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Venture Capital, Agency Costs, and the False Dichotomy of the Corporation

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VENTURE CAPITAL, AGENCY COSTS, AND THE FALSE DICHOTOMY OF THE CORPORATION

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An implicit dichotomy of the corporation exists in legal scholarship. On one side of the dichotomy rests the publicly held corporation suffering from a significant conflict of interest between its managers and dispersed shareholders; on the other side, the closely held corporation plagued by intershareholder conflict.

This Article argues that understanding the agency problems that can exist within a firm demands a rejection of this traditional dichotomy and the theories of the firm built upon it. Using venture capital (VC) finance, this Article demonstrates how this dichotomy obscures how all firms—public and private—often face the same agency problems. Start-up companies receiving VC investment are uniquely situated to examine this dichotomy, as they represent closely held firms structured to transition quickly to public equity markets. Additionally, by separating investment from company management, VC investment creates many of the investor-manager conflicts inherent in public companies.

By analyzing VC investment contracts, this Article reveals that start-up companies are indeed plagued by both vertical agency problems between investors and managers and horizontal agency problems among VC investors themselves. Significantly, academic scholarship has ignored the potential for interinvestor conflicts, using instead an analytical framework associated with public corporations that focuses exclusively on investor-manager agency problems. In so doing, VC scholarship provides a clear example of how the dichotomy of the corporation forces scholars to wear blinders in analyzing the agency problems in firms. To understand the full scope of these problems—and their implications for corporate investors—a new model of the firm is required that applies to all firms, public and private. This Article outlines this dynamic agency cost model and articulates its implications for corporate investors, corporate scholars, and corporate law in general.

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INTRODUCTION

In 1999, two venture capital (VC) firms invested $25 million in a newly formed Internet search firm called Google. Four years later, after Google's initial public offering (IPO), their investment was worth over $4 billion.[1] But not every company is a Google. Consider, for example, another $25 million investment made by prominent VC firm Benchmark Capital. Its investment in Juniper Financial, made during the dot-com bubble in 2000, ultimately

1. Bob Sechler, *Web-Search Sector Lures Venture Fires*, WALL ST. J., Feb. 15, 2006, at B3B.

resulted in a well-publicized and futile lawsuit by Benchmark against Juniper and a co-investor in the company when Juniper consummated a transaction that effectively destroyed the value of Benchmark's investment.[2] The challenge for investors is how best to manage risk in a world of uncertainty where the $25 million bet could turn out to be either a Google or a Juniper Financial.

Not surprisingly, analysis of the structural risks of corporate investment is a foundational issue for legal and financial scholars—but one in which context matters. Ask a corporate scholar to describe the structural investment risks for a publicly held corporation, and you will undoubtedly hear about the significant conflicts of interest that exist between a corporation's managers and its dispersed shareholders.[3] Ask the same about a closely held corporation, and be prepared for an analysis of the potential for intershareholder conflicts.[4] There are, in short, two "corporations" in modern corporate scholarship: one public, one private.[5] A peculiar result given that, for all practical purposes, our corporation statutes envision but one corporation.[6]

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2. *See* Lisa Bransten, *Deals & Deal Makers: Benchmark Capital Sues Company It Nurtured*, WALL ST. J., July 11, 2002, at C5.

3. *See, e.g.*, Stephen J. Choi, *Law, Finance, and Path Dependence: Developing Strong Securities Markets*, 80 TEX. L. REV. 1657, 1659 n.10 (2002) ("A well-known agency problem exists between managers and dispersed shareholders of public corporations."); *see also infra* text accompanying notes 27–43, 270–272.

4. *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1744–45 (2001) ("It is widely recognized that participants in closely held corporations face a high risk of loss from their fellow participants' opportunism . . . ."); *see also infra* text accompanying notes 283–285.

5. *See* John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 24 J. CORP. L. 837, 840 (1999). The literature comparing private and public corporations has made clear that the fundamental difference between the two is the differing dimensions of structural investment risk. *See, e.g.*, Lucian Arye Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U. L. REV. 489, 496 n.15 (2002) (describing the "agency problem associated with the inherent conflict of interests between managers and shareholders of public companies," which represents a "different problem[ ] than those posed by close corporations"); Blair & Stout, *supra* note 4, at 1799 (noting that "closely held corporations generally do not suffer the 'separation of ownership and control' thought to plague publicly held firms [but] are famous for presenting their own problems . . . in the form of opportunistic behavior *between* shareholders"); Victor Brudney & Robert Charles Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 998, 1003 (1981) (describing as a principal difference between public and private corporations the ability of investors in private firms to actively monitor management while investors in public firms have less ability to monitor the "diversions of corporate assets by fellow participants"); Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 277 (1986) (describing as the "fundamental difference" between public and private corporations the investor-manager conflicts created by the separation of risk bearing and management in publicly held firms and the intershareholder conflicts created by its unification in closely held firms). *But see* William J. Carney, *The Theory of the Firm: Investor Coordination Costs, Control Premiums and Capital Structure*, 65 WASH. U. L.Q. 1, 4 (1987) ("A complete theory of the firm must account not [only] for conflicts between agents and principals, but also for conflicts that may exist among co-owners.").

6. *See* Coates, *supra* note 5, at 840 ("[D]efault corporate law has only erratically and incompletely distinguished between [close corporations and public corporations]."). Although many

The thesis of this Article is that an accurate understanding of corporate investment risk demands the rejection of this traditional dichotomy of the corporation and the theories of the firm built upon it. Through an exploration of VC finance, this Article demonstrates how this false dichotomy obscures the fact that all firms—public and private—frequently face the same structural investment risks. Indeed, only by constructing a new model of the firm that ignores this dichotomy can we recognize the full scope of investment risks that affect firms of any mold.

Start-up companies[7] receiving VC investment are uniquely situated to examine this dichotomy, as they exist at a crossroads between private and public firms. VC investments are made in private companies developing new businesses with the goal of moving these companies to public equity markets either through an IPO or an acquisition by a publicly traded corporation. Additionally, by separating risk-bearing investment from day-to-day company management, VC investment creates many of the agency problems faced by investors in public corporations. In this regard, VC-backed start-up companies represent a logical starting point for examining how a firm can experience both the intershareholder conflicts typically associated with private companies as well as the investor-manager conflicts typically associated with public companies.

At the same time, the academic literature on VC investment provides a clear example of how the implicit dichotomy of corporate scholarship obscures an accurate understanding of investment risk. The significant investor-manager conflicts created by VC investment have led corporate scholars to apply an analytical framework to VC finance that is generally associated with analyses of public corporations. For over twenty-five years, scholarly analyses of VC investment have been based on a simple, standard model of VC investment focused exclusively on the conflicts of interest between VC investors and company managers. Informed in large part by the agency cost theory of the firm introduced in 1976 by Michael Jensen and William Meckling,[8] the model focuses on the significant information asymmetries and

states provide special close-corporation statutes, they are systematically underutilized by close corporations. *See generally* Tara J. Wortman, *Unlocking Lock-In: Limited Liability Companies and the Key to Underutilization of Close Corporation Statutes*, 70 N.Y.U. L. REV. 1362, 1381 (1995).

7. This Article uses the term "start-up company" to refer to any business organization receiving venture capital (VC) financing. Although any business entity may receive VC financing, most VC investors prefer to invest in corporations for a variety of technical reasons. *See* JACK S. LEVIN, STRUCTURING VENTURE CAPITAL, PRIVATE EQUITY, AND ENTREPRENEURIAL TRANSACTIONS ¶ 105.1, at 1-7 to 1-9 (1999).

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

agency risks that exist between a firm's investors and its managers, and the mechanisms VC investors use to minimize the resulting agency costs.[9]

Notably absent from discussions of VC investment are considerations of how start-up companies also suffer the types of interinvestor conflicts that have historically plagued closely held firms. Of particular significance for start-up companies are conflicts among VC investors themselves. Studies of VC investment utilizing the traditional agency cost model commonly assume either a single VC investor or a homogeneous group of VC firms to simplify their analysis of management agency risk.[10] Yet, as this Article demonstrates, VC investments are made jointly by investors whose economic interests often clash. Paradoxically, it is the very techniques investors use to minimize potential agency risk with company managers that create the potential for these interinvestor conflicts.

