., 2004 WL 936512, at *5 (Del. Ch. Apr. 28, 2004) ("Nor could they rely upon a certificate provision prohibiting disclosure to avoid a shareholder's inspection right conferred by statute."); *BBC Acq. Corp. v. Durr-Fillauer Med., Inc.,* 623 A.2d 85, 90 (Del. Ch. 1992) (holding that a contract with a third party could not be used to limit inspection rights, which "cannot be abridged or abrogated by an act of the corporation"); *Loew's Theaters, Inc. v. Commercial Credit Co.*, 243 A.2d 78, 81 (Del. Ch. 1968) (holding that charter provision which limited inspection rights to holder of 25% of shares was void as conflicting with statute); *State ex rel. Healy v. Superior Oil Corp.*, 13 A.2d 453, 454 (Del. Super. Ct. 1940) ("In Delaware it has been considered that the right of a stockholder to examine the books of the company is a common law right and can only be taken away by statutory enactment."); *State v. Loft, Inc*., 156 A. 170, 173 (Del. Ch. 1931) (following *Penn-Beaver*)." *Id.* at 24 n.14.

[161] In footnote 15 of the *JUUL* case, the Delaware court cited to the following cases that recognized the ability to waive not only inspection rights but even constitutional rights. "*See Baio v. Commercial Union Ins. Co*., 410 A.2d 502, 508 (Del. 1979) ("Clearly, our legal system permits one to waive even a constitutional right . . . and, a fortiori, one may waive a statutory right.") (citations omitted); *see, e.g., Graham v. State Farm Mut. Auto. Ins. Co*., 565 A.2d 908, 913 (Del. 1989) (holding that an arbitration clause in a contract effectuated a valid waiver of the constitutional right to a jury trial); *Manti Hldg., LLC v. Authentix Acq. Co*., 2019 WL 3814453, at *4 (Del. Ch. Aug. 14, 2019) (concluding "that waiver of appraisal rights is permitted under Delaware law, as long as the relevant contractual provisions are clear and unambiguous"); *Tang Capital P'rs, LP v. Norton*, 2012 WL 3072347, at *7 (Del. Ch. July 27, 2012) (holding that the plaintiff contractually waived its rights to seek a receivership under Section 291 of the DGCL); *Libeau v. Fox*, 880 A.2d 1049, 1056 (Del. Ch. 2005) (holding that the plaintiff waived her right to statutory partition by contract, noting that "[b]ecause it is a statutory default provision, it is unsurprising that the absolute right to partition might be relinquished by contract, just as the right to invoke § 273 to end a joint venture or to seek liquidation may be waived in the corporate context"); *Red Clay Educ. Ass'n v. Bd. of Educ. of Red Clay Consol. Sch. Dist*., 1992 WL 14965, at *6 (Del. Ch. Jan. 16, 1992) (holding that a provision in a collective bargaining agreement constituted an effective waiver of negotiation right under unfair labor practices statute). The *Kortum* decision, cited above, held that a bilateral agreement had not waived

D. Mandatory Rules & Private Ordering

Despite the fact that different states have different corporate laws, all these laws have something in common—each has a set of default and immutable rules, respectively. States adopted these corporate law rules to make the incorporation process easier, cheaper, and more efficient. The "default" or "gap-filling" rules adopted by states give parties a choice. They can choose to use any of the default rules when setting up a company.

The rules are standardized and meant to save the parties on transaction costs that are associated with setting up a company. Default means that the parties can alter these rules or contract around them by using other specific language in the agreements that they enter into with each other.

Immutable rules, on the other hand, are mandatory rules—ones the parties cannot contract around. Section 220 of the DGCL, for example, is a mandatory rule. Distinguishing between default and immutable rules is attributed to the contrarian view of corporate law,[162] which is part of the law and economics view that regards corporate entities as a "nexus of contracts." The prominent supporters (and perhaps intellectual founders) of this view are Judge Frank Easterbrook and Professor Daniel Fischel, as well as Professors Michael Jensen and William Meckling.[163]

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statutory inspection rights where the waiver was not "clearly and affirmatively" expressed. *See Kortum*, 769 A.2d at 125; *accord Schoon v. Troy Corp*., 2006 WL 1851481, at *2 (Del. Ch. June 27, 2006). Perhaps even a clear and express waiver would be contrary to public policy under *Penn-Beaver* and its progeny, but the standard set forth in *Kortum*, at minimum, implies that a stockholders' agreement could waive statutory inspection rights if the waiver was sufficiently clear." *JUUL Labs, Inc.*, No. 2020-005-JTL at 24-25 n.15.

[162] *See* Stephen M. Bainbridge, *Contractarianism in the Business Associations Classroom*, 34 GEO. L. REV. 631 (2000).

[163] *See generally* Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs,* 38 STAN. L. REV. 271 (1986); Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395 (1983); Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982); Jensen & Meckling, *supra* note 107.

The firm is not simply regarded as a single entity but rather a nexus of contracts.[164] Firms are made of a set of different contracts between the firm's various constituencies, such as management and labor. Additionally, according to the transactional cost theory of the firm,[165] incomplete contracts are the reason for the creation of the firm. How does this affect our understanding of corporate law? As stated eloquently by Professor Cox,[166] "to nexus-of-contracts adherents, corporate rules are not mandatory but default rules; the parties are free to tailor the relationship to their own particular needs." As such, the parties are not obligated to follow them, but are free to tailor the relationship in an agreement as they see fit.

Cox criticized the fact that the Delaware legislature in 2015 amended the Delaware General Corporation Law "to authorize forum-selection bylaws."[167] The Delaware legislature acted following a decision by the Delaware Court of Chancery, *Boilermakers Local 154 Retirement Fund v. Chevron Corp* ("Boilermakers").[168] In *Boilermakers*, the Delaware Court of Chancery upheld a corporate bylaw provision that was adopted unilaterally by the corporation's directors, which designates Delaware as the exclusive forum for certain types of stockholder litigation. The court found that the forum selection bylaws were statutorily and contractually valid.[169] The end result is that today directors of a Delaware corporation can adopt such provisions to prohibit the stockholders from suing them in other states, except for Delaware.[170]

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[164] *See* Bainbridge, *supra* note 221. *See, e.g.,* JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 22 (2008) ("It has long been recognized . . . that the corporation . . . should be viewed as a 'nexus of contracts' or set of implicit and explicit contracts."). For an analysis that separates between the early scholars, see William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407 (1989). *See* James D. Cox, *Corporate Law and the Limits of Private Ordering*, 93 WASH. U. L. REV. 257 (2015).

[165] *See* Coase, *supra* note 49.

[166] *See* Cox, *supra* note 223.

[167] *See* Cox, *supra* note 223, at 257 ("In so acting, the legislature gave managers something they wanted, a way to deal with the scourge of multi-forum litigation, while pacifying the local bar that feared lucrative shareholder suits would disappear because of the chilling effect of a loser- pays rule for shareholder suits.").

[168] 73 A.3d 934, 939–41 (Del. Ch. 2013).

[169] *Id.*

[170] Companies started adopting forum selection bylaws following remarks by Vice Chancellor J. Travis Laster in the 2010 *Revlon* case. *In re* Revlon, Inc. S'holders Litig., 990 A.2d 940, at 960 (Del. Ch. 2010). *See also* Joseph A. Grundfest, *The History and Evolution of Intra-Corporate Forum Selection Clauses: An Empirical Analysis*, 37 DEL. J. CORP. L. 333, 338–39 (2012). In *Revlon*, Vice Chancellor Laster opined that "if boards of directors

It is not a secret that the Delaware courts have a laissez-faire attitude toward corporate governance contracting.[171] Professor Jill Fisch coined the term "new governance" to illustrate the ways in which private ordering is used to structure governance rights in organizational documents.[172] There is uncertainty on whether Delaware courts will uphold waivers of stockholder inspection rights.

Dicta in several cases might suggest that the court may be willing to uphold such waivers.[173] On the other hand, in other cases, the court did not allow parties to limit stockholder rights. In *Kortum v. Webasto Sunroofs Inc.*, the court observed that a shareholder's agreement does not waive the statutory inspection right and that such a waiver must be "clearly and affirmatively expressed."[174] In *Schoon v. Troy Corp.*, the court rejected the argument that the stock purchase agreement limits, in any way, the information that must be provided under Section 220.[175] As noted, there is uncertainty with regards to this.

The next step in the analysis perhaps, should be, in the event that the Delaware court decides to enforce the agreement between the parties. What constitutes consent? Traditional contract theory (and Coase) relies on bargaining that can then result in the consent to enter into an agreement. Consent (or the lack of) is linked to another fundamental theory of private ordering: the hypothesis that the

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and stockholders believe that a particular forum would provide an efficient and value-promoting locus for dispute resolution, then corporations are free to respond with charter provisions selecting an exclusive forum for intra-entity disputes." *See* Anne M. Tucker, *The Short Road Home to Delaware: Boilermakers Local 154 Retirement Fund v. Chevron*, 7 J. BUS., ENTREPRENEURSHIP, & L. 467, 469 (2014).