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9. This model of VC investment can be found in virtually any academic discussion of VC finance. *See, e.g.*, PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 158 (2004) (describing the problems faced by investors given the degree of asymmetric information between VC investors and entrepreneurs concerning a start-up company); Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1069 (2003) ("[T]he keystone of the U.S. venture capital market is private ordering—the contracting structure that developed to manage the extreme uncertainty, information asymmetry, and agency costs that inevitably bedevil early-stage, high-technology financing."); Steven N. Kaplan & Per Strömberg, *Characteristics, Contracts, and Actions: Evidence from Venture Capital Analyses*, 59 J. FIN. 2177, 2178 (2004) ("The theories [on VC finance] predict that characteristics of VC contracts will be related to the extent of agency problems [with entrepreneurs]."); William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473, 473 (1990) ("The venture-capital industry has evolved operating procedures and contracting practices that are well adapted to environments characterized by uncertainty and information asymmetries between principals and agents."); D. Gordon Smith, *Venture Capital Contracting in the Information Age*, 2 J. SMALL & EMERGING BUS. L. 133, 138 (1998) ("Most subsequent scholarship has followed Sahlman's lead, viewing venture capital contracts exclusively as mechanisms for reducing potential agency costs to venture capitalists."). For a concise summary of the literature, see generally Michael Klausner & Kate Litvak, *What Economists Have Taught Us About Venture Capital Contracting*, *in* BRIDGING THE ENTREPRENEURIAL FINANCING GAP 54, 55, 59 (Michael J. Whincop ed., 2001).

10. For instance, even where VC firms are recognized as collectively investing in a start-up company, their interests appear unified and aligned. *See, e.g.*, Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 283 n.5 (2003) ("It is beyond the scope of this paper to consider agency problems among VC syndicates. Given the repeated nature of syndications, we believe it is reasonable to aggregate holdings and assume that the VCs in each round act to maximize value."); D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 316 n.1 (2005) ("For the limited purpose of analyzing the venture capital relationship [in this Article] conflicts among members of . . . the venture capital syndicate are moved to the side . . . ."). In this regard, VC scholarship resembles corporate legal scholarship in general. *See* Carney, *supra* note 5, at 3 ("In the past many commentators have either confused [interinvestor conflicts] with agency costs or assumed them away. Conflicts among investors have often been confused with management misbehavior, or agency costs, at least by legal observers.").

To minimize management agency risk, VC investors undertake a number of strategies in making company investments. These strategies include the acquisition of control and monitoring rights, the staging of investments through multiple rounds of financing, and the syndication of investments with other VC investors.[11] Although much has been written about these strategies,[12] little has been said about an important practical consequence of them: These strategies cause investors to acquire a company's securities at different times and at different prices. This simple fact, when combined with the compensation structure of most VC funds, can lead to significantly divergent preferences among a company's investors concerning the company and its transactions. The divergence of preferences can be particularly acute with regard to the timing of an exit event (such as an IPO or an acquisition) and the company's future financing. Aware of these potential conflicts, a VC investor negotiates specific economic and control rights with a start-up company and its other investors to protect these preferences when making an investment. These contractual provisions, however, only accentuate the potential for interinvestor conflict by driving a wedge between the economic interests of the company's investors. Consequently, a company's VC investors will often have both the incentive and the means to engage in rent-seeking behavior vis-à-vis other investors in certain economic contexts.

Thus, to truly understand VC investment, it is essential to move beyond the traditional analytical frameworks used in corporate scholarship. Specifically, understanding VC investment requires a model of the firm that accounts for at least two forms of potential agency risk: the vertical agency risk posed by the delegation of corporate authority to unrelated managers and the horizontal agency risk posed by the significant control rights held by other investors.[13] To be sure, this insight echoes those such as Margaret Blair

11. *See infra* Part I.A.

12. *See infra* notes 48–51 and accompanying text.

13. It should be emphasized at the outset that the agency framework utilized in this Article is rooted in agency cost economics as opposed to the law of principal-agent. As such, the lack of a legal principal-agent relationship between equity investors in a firm has no bearing on whether an agency relationship might exist between them in an economic sense. *See* Kenneth J. Arrow, *The Economics of Agency*, *in* PRINCIPALS AND AGENTS 37, 37 (John W. Pratt & Richard J. Zeckhauser eds., 1985) ("The agency relationship is a pervasive fact of economic life. Even in the limited sense in which the concept has traditionally been understood in ordinary and in legal discourse, the principal-agent relationship is a phenomenon of significant scope and economic magnitude. But economic theory has recently recognized that analogous interactions are virtually universal in the economy, representing a significant component of almost all transactions."). A number of studies have recently begun to use agency cost economics to analyze the divergence of interest that often exists among shareholders. *See, e.g.*, Lucian Bebchuk, Reinier Kraakman & George Triantis, *Stock Pyramids, Cross-Ownership, and the Dual Class Equity*, *in* CONCENTRATED CORPORATE OWNERSHIP 295 (R. Morck ed., 2000) (examining the shareholder agency problems created by

and Lynn Stout who have likewise noted the inadequacies of the traditional principal-agent paradigm of the public corporation. Blair and Stout's team production model rightfully expands the analytical framework by considering the full range of interstakeholder conflicts that exist within a firm (for example, shareholder versus managers or shareholder versus bondholder).[14] Their model, however, is expressly limited to public firms and stops short of considering the possibility for *intra*stakeholder conflicts such as those that so critically shape VC investment.[15] Moreover, their team production model continues to view agency problems as essentially stable and concrete.[16] Yet, as VC investment demonstrates, these problems are commonly dynamic and evolving. As noted above, it is the very attempt by investors to manage investor-manager agency risk that creates a second dimension of agency risk among investors themselves.

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the use of controlling minority structures that allow a shareholder or group of shareholders to maintain control of a company while holding less than a majority of the cash-flow rights associated with its equity); Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967 (2006) (examining the agency costs imposed by preferred stockholders on common stockholders in start-up companies); Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 785–86 (2003) (examining the tradeoff between the reduction in managerial agency costs that occurs with the presence of a controlling shareholder and the increase in controlling shareholder agency costs that arise through the extraction of private benefits of control); Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy* 119 HARV. L. REV. 1641, 1651 (2006) (describing as the "second element of the public corporation agency problem . . . the conflict between a controlling shareholder and noncontrolling shareholders over the extraction of private benefits of control—benefits to the controlling shareholder not provided to the minority shareholders"); Armando Gomes, *Going Public Without Governance: Managerial Reputation Effects*, 55 J. FIN. 615 (2000) (analyzing agency problems between controlling shareholders and minority shareholders). Indeed, a large literature now exists demonstrating that the primary agency problem faced by investors in countries outside the United States is not the agency problem between managers and dispersed shareholders but the agency problem posed by controlling shareholders. *See, e.g.*, Sea Jin Chang, *Ownership Structure, Expropriation, and Performance of Group-Affiliated Companies in Korea*, 46 ACAD. MGMT. J. 238, 238 (2003) ("[R]ecent studies have emphasized that the greatest source of agency problems is controlling shareholders, who expropriate value from minority shareholders."); Henrik Cronqvist & Mattias Nilsson, *Agency Costs of Controlling Minority Shareholders*, 38 J. FIN. & QUANTITATIVE ANALYSIS 695, 696 (2003) (noting that "in many countries around the world, the main agency problem is between [controlling minority shareholders] and non-controlling shareholders rather than between managers and small, dispersed shareholders"); Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471, 474 (1999) (finding that "the theory of corporate finance relevant for most countries should focus on the incentives and opportunities of controlling shareholders to both benefit and expropriate the minority shareholders"). For a discussion of agency relationships in agency cost economics, see *infra* note 34.

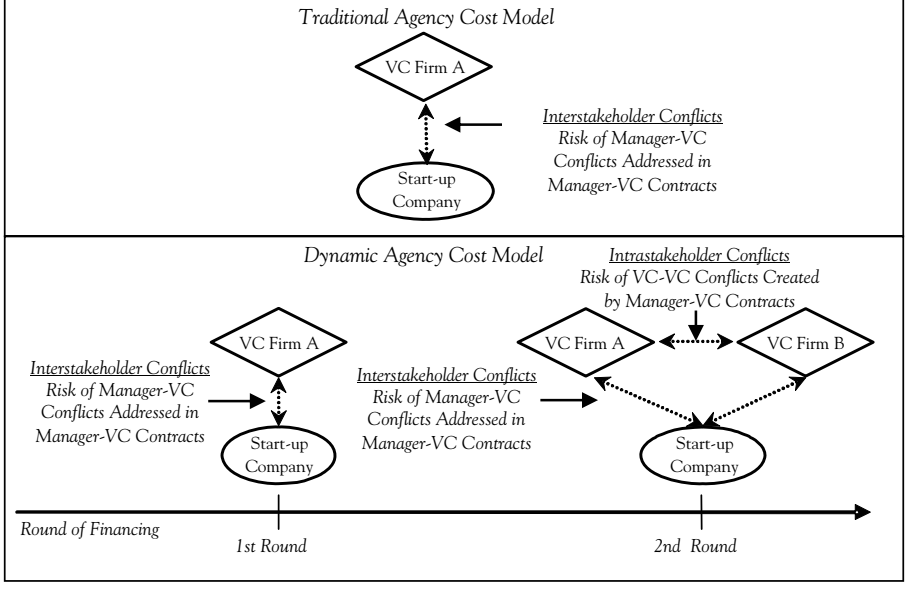
14. For a general description of Margaret Blair and Lynn Stout's team production theory, see Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

15. *See id.* at 280–82.

16. *See infra* text accompanying notes 277–279.

By analyzing the agency problems in VC finance, this Article therefore lays the groundwork for a new model of the firm that incorporates the dynamic formation of both interstakeholder and intrastakeholder conflicts and that applies to all firms, public and private. In general terms, it is a model that views the corporation from the perspective of an investor—be it an investor in capital, labor, or other firm input—who is indifferent with respect to whether a company is publicly held or privately held. Instead, she is concerned with understanding: (1) those constituencies in the corporate entity that have the means to enhance or destroy the value of her investment and will thus serve as the investor's agent in an economic sense; (2) the mechanisms available to align the interests of a particular agent with those of the investor's and to protect against value-destroying actions by the agent; and critically (3) the manner in which these mechanisms might alter the composition of the agents identified in (1) and the related agency problems they pose. Figure 1 sets forth this "dynamic agency cost model" as it applies to VC investment.

Figure 1: Traditional and Dynamic Agency Cost Models of VC Investment



A dynamic agency cost model provides more than just a better descriptive account of the potential agency problems in a firm. As a matter of corporate finance, it provides a significantly more robust means with which to analyze

the nonsystematic risks of corporate investment. Financial contracting theory tells us that when faced with nonsystematic risk such as agency risk, rational investors should respond by contracting against it or discounting the value of the investment.[17] Thus, in the context of VC investment, much of the academic scholarship has sought to develop formal models describing how VC investors can best address investor-manager agency risk.[18] Yet given the reality of both investor-manager *and* interinvestor agency risk, the traditional agency cost model's focus on vertical agency risk with managers necessarily provides us with an incomplete understanding of how VC investors should price and structure VC investments. The dynamic agency cost model remedies this limitation by providing a framework that accounts for the full scope of agency risk in VC investment. As such, it provides the proper starting point for practitioners and scholars alike to analyze how to plan successful VC investments and, more generally, to develop efficient VC economies. That business and contract scholars tend to draw lessons from VC contracting further strengthens the need for an accurate understanding of this important area of corporate finance.[19]

17. *See* AMIR BARNEA ET AL., AGENCY PROBLEMS AND FINANCIAL CONTRACTING 2 (1985).

18. *See, e.g.*, Anat R. Admati & Paul Pfleiderer, *Robust Financial Contracting and the Role of Venture Capitalists*, 49 J. FIN. 371 (1994) (describing a financial model demonstrating optimal use of "fixed-fraction contracts" to resolve agency problems between VC investors and entrepreneurs); Dirk Bergemann & Ulrich Hege, *Venture Capital Financing, Moral Hazard, and Learning*, 22 J. BANK. & FIN. 703 (1998) (describing a financial model demonstrating optimal mixture of debt and equity to address moral hazard risks posed by entrepreneurs); Erik Berglöf, *A Control Theory of Venture Capital Finance*, 10 J.L. ECON. & ORG. 247 (1994) (describing a financial model demonstrating optimal contract design to mitigate investor-manager conflicts of interest); Francesca Cornelli & Oved Yosha, *Stage Financing and the Role of Convertible Securities*, 70 REV. ECON. STUD. 1, 1 (2003) (describing a financial model demonstrating optimal use of convertible securities to minimize management "window dressing" of corporate performance); Thomas Hellmann, *The Allocation of Control Rights in Venture Capital Contracts*, 29 RAND J. ECON. 57 (1998) (describing a financial model demonstrating optimal use of VC control rights to protect against entrepreneur holdups); Klaus M. Schmidt, *Convertible Securities and Venture Capital Finance*, 58 J. FIN. 1139 (2003) (describing a financial model demonstrating optimal use of convertible securities to induce efficient investment by entrepreneurs and VC investors).

19. For instance, the success of VC firms in constructing a system of private ordering with few disputes has led commentators to suggest reform in other legal areas ranging from bankruptcy, *see* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 777 (2002), to close corporations, *see* Shannon Wells Stevenson, *The Venture Capital Solution to the Problem of Close Corporation Shareholder Fiduciary Duties*, 51 DUKE L.J. 1139 (2001). Studies of how to develop VC markets overseas have likewise focused on the need to replicate American-style VC contracts to develop efficient VC economies. *See, e.g.*, Peggy H. Fu, Comment, *Developing Venture Capital Laws in China: Lessons Learned from the United States, Germany, and Japan*, 23 LOY. L.A. INT'L & COMP. L. REV. 487, 495–96 (2001) (noting the importance of the American system of VC contracting to the success of the U.S. VC market); Gilson, *supra* note 9; Haksoo Ko & Hyun Young Shin, *Venture Capital in Korea? Special Law to Promote Venture Capital Companies*, 15 AM. U. INT'L L. REV. 457, 459–62 (2000) (noting the importance of the American system of VC contracting to the success of the U.S. VC market).

For similar reasons, this new model permits a much more nuanced understanding of how investors actually use financial contracts to address company-specific investment risk. Just as the traditional analytical frameworks have obscured the scope of agency risks within a firm, they have likewise limited empirical analysis of how investors use financial contracts to control these risks. Once again, VC scholarship provides a ready example. An impressive body of scholarship now exists that seeks to present a positive account of how VC investors draft VC contracts to protect themselves against investor-manager agency risk.[20] By focusing on investor-manager conflicts, the traditional agency cost model lacks the capacity to explain—indeed, even recognize—the prominent features of VC contracting that arise due to the potential for agency problems among investors. Viewing VC contracts through the lens of the dynamic agency cost model, however, we can see that real-life VC contracts are about much more than controlling investor-manager conflicts—they are also about controlling potential interinvestor conflicts. This perspective allows us to analyze for the first time characteristics of VC contracting that have previously been ignored in VC scholarship. Likewise, the dynamic model permits a fresh look at the reasons for and the effects of many commonly studied provisions of VC contracts that are distinct from the explanations provided by traditional agency cost analysis.[21]

In this regard, the model provides a new perspective on one of the most persistent questions in the academic literature on VC finance: Why do VC investors routinely invest in preferred stock despite its numerous disadvantages?[22] To date, the copious literature on this subject has focused on preferred stock's advantageous tax characteristics and its capacity for aligning the interests of managers and VC investors.[23] Using the dynamic agency cost model, this

20. *See infra* text accompanying notes 48–51.

21. *Cf.* Carney, *supra* note 5, at 10 (arguing that interinvestor conflicts "provide an important explanation for the capital structure of firms, as well as for other contractual arrangements among co-investors, which the agency-cost hypothesis does not entirely explain").

22. *See* Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 875–76 (2003).

23. *See, e.g.*, Berglöf, *supra* note 18, at 247 (providing control theory for preferred stock usage); William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891 (2002) (same); Cornelli & Yosha, *supra* note 18 (finding that convertible securities prevent signal manipulation by entrepreneurs); Gilson & Schizer, *supra* note 22, at 889–901 (providing tax explanation for preferred stock usage); Sahlman, *supra* note 9, at 510 (noting that "[f]lexible conversion terms alter the risk-and-reward-sharing scheme" and encourage entrepreneurs to build value); Thomas Hellmann, *IPOs, Acquisitions and the Use of Convertible Securities in Venture Capital* (Univ. of B.C., Sauder Sch. of Bus., Working Paper No. 1702, 2002), *available at* http://ssrn.com/abstract=257608 (explaining how convertible securities provide an optimal tradeoff between the need to allocate cash flows to VC investors and the desire to make efficient exit decisions); *see also infra* text accompanying notes 68–71.

Article presents another important but overlooked advantage: Preferred stock makes it easier for VC investors to manage contractually interinvestor conflicts. In this light, a long-held corporate doctrine requiring a narrow construction of preferred stock rights presents a troubling problem for efficient VC investment. Narrow construction of preferred stock rights significantly impairs VC investors' ability to use preferred stock to minimize interinvestor agency problems, leaving VC investors little choice but to increase the cost of capital for start-up companies seeking VC investment. As such, courts' adherence to this principle risks interfering with an efficient contracting practice that benefits both VC investors and start-up companies alike.

Finally, as this last point suggests, the dynamic agency cost model has important normative implications for corporate law in general. The existence within a single firm of both interstakeholder and intrastakeholder conflicts places renewed emphasis on the need for governance structures to resolve these conflicts as they arise. While a full analysis of these structures must await a separate exposition, the VC investment experience provides at least two initial insights. First, where corporate participants have themselves sought to mediate these conflicts through express contract provisions, courts do little good by treating these provisions as anything other than contract. To the extent courts rely on doctrines such as the narrow construction of preferred stock rights, they give a meaning to these contract provisions that is potentially distinct from their original intent and thereby risk increasing the agency problems within a firm. Second, the dynamic development of agency problems in VC investment provides a cautionary tale for those who seek to remedy agency problems of any sort. As this Article shows, the very attempt to manage one form of agency problems may itself result in a second, equally troublesome dimension of agency problems among other corporate constituents.