[171] Megan Wischmeier Shaner, *Interpreting Organizational "Contracts" and the Private Ordering of Public Company Governance*, 60 WM. & MARY L. REV. 985 (2019).

[172] Jill E. Fisch, *The New Governance and the Challenge of Litigation Bylaws*, 81 BROOK. L. REV. 1637, 1638-39 (2016).

Shaner, *supra* note 230. *See also* D. Gordon Smith et al., *Private Ordering with Shareholder Bylaws*, 80 FORDHAM L. REV. 125, 127 n.12 (2011).

[173] *See* Fisch, *supra* note 231.

[174] *See, e.g.,* Kortum v. Webasto Sunroofs Inc., 769 A.2d 113, 125 (Del. Ch. 2000) (observing that the shareholders agreement "does not expressly provide for a waiver of statutory inspection rights [and] there can be no waiver of a statutory right unless that waiver is clearly and affirmatively expressed . . . .").

[175] Schoon v. Troy Corp., 2006 Del. Ch. LEXIS 123, *7 (rejecting argument that shareholder's section 220 rights were defined by the stock purchase agreement).

resulting contract will account for the terms and these terms are fully priced into the value of the firm's securities.

Regardless of whether one agrees with this theory of the firm or not, the elements of consent and meeting of the minds are necessary for the contractual paradigm to work.[176] With regards to employees, in several cases, the employees stated that they did not consent to the contract arrangement and had no knowledge that they are waiving their stockholder inspection rights. Would that make a difference? The employees are in a hold up situation.

The problem with employees is very severe, because they entered into a contract with a company when they are under the impression that the startup is going to have an exit.[177] However, if they end up working for firms that become unicorns (stay private for long periods of time) then the employees are in a hold up situation because they cannot exit easily, have to make an investment decision without information, and might need to renegotiate the contract with the company ex-post.

It is clear that the Delaware courts allowed parties to use private ordering to contract around other types of mandatory laws.[178] Recently,

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[176] *See* Cox, *supra* note 223.

[177] *See* Mark A. Lemley, & Andrew McCreary, *Exit Strategy*, 101 B.U. L. REV. 1, 1 (2021) ("The venture capital funding model that dominates the tech industry is focused on the "exit strategy" — the ways funders and founders can cash out their investment. While in common lore the exit strategy is an initial public offering ("IPO"), in practice IPOs are increasingly rare. Most companies that succeed instead exit the market by merging with an existing firm.").

[178] In footnote 15 of the *JUUL* case, the Delaware court cited to the following cases that recognized the ability to waive not only inspection rights but even constitutional rights. "*See Baio v. Commercial Union Ins. Co*., 410 A.2d 502, 508 (Del. 1979) ("Clearly, our legal system permits one to waive even a constitutional right . . . and, a fortiori, one may waive a statutory right.") (citations omitted); *see, e.g., Graham v. State Farm Mut. Auto. Ins. Co*., 565 A.2d 908, 913 (Del. 1989) (holding that an arbitration clause in a contract effectuated a valid waiver of the constitutional right to a jury trial); *Manti Hldg., LLC v. Authentix Acq. Co*., 2019 WL 3814453, at *4 (Del. Ch. Aug. 14, 2019) (concluding "that waiver of appraisal rights is permitted under Delaware law, as long as the relevant contractual provisions are clear and unambiguous"); *Tang Capital P'rs, LP v. Norto*n, 2012 WL 3072347, at *7 (Del. Ch. July 27, 2012) (holding that the plaintiff contractually waived its rights to seek a receivership under Section 291 of the DGCL); *Libeau v. Fox*, 880 A.2d 1049, 1056 (Del. Ch. 2005) (holding that the plaintiff waived her right to statutory partition by contract); *Red Clay Educ. Ass'n v. Bd. of Educ. of Red Clay Consol. Sch. Dist*., 1992 WL 14965, at *6 (Del. Ch. Jan. 16, 1992) (holding that a provision in a collective bargaining agreement constituted an effective waiver of negotiation right

in *Manti Holdings LLC v. Authentix Acquisition Co*., private equity and venture capital investors won the case when the Delaware Supreme Court confirmed the enforceability of appraisal waivers by private contract. *Manti*, however, should be distinguished from cases like *Domo* or *JUUL* because of the negotiation power of the parties involved. In *Manti*, the stockholders that agreed to the waiver were sophisticated, informed, and represented by counsel. They presumabely had some bargaining power, unlike company employees who are not sophisticated, informed, and represented by counsel when they enter into stock option agreements.[179]

What about Section 220? If the court feels that there is a vague legal standard here, perhaps it is waiting for the Delaware legislature to change the law so that parties can account *ex ante* to this complexity? As we know, creating bright-line rules is very important for lowering costs and having certainty for all the parties involved. This issue needs to be resolved sooner than later.

Delaware courts may endorse this should they hear an appeal from *Juul v. Grove*. Moreover, this issue can also be litigated in other states, outside of Delaware, due to concern by plaintiff bar that Delaware courts will side with management. In *JUUL*, for example, the suit was brought a suit in California, invoking California's Section 1601.[180] Until now, it was my understanding that in a case like this, a California court is entitled to apply California law, because the plaintiff is a California resident, and is seeking to inspect the books and records of a Delaware corporation that is doing business as a foreign corporation in California.

Building on Stephen Bainbridge's work, and use his textbook to teach my students Business Associations. Bainbridge postulates that

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under unfair labor practices statute). The *Kortum* decision, cited above, held that a bilateral agreement had not waived statutory inspection rights where the waiver was not "clearly and affirmatively" expressed. *See Kortum*, 769 A.2d at 125; *accord Schoon v. Troy Corp*., 2006 WL 1851481, at *2 (Del. Ch. June 27, 2006). Perhaps even a clear and express waiver would be contrary to public policy under *Penn- Beaver* and its progeny, but the standard set forth in *Kortum*, at minimum, implies that a stockholders' agreement could waive statutory inspection rights if the waiver was sufficiently clear." *JUUL Labs, Inc.*, No. 2020-005-JTL at 24-25 n.15.

[179] Upshots of Del. Holding on Appraisal Rights Waivers in M&A, https://www.troutman.com/insights/upshots-of-del-holding-on-appraisal-rights-waivers-in-manda.html

[180] California adopted section 1601 inspection of books and records from the MBCA.

he "long understood (and taught) that shareholder inspection rights are a rare exception to the internal affairs doctrine."[181] To my surprise, the Delaware court in *JUUL* held that under United States Supreme Court and Delaware Supreme Court precedent, stockholder inspection rights are a matter of internal affairs. Is it?

Delaware law is my bible, however, the following is a short explanation of this analysis, and more importantly the ramifications for future corporate practice and litigation.

E. Internal Affairs

Every state in the U.S. has its own unique set of state corporate laws. These provide a standard set of rules for investors, shareholders, managers, creditors, directors and other stakeholders. These differences are possible thanks to a choice of law rule called the "internal affairs doctrine."

Under the internal affairs doctrine, the laws that govern the corporation and any future disputes between the parties arising from the internal affairs of the corporation, are determined by the state of incorporation. That is why the state of incorporation governs the disputes between parties, even when the firm is predominantly doing business in other state and is located outside the state of incorporation.

In the *JUUL* case, a claim was brought in California to inspect the books. *JUUL* is a foreign corporation that is doing business within the borders of California. It is a corporation outside of California, in Delaware. At issue is which state law governs? California or Delaware? This is a conflicts of law question. It involves the rights of a shareholder of a Delaware corporation, which is headquartered in California and doing substantial business in California. It poses special problems because this issue which can be determined differently depending on

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[181] Stephen Bainbridge, *Are Shareholder Inspection Rights Subject to the Internal Affairs Doctrine?*, PROFESSORBAINDRIDGE.COM BLOG (Oct. 5, 2020),

https://www.professorbainbridge.com/professorbainbridgecom/2020/10/are-shareholder-inspection-rights-subject-to-the-internal-affairs-doctrine.html. Building on Bainbridge's work, I also teach the case *Crane Co. v. Anaconda Co.*, 346 N.E.2d 507 (N.Y. 1976), in which the court applied New York law to determine whether a shareholder (that was incorporated in Illinois) was eligible to examine the stockholder list of a company incorporated in Montana. (Access to stockholder lists, in fact, is a well-established exception to the internal affairs doctrine as a matter of both corporate law and conflicts of law.)

the state in question. It should be noted that these types of cases can and probably will continue to come up in this context, as is illustrated by the empirical investigation below.

The Restatement (Second) of Conflict of Laws,[182] provides that states can exercise authority to require disclosure. However, this is an evolving and intriguing area of the law, which has been and still is evolving rapidly. As noted by Francis Pillegi, Section 220 is not for the faint-hearted. It is well established that a foreign corporation authorized to do business in a state is going to be subject to that domestic state's statutory provisions. Unless the language in the domestic state's statute has some sort of limitations, such as explicit language that it only applies to domestic corporations. Most states respect requests for access to corporate books and records.[183]

The *JUUL* case raises constitutional questions, and inquiries about the concept of the corporation and limits of state power.[184] State sovereignty suggests that the state can exercise its power and authority within its borders (jurisdiction).[185] Each state has powers to subject

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[182] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 304, cmt. d (1971).