This Article proceeds as follows. Part I provides a brief overview of the traditional agency cost model of VC investment, highlighting how it provides an incomplete explanation for many prominent features of VC finance. Part II sets forth a dynamic agency cost model of VC investment. Specifically, it shows how the investment techniques described in Part I create potential interinvestor conflicts of interest to which VC investors respond by negotiating contract provisions that further increase the potential for investor conflict. Part III examines how the economy following the dot-com bubble turned these potential conflicts into actual conflicts and laid the foundation for a series of interinvestor lawsuits after 2000. These include the landmark case of

Benchmark Capital Partners IV, L.P. v. Vague[24]—one of the most famous lawsuits concerning the VC industry, but until now one that remained unexplained by the traditional agency cost model. After examining the interinvestor dispute underlying *Benchmark*, Part IV moves to an explanation of how VC investors ordinarily rely on preferred stock contracting to resolve these disputes and why this system failed in *Benchmark*. The part continues by examining how the development of interinvestor conflict in *Benchmark* signifies the need to reassess the theory of the firm in corporate legal scholarship.

I. THE TRADITIONAL AGENCY COST MODEL OF VC INVESTMENT

A. How to Make the Entrepreneur a Better Agent

Since William Sahlman published his highly influential article on VC finance in 1990,[25] VC scholarship has been concerned with primarily one question: How do VC investors respond to the extreme uncertainty, information asymmetry, and agency problems inherent in VC investment?[26] From the perspective of intellectual history, the singular obsession with this question is hardly surprising. Fundamentally, the question is rooted in the same challenge that has occupied corporate law scholars and economists for over half a century: How do investors in modern corporations avoid the multiple problems that arise when ownership of the corporation (equity investment) is separated from its control (management)? Appreciation of this challenge, famously articulated by Adolf Berle and Gardiner Means in 1932[27] and subsequently formalized by Jensen and Meckling in 1976,[28] defines the primary analytical framework used in contemporary corporate scholarship.[29]

Alternatively dubbed the "agency cost theory of the firm" and the "nexus-of-contracts" conception of the corporation,[30] this analytical framework

24. No. Civ. A. 19719, 2002 WL 1732423 (Del. Ch. July 15, 2002), *aff'd sub nom.* Benchmark Capital Partners IV, L.P. v. Juniper Fin. Corp., 822 A.2d 396 (Del. 2003).

25. *See* Sahlman, *supra* note 9.

26. *See* Gilson, *supra* note 9, at 1069.

27. *See* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 127 (1932).

28. *See* Jensen & Meckling, *supra* note 8.

29. *See, e.g.*, Blair & Stout, *supra* note 14, at 248 n.1 ("The literature employing the principal-agent approach [to corporate governance] is too voluminous to cite in its entirety."); Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 623 (2004) ("Agency cost theories of the firm dominate the modern literature of corporate law and economics.").

30. In general, legal scholars have demonstrated a propensity for the term "nexus of contracts" while economists have preferred "agency cost theory," although the terms are used interchangeably within both academic camps. Michael Jensen and William Meckling utilized each concept in setting forth the general theory, *see* Jensen & Meckling, *supra* note 8, at 308–11,

models organizations as webs of express, implied, and metaphorical contracts among individuals with conflicting interests.[31] At the center of this web rests the corporation—a legal fiction that serves "as a nexus for a set of contracting relationships among individuals."[32] A critical insight of this approach has been to demonstrate the importance of principal-agent economics for the study of firms.[33] Agency relationships are created among contracting parties because one party (the agent) will ordinarily hold discretionary and unobservable decisionmaking power to affect the wealth of another (the principal).[34] In general, this discretionary power can give rise to two distinct behaviors among the parties to an agency relationship. First, recognizing that an agent may not always act in its best interests, a principal might expend resources to monitor the agent or it might create appropriate incentives that limit divergences from the principal's interest.[35] Second, an agent might seek to "bond" itself to a principal by expending resources to guarantee to a principal that the agent will not take actions that would harm the principal or to ensure that the principal is compensated if the agent takes such

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and all credit them with first developing the framework, *see* Sharon Hannes, *Images of Organizations and Interfirm Externalities: A Comment on Rubin*, 6 THEORETICAL INQUIRIES L. 391, 393 n.4 (2005). This Article uses the term "agency cost theory" because (1) it better emphasizes the principal-agent conflict between investors and managers that is central to corporate scholarship in general and VC scholarship in particular, and (2) it reflects Jensen and Meckling's primary concern with analyzing the scope of agency costs within a firm. *See* Jensen & Meckling, *supra* note 8, at 308–10.

31. *See* Jensen & Meckling, *supra* note 8, at 310–11. For a definitive exposition of this theory in corporate legal scholarship, see FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 1 (1991).

32. Jensen & Meckling, *supra* note 8, at 310.

33. As Jensen and Meckling describe it, "Many problems associated with the inadequacy of the current theory of the firm can also be viewed as special cases of the theory of agency relationships . . . ." *Id.* at 308; *see also* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 291 (1980).

34. *See* Jensen & Meckling, *supra* note 8, at 308 ("We define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent."); *see also* Arrow, *supra* note 13, at 37 (describing an agency relationship as one in which "[t]he action [of the agent] affects the welfare of both the agent and another person, the principal"); John W. Pratt & Richard J. Zeckhauser, *Principals and Agents: An Overview*, *in* PRINCIPALS AND AGENTS, *supra* note 13, at 1, 2 ("Whenever one individual depends on the action of another, an *agency relationship* arises. . . . In many contexts, the agency relationship may be reciprocal."). As this definition indicates, an agency relationship in principal-agent economics is considerably broader than an agency relationship at law. Indeed, Jensen and Meckling suggest that agency relationships need not be limited to contracting parties at all: "Note also that agency costs arise in any situation involving cooperative effort (such as the co-authoring of this paper) by two or more people even though there is no clear cut principal-agent relationship." Jensen & Meckling, *supra* note 8, at 309.

35. *See* Jensen & Meckling, *supra* note 8, at 309.

actions.[36] Monitoring and bonding are not costless, however; nor are they perfect. It is impossible to prevent all divergences between an agent's decisions and those decisions that maximize the principal's welfare. The dollar equivalent of the reduction in economic welfare experienced by a principal due to this residual divergence of interest is also a cost of the agency relationship. The combination of these three costs—monitoring expenditures by a principal, bonding expenditures by the agent, and residual loss—constitute the total agency costs in an agency relationship.[37]

As applied to organizations, agency cost theory proved especially useful in analyzing the conflict that exists between shareholders and managers. Although agency relationships can exist among a variety of organizational participants—shareholders versus bondholders or labor versus management, for example[38]—corporate scholarship has focused primarily on the agency relationship between shareholders and managers in modern public corporations.[39] For instance, shareholder-manager agency conflicts dominate Frank Easterbrook and Daniel Fischel's classic analysis, *The Economic Structure of Corporate Law*.[40] In their view, corporate law should generally defer to the contractual arrangements explicitly or implicitly agreed to among corporate participants, and the agency costs created by the separation of management and risk bearing fundamentally shape these arrangements.[41] Other scholars, holding a less sanguine view of market efficiency, have used the theory to argue for reform efforts that reduce agency costs borne by public company shareholders.[42] Yet even where corporate scholars disagree over the implications of this agency relationship, they share a common predisposition to view it as the central agency relationship within a corporation. Indeed, today the agency cost model is commonly described as relating solely to the agency problems created by the separation between management and risk-bearing equity in public corporations.[43]

36. *See id*.
37. *See id*.
38. *See* JOSEPH T. MAHONEY, ECONOMIC FOUNDATIONS OF STRATEGY 145 (2005).
39. Jensen and Meckling themselves discuss only two agency relationships in setting forth their agency cost theory: the relationship between managers and outside equity and the relationship between managers and debt holders. *See* Jensen & Meckling, *supra* note 8, at 310.
40. EASTERBROOK & FISCHEL, *supra* note 31.
41. *See id*. at 8, 15.
42. *See, e.g.*, Reza Dibadj, *Reconceiving the Firm*, 26 CARDOZO L. REV. 1459, 1473, 1474 (2005) (summarizing literature).
43. *See, e.g.*, John E. Core, Wayne R. Guay & Randall S. Thomas, *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1145 (2005) ("This model rests on the widely accepted agency cost model of the American corporation: diffuse ownership of large corporations leaves substantial discretion in professional managers' hands as to

Although VC investment occurs in private rather than public companies, the influence of agency cost theory is clearly evident in virtually any discussion of VC investment. In general, VC scholarship has focused on the variety of agency problems a VC investor encounters due to the separation between investment and company management. For instance, as a condition of an investor's investment, managers are generally required to transfer a portion of the profits generated from the venture back to the investor.[44] The managers may therefore fail to exert an optimal level of effort.[45] The managers may also have other incentives to use firm resources to create private benefits, to adopt strategies that entail inappropriate levels of risk relative to the expected return, or to threaten to leave the firm at a time when replacement of a manager is costly.[46] Additionally, managers know more about the company and about their own abilities than investors do. This asymmetry of information makes it difficult for VC investors to distinguish between competent and incompetent managers.[47]

Likewise, a primary goal of VC scholarship has been to understand the manner in which VC investors address these agency problems and thereby minimize the agency costs of VC finance. The literature is extensive, ranging from descriptive accounts of VC contracts,[48] to theoretical models of optimal contract design,[49] to testing these models against empirical analyses of VC contracts.[50] Although commentators often differ as to the optimal means to minimize agency costs, there is general consensus that venture capitalists have developed financial contracts that are successful in doing so.[51]

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how to run the company, and managers can use this discretion in ways that do not maximize shareholder value."); *see also* Blair & Stout, *supra* note 14, at 248 ("Contemporary discussions of corporate governance have come to be dominated by the view that public corporations are little more than bundles of assets collectively owned by shareholders (principals) who hire directors and officers (agents) to manage those assets on their behalf.").