[183] In *JUUL*, in footnote 7, the court states that there is a substantial volume of authority that posits that the internal affairs doctrine should not limit the ability of a non-chartering jurisdiction to grant rights to inspect the books and records of a foreign corporation. The court cited the following sources: "*See, e.g.,* 36 Am. Jur. 2d *Foreign Corporations* § 58, Westlaw (database updated Aug. 2020). *id.* § 377; Deborah A. DeMott, *Shareholder Derivative Actions: Law and Practice* § 2:13(1) (2019–20) (collecting "inspection cases" involving the "application of forum-state law" to a foreign corporation); K. M. Potraker, Annotation, *Stockholder's Right to Inspect Books and Records of Foreign Corporation*, 19 A.L.R.3d 869 (1968) (collecting cases); *see also* Elvin R. Latty, *Pseudo-Foreign Corporations*, 65 Yale L.J. 137, 138–39 (1955) ("Legislation relating to corporations not infrequently contains protective provisions that the parties to be protected cannot 'waive' by contract in drafting the charter.)". JUUL Labs, Inc. v. Grove, No. 2020-005-JTL, at 12-13 n.7 (Del. Ch. Aug. 13, 2020).

[184] The internal affairs doctrine rises to the level of a constitutional doctrine. *See Can California Require Delaware Corporations to Comply with California's New Board of Director Gender Diversity Mandate? No,* PROFESSOR BAINBRIDGE.COM (Sept. 1, 2018), https://www.professorbainbridge.com/professorbainbridgecom/2018/09/can-california-require-delaware-corporations-to-comply-with-californias-new-board-of-director-gender.html; *And* Stephen Bainbridge, Contributor, *California Corporate-Board Quota Law Unlikely to Survive a Constitutional Challenge* , WASH. LEGAL FOUND. (Oct. 2, 2018), https://www.wlf.org/2018/10/02/wlf-legal-pulse/california-corporate-board-quota-law-unlikely-to-survive-a-constitutional-challenge/.

[185] According to the *JUUL* court, "That concept of the corporation (and of state-chartered entities more generally) can have implications for the valid

persons, including domestic and foreign corporations, and goods to the process of its courts based on its adjudicative jurisdiction.[186] The crucial question that arises from the JUUL case is whether Delaware's jurisdiction extends outside its borders? Is a California court going to say to the parties – you need to take this lawsuit to Delaware? or will apply Delaware law?

The important take away from the *JUUL* case is that Delaware law applies for inspection cases, regardless of where a company's principal place of business is located.[187] It is not surprising, therefore, that the Delaware court in *JUUL* declared that the employee's rights as a stockholder are governed by Delaware law, and that he thus could not seek an inspection under California's Section 1601.[188]

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exercise of one state's power in relation to other states." *JUUL Labs, Inc*., No. 2020-005-JTL at 14 n.7.

[186] According to the *JUUL* court, "the DGCL rests on a concept of the corporation that is grounded in a sovereign exercise of state authority: the chartering of a "body corporate" that comes into existence on the date on which a certificate of incorporation becomes effective." *Id.* at 14 n.7. *See* 8 DEL. C. § 106. Id.

[187] "Under principles articulated by the Supreme Court of the United States and applied by the Delaware Supreme Court, Delaware law governs its internal affairs. The scope of Grove's inspection rights is a matter of internal affairs, so Delaware law applies." *JUUL Labs, Inc.*, No. 2020-005-JTL at 2.

[188] "Because Grove's inspection rights implicate the Company's internal affairs, Grove must pursue any remedy in this court under the exclusive forum-selection provision in the Company's certificate of incorporation." *Id.* at 2. The court is citing the following sources: "George S. Geis, *Information Litigation in Corporate Law*, 71 Ala. L. Rev. 407, 448 (2019) ("Inspection rights clearly relate to the internal affairs of the corporation . . . ."); P. John Kozyris, *Corporate Wars and Choice of Law*, 1985 Duke L.J. 1, 63 (stating that "[c]ertain internal affairs matters are even less amenable to differential treatment than others" and that "[t]he hard core areas where 'indivisible unity' is paramount should include first and foremost the rights that attach to corporate shares" like "obtaining information" and "inspecting corporate records"); Deborah A. DeMott, *Perspectives on Choice of Law for Corporate Internal Affairs*, 48 L. & Contemp. Probs. 161, 168 (1985) [hereinafter DeMott, *Perspectives on Choice of Law*] (describing "shareholders' inspection rights" as one of the "quintessentially internal matters"); *see Restatement (Second) of Conflict of Laws* § 304 (concluding that the law of the state of incorporation generally should "determine the right of a shareholder to participate in the administration of the affairs of the corporation"); 17 William Meade Fletcher et al., *Fletcher Cyclopedia of the Law of Private Corporation*s § 8434 (Sept. 2019 update) ("It has been held that shareholder meetings and maintenance of books and records were 'internal affairs' of the corporation not subject to regulation in another state.")." *Id.* at 16 n.8.

But the question remains - what about the other states? are they going to follow Delaware or resist? Delaware is the state of choice for incorporation for many firms in the U.S. and around the world. What about unicorns? In a separate study, relying on hand collected data consisting of various filings, I find that 89% of the unicorn firms in the United States choose to incorporate in Delaware.[189] Thus, any Delaware court decision on this issue will determine the rights of hundreds of thousands of unicorn employees across the U.S.

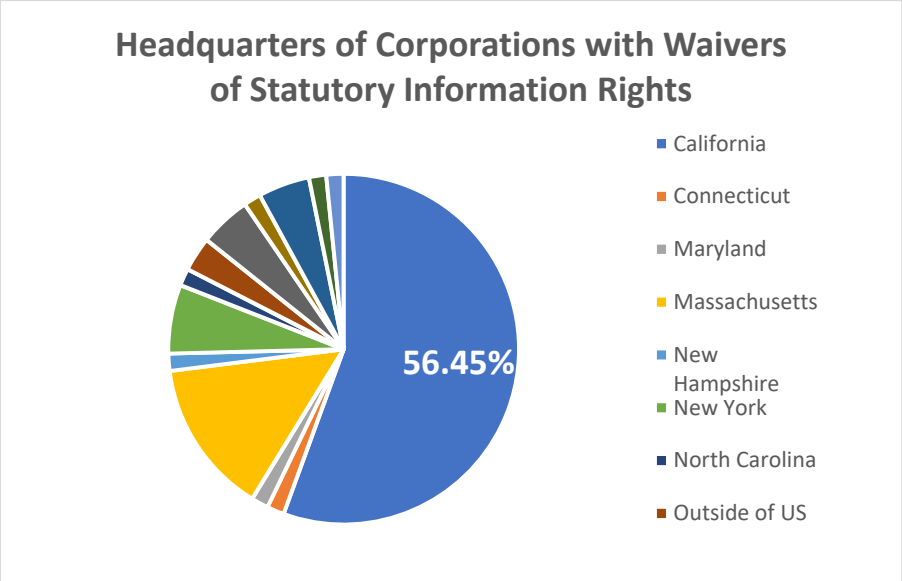
There is still uncertainty with regards to choice of law clauses because the question of whether forum selection clauses, for example, are even enforceable is usually highly contested in the U.S.. Can contracting parties exercise their autonomy and select via contract the *forum* in which these types of books and records disputes will be resolved? The answer to this question requires further research on constitutional law and is therefore outside the scope of this Article.

One thing is clear, other states can and in practice do define the terms by which stockholders of a foreign corporation can inspect books and records in their jurisdiction. Unfortunately for practitioners, this means uncertainty. A Delaware corporation is going to be subjected to different legal and policy standards, depending on the specific jurisdiction and the ways in which that jurisdiction follows Delaware law.

Perhaps, parties can state as clearly as possible that they want their clause to (a) be exclusive or non-exclusive, (b) apply or not apply to this specific type of claim – inspection of books and records, (c) apply or not apply to non-signatories, or (d) select specific state courts that have authority to adjudicate these matters.

Figure 1: This figure breaks down the percentages of each corporation that has adopted a waiver by examining the state in which their headquarters is located

[189] *See* Anat Alon-Beck, *Where do Unicorns Incorporate*? (work in progress).



F. NVCA Moves to Standardize Statutory Stockholder Inspection Waivers

Another very important development in this field is an effort by interest groups that represent tech firms to standardize statutory stockholder inspection waivers. Recently, between July 28, 2020 and September 1, 2020, the National Venture Capital Association (the "NVCA") released updates to its model legal documents for use in venture capital financing transactions that incorporated the waiver language in the Investors' Right Agreement ("IRA").[190]

The purpose of this change is to reduce the potential claims from shareholders involving demands for access to books and records under Section 220 of the DGCL. Some law firms even advise their clients that a Delaware court may hold the waiver provision enforceable, given the trend to enforce private agreements between sophisticated investors.[191] Do they consider the fact that employees are

[190] *Venture Capital Investing: New NVCA Models, and New Challenges for Foreign Investors in Early-Stage U.S. Companies*, CLEARY GOTTLIEB (Oct. 7, 2020), https://www.clearygottlieb.com/-/media/files/alert-memos-2020/20201007-venture-capital-investing-new-nvca-models-and-challenges-for--pdf.pdf.