44. *See* Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts* 3 (Ctr. for Research in Sec. Prices, Working Paper No. 513, 2000), *available at* http://ssrn.com/abstract=218175.

45. *See* Klausner & Litvak, *supra* note 9, at 56.

46. *See id*.

47. *See* GOMPERS & LERNER, *supra* note 9, at 158.

48. *See, e.g.*, GOMPERS & LERNER, *supra* note 9; Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 253 (1998); Sahlman, *supra* note 9.

49. *See supra* note 18.

50. *See, e.g.*, GOMPERS & LERNER, *supra* note 9, at 171, 241; Bratton, *supra* note 23, at 901; Kaplan & Strömberg, *supra* note 9, at 2177–81; Kaplan & Strömberg, *supra* note 10, at 281 (comparing actual VC contracts to "the assumed and predicted ones in different financial contracting theories"); Smith, *supra* note 10, at 330 (finding that VC contracts conform to hypothesized Aghion-Bolton contingent control model of incomplete contracting).

51. *See* Klausner & Litvak, *supra* note 9, at 58–59.

Specifically, the traditional agency cost model of VC investment has revealed that venture capitalists accomplish this by designing contracts that provide for: (1) the use of staged investment; (2) the use of equity-based compensation; (3) the retention of control and monitoring rights; (4) the sale of convertible preferred stock; and (5) the ability to syndicate investments. What follows is a brief summary of the ways in which these five techniques have been found to address the agency risk inherent in VC investment.

1. Staged Investment

A venture capitalist will typically stage its investment in a start-up company by incrementally investing capital over time after observing the company's progress in relation to its initial projections.[52] As an initial matter, staging its investment allows a VC investor to minimize the risk of investing a large sum in an unfamiliar management team and a business with uncertain prospects. If the business or team disappoints, the VC investor may discontinue funding the company, thereby cutting its losses. Alternatively, to the extent a VC investor decides to finance a troubled company, the VC investor can utilize the new round of financing to acquire additional control rights. Staged investing can therefore provide an efficient contingent control mechanism that permits a VC investor to entrust decision-making power to a company's founders until such time as it becomes optimal for control to shift to a company's VC investors.[53]

Staged investing also provides an important screening and monitoring function. Managers, realizing the consequences of failing to meet their projections, will be less likely to exaggerate a company's prospects in negotiating with a VC investor, and low-quality managers may be deterred altogether

52. *See id.* at 60; *see also* Black & Gilson, *supra* note 48, at 253.

53. *See* Smith, *supra* note 10, at 330–31. The desirability for a contingent control mechanism arises from the challenge of incomplete contracts. The impossibility of writing a contract that specifies the appropriate action for a manager and a VC investor in every future state of nature gives rise to a number of potential problems. For instance, a company manager may seek to continue an existing business strategy (and thereby retain his job) rather than sell the firm following an unanticipated drop in company business. Conversely, a VC investor who holds decisionmaking authority over the firm may decide to sell the firm prematurely when it would be optimal for company managers to grow the business. Professor Smith posits that VC contracts solve this conundrum by utilizing a contingent control mechanism as hypothesized by Philip Aghion and Patrick Bolton in their foundational article on incomplete contracting. Specifically, Smith suggests that staged financing mimics the contingent control mechanism by ensuring that the entrepreneur controls the firm in "good" states of nature and that the VC controls the firm in "bad" states of nature. *See id.* For an articulation of the contingent control model, see Phillipe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473, 476 (1992).

from seeking VC financing.[54] Once an investment is made, staged investment thereafter provides a powerful incentive for managers to meet designated milestones in order to receive future financing.[55] Managers might seek financing from an outside investor, but most commentators believe an existing investor's unwillingness to fund the company provides a negative signal to new investors regarding the company's quality.[56] Moreover, the existing VC investor will likely have negotiated veto rights and rights of first offer on the future issuance of securities that allow the investor to block new equity financings by the company.[57]

2. Equity-Based Compensation

The structure of management compensation provides a secondary means to control the agency risks inherent in VC investing. Management salaries at start-up companies will often be set at relatively low amounts, with a significant component of compensation consisting of stock options or shares of restricted stock that vest over time.[58] By tying management's compensation to the company's overall performance, equity-based compensation is intended to minimize the risk that managers will shirk their duties or pursue private benefits that do not accrue to the company's stockholders generally. Likewise, the vesting provisions provide an incentive for managers to retain their employment, thereby minimizing the risk of untimely management departure.[59]

3. Control and Monitoring Rights

A VC investor also seeks to mitigate agency risk with company managers through negotiating control and monitoring rights that are disproportionate to its stock ownership. Steven Kaplan and Per Strömberg found in their analysis of 213 VC investments in 119 start-up companies that a VC investor obtained the right to a seat on the company's board of directors in over 40 percent of the financing transactions and controlled the board in 25 percent.[60] Additionally, a VC investor typically obtains special stockholder voting rights (or "protective provisions") allowing the investor to veto important corporate

54. *See* Klausner & Litvak, *supra* note 9, at 60.
55. *See id*.
56. *See id*. *But see infra* text accompanying notes 113–117 (noting existing investors may stop funding a company without necessarily harming its fundraising ability).
57. *See* Klausner & Litvak, *supra* note 9, at 60.
58. *See id*. at 62.
59. *See id*.
60. *See* Kaplan & Strömberg, *supra* note 10, at 287–89.

actions.[61] The scope of these protective provisions differs from company to company, but a VC investor will commonly have veto rights over the issuance of securities, asset sales, mergers, or other important corporate transactions.[62] Lastly, the practical effect of staged financing supplements these formal control rights; by controlling a company's funding spigot, a VC investor gains considerable influence over the development of a company's business.[63]

4. Use of Convertible Preferred Stock

In making an investment, a VC investor generally acquires shares of a company's convertible preferred stock.[64] Preferred stock entitles a VC investor to numerous preferential economic rights such as a liquidation preference payable in the event of the company's liquidation or sale,[65] preferential dividend rights, redemption rights, and antidilution protection.[66] Ordinarily, shares of preferred stock are convertible at the option of the holder into shares of common stock, at which time all preferential rights are lost.[67]

Financial economists have extensively modeled the manner in which these preferred stock rights help address the agency costs and information asymmetries typical of VC investing.[68] Prior to a manager approaching a venture capitalist, the preferential economic rights provide a screening function by discouraging low-quality entrepreneurs from seeking VC financing.[69]

61. *See* Douglas G. Smith, *The Venture Capital Company: A Contractarian Rebuttal to the Political Theory of American Corporate Finance?*, 65 TENN. L. REV. 79, 87–89 (1997).

62. *See, e.g.*, Nat'l Venture Capital Ass'n, Amended and Restated Certificate of Incorporation 17–18 (May 2006), http://www.nvca.org/model_documents/Charter%20Rev%203.DOC [hereinafter NVCA Model Charter] (providing investor veto rights over the following actions: liquidation; dissolution; change in control; charter or bylaw modifications; creation or issuance of securities; purchase or redemption of securities; or change in number of directors). The number of protective provisions requested by a VC investor may often be tied to an investor's geographic focus. A well-known generalization among practitioners is that East Coast VC investors tend to request significantly more control rights than West Coast investors. As the general counsel to Charles River Ventures, Inc., jests, "From the West Coast perspective, [East Coast VC firms] look like control freaks, who are simply going to be unhelpfully interfering with and impeding what should just be routine corporate matters." Sarah Reed, *Will West Ever Meet East?: Bicoastal Conflict in the Jargon of Venture-Capital Financing*, BUS. L. TODAY, May/June 2002, at 24, 27.

63. *See* Gilson, *supra* note 9, at 1069.