[191] Cameron R. Kates, James B. Jumper, Daniel R. Sieck & Geoffrey S. Garrett, *Modeling the Market: The National Venture Capital Association Revises its Model Documents*, TROUTMAN PEPPER (Sept. 16, 2020), https://www.troutman.com/insights/modeling-the-market-the-national-venture-capital-association-revises-its-model-documents.html.

not represented and not accredited to be sophisticated? Perhaps, however, I strongly disagree with this view.

V. SUGGESTIONS

Delaware courts need to provide more clarity in this area of the law where choice of law issues is relatively likely to come up on a regular basis in the future — stockholder inspection rights. Specifically, with regards to unicorn firms, since 89% of them are incorporated in Delaware.

A. Delaware Courts

Delaware courts should not depart from the established common law tradition that enforces mandatory immutable inspection rights. Delaware courts should make it clear that it is not permittable to contract out of mandatory stockholder inspection rights. More importantly, Delaware courts should declare that they will continue to allow minority employee stockholders to access the books and records of their companies under Section 220 in order to evaluate their stake in the company.

This does not represent a radical shift in the law but rather a restoration of the understanding of it that existed long before *Domo* or *JUUL* were litigated. Delaware courts have consistently taken steps to protect minority shareholders. Despite attempts under federal law to strip away employees' status as shareholders, Delaware should step up and consider the broader role these shareholders play in governance and corporate purpose.

B. Delaware Legislature

The Delaware legislature should not amend its statutes to enable corporations to waive the important stockholder inspection right via private ordering. Section 220 affords protection to minority stockholders from the oppressive behavior of the majority by allowing minority stockholders to gain access to their company's books and records.

Unfortunately, DGCL Section 220 does not offer such protections to stock-option-holders. Therefore, this Article further calls on legislature to amend its statutes in order to enable stock-option-

holders, in limited situations, to access their companies' books and records under DGCL Section 220. Such stock-option-holders inspection right can be drafted to clearly state that they only include certain categories, such as employees, and further limit it to information would only be provided at a reasonable time, in connection with a proper purpose and limit the type of information provided to value the equity.

C. Practitioners Everywhere

Practitioners, who are advising tech companies should innovate by helping their clients to find ways to provide information to their employees while protecting the firm's intellectual property. A departure from the traditional stock option model will not benefit the firm.

Practitioners are innovating because they want to protect the firm from a rise in potential lawsuits from employees, which is understandable. But they need to fix the problem, not cerate a bigger one. This waiver does not solve the problem but makes it worse. When employees complain about their company in public (on online platforms) and initiate lawsuits against the company, it raises costs. The firm has to monitor, retain and engage labor, especially when there is a short supply and fierce competition in technology markets.

The problem is about asymmetry of information. To mitigate it, attorneys can require that the firm disclose the following information to employees. First, in addition to the Stock Option Purchase Agreement and the Plan, the attorney can produce a schedule with the amount of capital that was raised by the company until that point. The schedule would include a list of investors that received liquidation preferences and founders who were granted super voting common stock.

Second, disclose how much debt has accumulated (including debt evidenced by convertible or SAFE notes). Third, if the firm allows employees to trade on secondary platforms, it will also provide appropriate disclosure, including any restrictions on resale, to make sure that employees understand and comply with the applicable securities regulations. If firm does not allow employees to trade on

secondary platforms, then it can facilitate private secondary market sales, or stock buybacks.[192]

Fourth, disclosure would include information on the compensation of the management team, information concerning current and future stock and debt issuances, a list of investors holding more than a specified percentage (perhaps 15%) of the outstanding stock (including their liquidation preferences and conversion rights), and a quarterly estimated fair market value of the stock. Finally, a request that unicorns be audited by an independent auditing firm. The employees should have access to and be entitled to rely on these reports.[193]

Employers may not have much choice going forward. According to Barzuza, Curtis, and Webber, Millennial employees, consumers, and investors are more willing to demand what they call "radical transparency."[194] This calls for information far exceeding the minimum requirements of securities laws and public companies are responding rapidly in an attempt to build loyalty amongst this generation and Gen Z, their younger counterparts.[195] Over the next two decades, these two generations will represent the majority of employees, investors, and voters.[196] It is essential for unicorns to adapt as well to avoid the potential backlash and to create the loyalty they will need to maintain their human capital pool.[197]

These disclosures can produce increasingly equitable and sustainable employee participation in unicorn companies. Although these disclosures are equitable for employees—and can show that investing in the company is sustainable—disclosures are a nightmare for unicorn management teams. There is a need for innovation with

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[192] *See* Ric Marshall et al., *Taking Stock: Share Buybacks and Shareholder Value*, Harv. Law School F. Corp. Governance & Fin. Reg. (Aug. 19, 2018), https://corpgov.law.harvard.edu/2018/08/19/taking-stock-share-buybacks-and-shareholder-value/ [https://perma.cc/SL43-FMXR] (finding no compelling evidence of a negative impact from share buybacks on long-term value creation for investors overall).