64. *See* Kaplan & Strömberg, *supra* note 10, at 286 (reporting that convertible preferred stock was used in 95 percent of their sample financing transactions).

65. For a discussion of liquidation preferences, see *infra* text accompanying notes 106–107.

66. For a discussion of antidilution protection, see *infra* text accompanying note 153.

67. In general, a VC investor will have no incentive to convert its shares of preferred stock into common stock until a company's Initial Public Offering (IPO), at which time a company's underwriters will require the conversion of all shares of preferred stock. *See infra* note 138.

68. For a summary of this literature, see *supra* text accompanying note 23.

69. *See* Klausner & Litvak, *supra* note 9, at 64.

Similarly, after an investment has been made, these preferential rights create an incentive for management to meet the company's financial projections. They do so by forcing managers to face a greater risk of realizing little value on their common stock interests unless the company performs well.[70] Ronald Gilson and David Schizer have also found that the use of preferred stock enhances the incentive effect of common stock options. In particular, the preferred stock rights allow a company to issue common stock to an employee at a fraction of the price of the preferred stock without any adverse tax consequences to the employee.[71]

5. Syndication of Investments

Lastly, VC investors reduce the agency risk of VC investment through investment syndication.[72] In general, investment syndication takes one of two forms. First, upon identifying a promising start-up company, a VC investor will commonly syndicate the investment by sharing the opportunity with other investors. Second, as the company grows and requires additional financing, the company and its VC investors will solicit a new investor to lead each round of financing, with existing investors co-investing alongside it.[73] Thus, Paul Gompers and Josh Lerner have found that an average of 2.2 VC firms invest together at a company's first stage of financing; at the second stage, an average of 3.3 invest together; and in later stages, the average increases to 4.2.[74]

Syndication reduces agency risk for VC investors in a variety of ways. Perhaps most importantly, by sharing an investment opportunity with other investors, a VC investor reduces its exposure to the firm-specific agency risk it would otherwise bear if it made the entire investment on its own. Similarly, syndication ensures that as a company matures, its future capital requirements do not create undue exposure to firm-specific agency risk for its existing investors. At the same time, VC investors commonly reciprocate investment invitations, suggesting that syndication helps VC investors diversify their investment portfolios.[75]

70. *See id.* at 65–66.
71. *See* Gilson & Schizer, *supra* note 22, at 889–909.
72. *See* Klausner & Litvak, *supra* note 9, at 66–67.
73. *See* Joshua Lerner, *The Syndication of Venture Capital Investments*, 23 FIN. MGMT. 16, 18 (1994).
74. *See* GOMPERS & LERNER, *supra* note 9, at 261.
75. *See* Olav Sorenson & Toby E. Stuart, *Syndication Networks and the Spatial Distribution of Venture Capital Investments*, 106 AM. J. SOC. 1546 (2001).

Additionally, syndication may play a role in reducing the information asymmetries inherent in VC investment. Empirical studies of syndication patterns indicate that older and larger VC firms tend to syndicate with one another,[76] suggesting that VC investors syndicate to obtain each other's judgment with respect to particular investment opportunities.[77] Likewise, the use of a new investor to lead subsequent financing rounds facilitates each financing by having an outside third party set the investment terms. This aspect of syndication also promotes a screening function for the new investor; the new investor may use the willingness of existing investors to co-invest as a signal of the company's perceived quality among its existing investors.[78]

B. Limitations of the Traditional Model

Although the traditional agency cost model explains many prominent features of VC contracting, it omits much. Indeed, adherents of the model have themselves noted that "real world" VC contracts are more complex than the model predicts.[79] One hardly need look far to find a number of these common, unexplained features of VC contracts.

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76. *See* GOMPERS & LERNER, *supra* note 9, at 261–66.

77. *See* Klausner & Litvak, *supra* note 9, at 66.

78. *See id.* at 67. While each of the aforementioned contracting techniques helps VC investors minimize agency risk, they also give rise to the possibility that the venture capitalist may use the contract rights opportunistically to extract concessions from management. Most commentators that have examined this issue generally conclude that reputational concerns likely constrain an investor from acting opportunistically toward management. *See* PAUL A. GOMPERS & JOSH LERNER, THE MONEY OF INVENTION 12 (2001) ("[W]hile the controls that venture capitalists demand may be essential, they also create the potential for abuse. A venture capitalist's reputation for fairness is the only assurance an entrepreneur has of being treated with respect."). The intuition is that a VC investor who acts opportunistically toward management in one company will obtain a reputation for opportunism among other managers. This could result in the VC investor receiving fewer invitations from managers to finance promising companies, particularly in a community of venture capitalists and entrepreneurs known for its small size and geographic concentration. *See id.* at 13–14. *But see infra* text accompanying notes 224–226 (noting the significant growth and fluidity of the VC community). Venture capitalists themselves have often expressed a similar sentiment that reputational concerns encourage VC investors to act fairly toward company management. *See, e.g.*, Alistair Christopher, *Founders Face Dilution in Follow-on Financings*, VENTURE CAPITAL J., Nov. 2001, at 10, 10–11 (quoting investor as stating, "You always worry about the founders, because it is your reputation as a firm that is on the line, so it is a small price to pay to treat founders fairly"); Bart Schachter & George Hoyem, *What VCs Can Learn from Their Cousins in Buyouts,* VENTURE CAPITAL J., Sept. 2004, at 41, 41 ("In an industry where reputation is everything, many VCs don't want to harm their reputations by alienating management. After all, their very next deal might be sourced by a friend of the CEO whose job is now on the line.").

79. Kaplan & Strömberg, *supra* note 10, at 307–08.

For instance, the VC practitioner literature is replete with articles discussing a contracting provision called a "pay-to-play."[80] A pay-to-play penalizes a company's existing VC investors who fail to participate at a prespecified amount in a subsequent stage of a company's financing. The penalty ordinarily consists of the loss of certain preferential rights (such as an investor's antidilution protection) but may also consist of the automatic conversion of a nonparticipating investor's preferred stock into common stock, thereby stripping the investor of all preferential rights.[81]

To date, neither financial economists nor legal academics have analyzed this provision—a peculiar result given that it impairs a VC investor's ability to control investor-manager agency risk through staged financing. Arguably, the provision would be consistent with the traditional agency cost model if managers demanded the provision to protect themselves against potential opportunism by VC investors.[82] Yet a pay-to-play provision applies only if a sufficient number of a company's *VC investors* approve a financing—approval by the company's management is irrelevant. Moreover, in practice it is VC investors and not managers who typically demand the term. In a discussion of "[venture capital] terms that really matter," the managing director and general counsel of one prominent VC firm explain why:

> When our co-investors push back on this term, we ask: "Why? Are you not going to fund the company in the future if other investors agree to?" . . . A pay-to-play term insures that all the investors agree in advance to the "rules of engagement" concerning participating in future financings.[83]

The traditional agency cost model fails to explain why it is necessary to establish these rules of engagement with other investors or why VC investors might differ with regard to participating in future financings.

Similarly, the traditional agency cost model says little about why a company's VC investors would routinely bargain with each other over the distribution of preferred stock rights among investors participating in the company's different stages of financing. Indeed, adherents of the traditional model generally ignore the fact that start-up companies commonly grant different

80. *See, e.g.*, Colin Blaydon & Michael Horvath, *Bury the Ratchets*, VENTURE CAPITAL J., Jan. 2002, at 11, 12 (discussing pay-to-play); John R. LeClaire et al., *WatchMark Ruling Clarifies Pay-To-Play*, VENTURE CAPITAL J., Apr. 2005, at 43, 43 (noting that "[r]ecent times have seen a surge in the use of 'pay-to-play' techniques in private company financing rounds").

81. For an example of a pay-to-play provision, see the NVCA Model Charter, *supra* note 62, at 32–34.

82. *Cf. supra* note 78.

83. Posting of Brad Feld to Feld Thoughts, Term Sheet: Pay-To-Play, http://www.feld.com/blog/archives/2005/03/term_sheet_payt.html (Mar. 22, 2005, 06:46 PST).

preferential rights to their investors at each stage of financing.[84] Those commentators who have studied the issuance of preferred stock over multiple stages have tended to focus on the different agency costs and information asymmetries VC investors seek to control at each stage. For instance, Gompers and Lerner have found that VC investors in late-stage financings permit more time to elapse between a company's financing stages, as later-stage companies tend to demonstrate fewer agency risks and therefore require less monitoring by VC investors.[85] Conversely, Kaplan and Strömberg have argued that VC investors increase their cash flow and control rights in later financing rounds, demanding from managers "more equity and control as compensation for providing additional funding."[86] Each study analyzed a company's VC investors as a homogenous whole; therefore, none studied the way in which these stage-specific rights are specifically allocated among different VC investors.

Even a cursory look at several recent VC investments reveals that much of the complexity of VC contracting stems from this allocation of preferential rights. Between January 1, 2001 and December 31, 2004, 155 U.S. start-up companies completed an IPO after having completed more than one round of VC financing.[87] Analysis of these companies' capitalization histories reveals a

84. For instance, in their highly influential work on VC contracting, Ronald Gilson and David Schizer use a single-stage investment framework to demonstrate how U.S. tax laws encourage the use of preferred stock in the VC industry. Their framework depicts a VC investor making a $1 million investment in a start-up company in which the investor receives the preferred stock rights described in Part I.A. After demonstrating the limited economic significance of these preferential rights, Gilson and Schizer argue that U.S. tax authorities nevertheless respect these formal economic rights and would allow the start-up company to report a lower valuation for the company's common stock because of them. This low valuation, in turn, permits the issuance of "cheap" common stock to company managers, allowing them to report any appreciation in the stock as (lower-taxed) capital gains rather than (higher-taxed) ordinary income. *See* Gilson & Schizer, *supra* note 22, at 889–909. As with most proponents of the traditional agency cost model, however, Gilson and Schizer refrain from analyzing how the issuance of preferred stock in multiple stages of financing might affect the economic significance of a company's preferred stock. As discussed in Part III, the issuance of multiple series of preferred stock over time can result in truly worthless common stock.

85. *See* GOMPERS & LERNER, *supra* note 9, at 183–92.

86. Kaplan & Strömberg, *supra* note 10, at 313.

87. The sample was constructed from a search of the Global New Issues database maintained by the Securities Data Corporation. The sample includes all issuers in the database that are listed as having completed an IPO of common stock on a U.S. exchange between January 1, 2001 and December 31, 2004, and as having received at least two prior rounds of VC financing. Companies organized outside the United States (or that have their headquarters outside the United States) were excluded from the sample on the basis that non-U.S. securities regulations and tax laws often prevent these issuers from issuing preferred stock. Information concerning each company's capitalization history was obtained by separately examining the company's registration statement filed with the Securities and Exchange Commission (SEC). Under Rule 601 of Regulation S-K, an issuer must file a number of exhibits to its registration statement including most VC contracts (in particular, the company's charter), and Regulation S-X requires that all

typical capital structure that is considerably more complex than that ordinarily depicted in the traditional agency cost model. As predicted by the model, 151 (97 percent) of the companies in the sample issued preferred stock to their VC investors. What is universally ignored in the model, however, is the fact that for 141 (91 percent) of these companies, the preferred stock was issued in more than one series (for example, Series A, Series B, and so on).

Examination of these different series of preferred stock reveals real economic differences in their terms. An example appears with FormFactor, Inc., a start-up company that completed its IPO in 2003 and whose registration statement contained a large amount of information concerning its prior VC financings.[88] From 1996 through 2001, FormFactor conducted seven stages of financing, issuing a separate series of preferred stock at each stage beginning with "Series A Preferred Stock" and ending with "Series G Preferred Stock." FormFactor's VC contracts reflect clear bargaining among its VC investors over the distribution of preferred stock rights among these different series. For instance, with regard to liquidation preferences, proceeds of a liquidation or acquisition of FormFactor were to be distributed according to Figure 2.[89]

Figure 2: Liquidation Preferences of FormFactor, Inc.

Liquidation Preference	*Recipient*
First $76,000,000 of proceeds	Holders of Series D–Series G Preferred Stock
Next $13,000,000 of proceeds	Holders of Series B and Series C Preferred Stock
Next $270,898 of proceeds	Holders of Series A Preferred Stock
Any remaining proceeds	Holders of Series A Preferred Stock and Common Stock

If, as the traditional agency cost model suggests, liquidation preferences are about managing investor-manager conflicts, why would VC investors so carefully structure this hierarchy of payouts among the different series?

financial statements filed as part of a registration statement include footnote disclosures regarding the terms of the company's outstanding preferred stock. *See* 17 C.F.R. § 210.5-02(28)–(29) (2006).

88. Data concerning FormFactor's VC financings was obtained from the financial statements and exhibits included as part of its S-1 Registration Statement. *See* FormFactor, Inc., Amendment No. 9 to Form S-1 Registration Statement (June 11, 2003), *available at* http://www.sec.gov/Archives/edgar/data/1039399/000089161803002950/f80848a9sv1za.htm [hereinafter FormFactor Registration Statement].

89. The liquidation preferences for Series B through Series G Preferred Stock set forth in Figure 2 include amounts payable from accrued but unpaid dividends. Because the issuance date for each share of preferred stock was not provided in the registration statement, the amount of accrued dividends was estimated based on information provided in FormFactor's financial statements. *See id*. at F-17 to F-18.

Regardless of the order in which preferences are paid, the liquidation preferences should have the same incentive effect on managers who hold common stock, the most junior security. Likewise, significant bargaining appears to have occurred with regard to which series of preferred stock would be entitled to elect investor-representatives to the board of directors.[90] The negotiated arrangement of board representation is in marked contrast to the description of VC investors' board rights found in most VC scholarship where VC investors are analyzed collectively to determine the extent to which they control the board of directors.[91] If FormFactor's VC investors were uniformly aligned in their interest to maximize wealth, why would they create this complicated structure of board representation? FormFactor's charter also makes clear that when a company's later-stage VC investors received special preferential rights, earlier preferred series did not necessarily receive the benefit of these new rights. For instance, only the holders of FormFactor's Series D through Series G Preferred Stock were entitled to antidilution protection. Once again, if preferential investor rights were primarily about containing investor-manager conflicts, why would FormFactors' VC investors grant certain preferential rights to one class of investors but not to others?

Lastly, the traditional agency cost model does little to explain the several lawsuits commenced by VC investors in recent years against other VC investors involving a joint start-up company investment. The economic downturn following the turn of the century led to a variety of lawsuits against VC investors concerning their investments in start-up companies.[92] Many of these cases involved suits by managers against a company's VC investors, often alleging that VC investors opportunistically utilized preferential rights to effect self-dealing transactions.[93] In several of the cases, however, the plaintiffs have been VC investors seeking redress against their co-investors in a start-up company.[94]

90. Under FormFactor's charter, one director was to be elected by holders of a majority of the Series B Preferred Stock; one director by holders of 70 percent of the Series D Preferred Stock; two directors by the holders of the Series A Preferred Stock and Common Stock (voting together on an as-converted basis); and one director by the holders of Common Stock and all Preferred Stock (voting together on an as-converted basis). *See* FormFactor, Inc., Form S-1 Amended and Restated Certificate of Incorporation, Exhibit 3.01, at 6 (June 17, 2003), *available at* http://www.sec.gov/Archives/edgar/data/1039399/000089161803005288/f93550orexv3w01.txt [hereinafter FormFactor Certificate].

91. *See supra* text accompanying note 60.

92. In a 2002 survey of court filings, the *Venture Capital Journal* identified fourteen "recent or active lawsuits involving VCs." Charles R. Fellers, *VCs Mired in Litigation of Their Own Making*, VENTURE CAPITAL J., Nov. 2002, at 5, 5.

93. *See id*.

94. For instance, in profiling nine of the fourteen lawsuits it identified, the *Venture Capital Journal* revealed that four of the nine suits involved interinvestor disputes concerning a VC financing. *See id*.

Given the potential for VC investor opportunism created by investors' contract rights described in Part I.A,[95] the traditional agency cost model readily explains why a manager might bring suit against VC investors. However, no analytical framework exists to explain the reasons why a VC investor might initiate a lawsuit against a fellow VC investor over a start-up company investment.

Thus, to better understand the structure of VC finance and its concomitant challenges for VC investors, a more nuanced model of VC investment is required. As the following part suggests, the key to building such a model is in departing from the common assumption that VC investors necessarily share unified economic interests. For the scholar of closely held corporations, it is perhaps an obvious point given the history of shareholder-shareholder conflicts that has bedeviled such companies. Yet in the context of VC finance, even where scholars have recognized the possibility that investor conflicts may exist, they have assumed away these conflicts to simplify their analysis of investor-manager agency problems.[96] In so doing, however, VC scholarship overlooks the manner in which VC contracts systematically seek to address the familiar problem of conflict among equity investors in a closely held corporation.

II. A DYNAMIC AGENCY COST MODEL OF VC INVESTMENT

By relaxing the assumption that a company's VC investors act as a unified whole, it is possible to modify the traditional agency cost model of VC investment to account for the unexplained features of VC finance noted in Part I.B. Under this new model, VC contracts reflect not only VC investors' attempts to address investor-manager conflicts but also the conflicts that arise among a company's VC investors. Indeed, as shown below, the very contract provisions that address conflicts with a company's managers create the potential for interinvestor conflict.