[193] For alternative suggestions on disclosure, see Aran, *supra* note 55, *Making Disclosure Work for Start-Up Employees*.

[194] *See* Michael Barzuza, Quinn Curtis & David H. Webber, *The Millennial Corporation* (Dec. 14, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3918443.

[195] *Id.*

[196] *Id.*

[197] *See* Alon-Beck, *supra* note 50; *see* Anat Alon-Beck, Michal Agmon-Gonnen & Darren Rosenblum, *No More Old Boys' Club: Institutional Investors' Fiduciary Duty to Advance Board Gender Diversity*, 55 U.C. DAVIS L. REV. 102 (2021).

regards to disclosure practices. Time will tell whether Section 220 will alleviate the problem of golden handcuffs and the ensuing constraint on employee mobility.[198]

VI. CONCLUSION

Unicorns stay private longer for various reasons, but in large part, to avoid public disclosures that could reveal their true financial conditions and fair market value, including to their own employees. Unicorns are notorious for their exaggerated valuations. Employees are not privy to confidential information, including financial statements, shareholder lists, and other material non-public documents. Unicorns are likely to refuse access to employees seeking such information.

Unicorn firms' founders, investors, and their lawyers have systematically abused equity award information asymmetry to their personal benefit. They use *ex ante* waivers of inspection rights or *ex post* nondislosure agreements in an effort to limit some shareholder inspection rights via private ordering. Unicorn firms do not provide their minority common stockholders and stock option holders—specifically, their employees—with information on their stake in the company, which could improve efficiency and reduce information asymmetries. Unicorn employees do not have access to financial reports and, in many cases, are denied access to such reports.

This Article demonstrates that following a recent Delaware case, *Biederman vs. Domo*, unicorns adopted a new, pervasive practice that compels their employees to waive inspection. Relying on a hand-collected data set consisting of the SEC's public filings, I found that unicorn firms require their employees to waive their inspection rights under DGCL Section 220 as a condition to receiving stock options from the company. Employees sign a waiver clause titled "Waiver of Statutory Information Rights," in which they waive their inspection rights of the following materials: company stock ledger, a list of its stockholders, other books and records, and the books and records of subsidiaries of the company. The waiver remains in effect until the first sale of the company's common stock to the public occurs.

Unicorn employees are turning to the courts to compel their companies to open up their books and records and to disclose financial information. Employees who are stock option holders, but not stockholders yet, do not have a right to access such information under Delaware law. To have standing in court, the employee must first

[198] *See supra* Section IV.

exercise her options and become a stockholder of record. This Article advocates for reform. Both minority stockholders and stock option holders should be entitled to information so they can make informed investment decisions, such as deciding whether to exercise their options or to let them expire overnight.

The Article also presents evidence that U.S. unicorn firms prefer to incorporate in Delaware. Relying on hand-collected data, I found that 89% of the unicorns in the United States are incorporated in Delaware. Therefore, the Article calls on the Delaware courts and legislature not to allow unicorns to modify or eliminate the mandatory inspection rights expressly set forth in the DGCL. Delaware law is and should continue to serve as a valuable tool for minority stockholders and stock option holders (employees) who are questioning the value of their shares. Delaware courts and legislators' actions on and resolution of this important issue will have tremendous influence on corporate law, litigation, and practice.

VII. APPENDIX

Table 1: Unicorn Firms Incorporated in Delaware with Public Record of Statutory Waiver of Information

Corporation	Date of Incorporation	Date of Waiver	Valuation of Firm (Billions)
JUUL Labs	3/12/2007		$50.0
DoorDash	5/21/2013	11/13/2020	12.6
SoFi	4/26/2011		4.5
OpenDoor Labs	12/30/2013		3.8
GoodRx	9/12/2011	8/28/2020	2.8
Pax Labs	4/21/2017		1.7
Asana, Inc.	12/16/2008	8/24/2020	1.5
Segment	5/2/2011		1.5
One Medical Group	7/5/2002	1/3/2020	1
Casper	10/24/2013	1/10/2020	1.1
Hims	12/30/2013	1/26/2021	1.1
Sumo Logic	3/29/2010	8/24/2020	1