Before proceeding further, it is useful to clarify how an interinvestor conflict can exist among a company's investors and thereby give rise to a horizontal agency problem. In general, an interinvestor conflict can arise whenever a company action stands to benefit or cost one investor in a manner that is different from the benefit or cost realized by another investor. A clear example is when a VC division of a public corporation co-invests with traditional VC investors in a company with which the public corporation has

95. *See supra* note 78.
96. *See supra* text accompanying note 10.

a strategic relationship.[97] In the event a competitor of the public corporation seeks to acquire the company, the interests of the corporate investor will undoubtedly differ from those of the company's traditional VC investors. While the corporate VC investor may object to the acquisition for competitive reasons, the other VC investors will desire the acquisition if it results in a significant return on their investment.[98]

Although these direct interinvestor conflicts exist in certain contexts, the focus of this Article is on a more subtle and pervasive form of interinvestor conflict that exists among even traditional VC investors. Two features of virtually all VC funds, when combined with the techniques venture capitalists use to manage agency risk with managers, give rise to these conflicts. Both features stem from the attempt by limited partners (LPs)[99] in a VC fund to protect against the risk that a venture capitalist will himself be a poor agent of the LPs.

First, VC funds are constrained with respect to both time and capital in their start-up company investments (the capital-time investment constraint). VC funds are limited in duration (funds ordinarily have a ten-year life) and have a limited amount of capital with which to make investments.[100] By imposing these limitations, LPs minimize their downside risk if they invest in a poorly performing fund, and they also create a strong performance incentive for the venture capitalist. Only by posting acceptable returns for a fund will a venture capitalist be able to market future funds to LPs and thereby continue in business.[101]

Second, in addition to these implicit incentives, VC funds provide explicit incentives for a venture capitalist to achieve positive investment returns (the investment return incentives). Specifically, a venture capitalist's incentive

97. During 2003, corporate VC investors accounted for direct investments of $1.1 billion, or 6.3 percent of all VC investments. *See* THOMSON VENTURE ECON., 2004 NATIONAL VENTURE CAPITAL ASSOCIATION YEARBOOK 38 (2004) [hereinafter NVCA YEARBOOK].

98. To prevent a corporate investor from blocking such a transaction, venture capitalists often require corporate VC investors to sign a drag-along agreement, in which an investor agrees to vote for any acquisition that is approved by stockholders holding a specified amount of preferred stock. *See, e.g.*, Nat'l Venture Capital Ass'n, Amended and Restated Voting Agreement 5–8 (May 2006), http://www.nvca.org/model_documents/Voting%20Agmt%20Rev%203.DOC (providing for drag-along right).

99. VC funds are generally organized as limited partnerships. *See* David Rosenberg, *Venture Capital Limited Partnerships: A Study in Freedom of Contract*, 2002 COLUM. BUS. L. REV. 363, 365 (2002). In the interest of simplicity, this Article will use the term "limited partners" or "LPs" when referring to investors in these funds.

100. *See* Sahlman, *supra* note 9, at 489–91.

101. A number of studies have examined the manner in which the capital-time investment constraint provides a "powerful incentive for venture capitalists to produce profits [on VC funds]." Rosenberg, *supra* note 99, at 396. For a summary of this scholarship, see *id.* at 394–98.

compensation (or "carried interest") creates a powerful incentive to focus on posting positive returns for each VC fund. The carried interest ordinarily entitles a venture capitalist to receive a specified percentage (commonly 20 percent) of a fund's realized profits.[102] As a result, the primary means for a venture capitalist to share in the success of the fund is to achieve a net positive return on the fund's start-up company investments.

The capital-time investment constraint and the investment return incentives contribute to the formation of interinvestor conflicts in the following manner. First, as described in more detail in Part II.A, investment syndication and the staging of investments ensure that a company's VC investors will hold different amounts of the company's preferred securities that are issued at each stage of financing. Next, because these securities are commonly issued at different prices at each stage of financing, the capital-time investment constraint and the investment return incentives encourage a company's VC investors to develop conflicting interests concerning the price at which they should sell these securities through a company exit event (such as an IPO or sale of the company), and the price at which the company should issue securities in the future. The fact that these securities are issued at different times may also create conflicts among a company's investors due to the capital-time investment constraint: Investors who purchase securities in earlier stages of financing may be more limited in their ability to support the company in future financings or to wait for an acceptable exit event.

The potential divergence of investor interests can give rise to significant agency problems among investors given the control rights routinely demanded by VC investors to minimize manager-investor conflicts. The VC investors who hold the control rights outlined in Part I.A.3 may have economic interests that differ from other VC investors owing to the capital-time investment constraint and investment return incentives. Consequently, the possibility exists that these control rights may be used in a manner that adversely affects the wealth of a particular group of investors in much the same way that a manager may use his or her discretionary decisionmaking power to adversely affect the wealth of all stockholders. This is especially true with regard to a VC investor's control rights over exit events and future financings where the potential for interinvestor conflict is at its greatest. To address this potential horizontal agency problem, VC investors having divergent economic interests therefore seek to retain their own set of control rights to protect their particular interests. Yet as shown below, these carefully negotiated provisions are at best imperfect solutions to resolving interinvestor conflict

102. *See* GOMPERS & LERNER, *supra* note 9, at 67–70.

and may even accentuate interinvestor conflict in certain circumstances. Indeed, it is this underlying imperfection in VC contracting that laid the foundation for the interinvestor disputes that occurred following the economic downturn in 2001.

Before turning to these contract provisions and the conflicts they address, however, it is first necessary to examine more closely how the combination of staged investment and investment syndication leads a company's VC investors to acquire over time different amounts of a company's differently priced securities.

A. The Economics of Staged Investment and Investment Syndication: An Example

Assume EarlyFund, a VC investor, has agreed to invest $5,000,000 in NewCo, a newly formed start-up company. As an initial matter, EarlyFund and NewCo must determine the company's valuation following this agreement.[103] The valuation will determine the amount of the company purchased by EarlyFund and, consequently, the extent to which the new capital infusion reduces or "dilutes" the ownership interest of NewCo's existing stockholders. For instance, assuming EarlyFund values NewCo at $10,000,000, EarlyFund's $5,000,000 investment will purchase equity representing 33.3 percent of NewCo's ownership ($5,000,000 investment ÷ ($10,000,000 valuation + $5,000,000 investment)).[104] The ownership interest of NewCo's existing stockholders will correspondingly be reduced from 100 percent to 66.6 percent.

EarlyFund and NewCo will use this valuation to determine the price per share of the preferred stock issued to EarlyFund in the financing. To calculate this price, the valuation must be divided by NewCo's total number of shares of common stock outstanding.[105] Assuming there are 10,000,000 shares of common stock outstanding, a $10,000,000 valuation yields a price per share

103. *See* Posting of Brad Feld to Feld Thoughts, Venture Capital Deal Algebra, http://www.feld.com/blog/archives/2004/07/venture_capital.html (July 7, 2004, 00:56 PST).

104. In contrast, if EarlyFund values NewCo at $15,000,000, it would purchase equity representing only 25 percent of NewCo's ownership ($5,000,000 investment ÷ ($15,000,000 valuation + $5,000,000 investment)).

105. For this purpose, the number of shares of common stock outstanding ordinarily includes the number of shares of common stock that may be issued contingently, such as shares reserved for issuance under a stock option plan and shares that may be issued upon conversion of outstanding shares of preferred stock. The definition of "common stock outstanding" for this equation is often highly negotiated between a VC investor and a start-up company. In particular, differences may arise concerning the treatment of contingent rights (such as warrants to purchase common stock or a proposed option plan increase). A VC investor may argue that all contingent issuances be included in the number of shares of common stock outstanding, thereby decreasing the price per share and increasing the percentage of the company purchased in the new financing.

of $1.00 ($10,000,000 valuation ÷ 10,000,000 shares). NewCo will therefore issue to EarlyFund 5,000,000 shares of preferred stock at $1.00 per share in exchange for EarlyFund's $5,000,000 investment.

Once established, the $1.00 price per share determines a number of economic rights provided to EarlyFund. For instance, assuming EarlyFund negotiates a liquidation preference, each share of preferred stock will be entitled to a specified dollar amount per share prior to any payment on the company's common stock in the event of NewCo's liquidation or acquisition. Traditionally, this dollar amount would equal the per-share price paid by EarlyFund, or $1.00.[106] Similarly, EarlyFund may negotiate antidilution protection to protect itself against the dilution that will occur if NewCo issues lower-priced stock in the future. If negotiated, the preferred stock will contain antidilution protection that applies only if NewCo issues stock in the future at a price below $1.00 per share.[107]

As NewCo undergoes additional rounds of staged financing, the economic rights negotiated in each stage will similarly be tied to the price per share of the preferred stock sold. Obviously, if the price of preferred stock changes in each financing, tracking these preferred stock rights can become quite complicated. As a result, the preferred stock authorized by NewCo will consist of a special series of preferred stock to segregate the rights of EarlyFund from the preferred stock rights of future investors. As this is NewCo's first round of financing, we will assume it adopts the common industry practice of authorizing a new series of "Series A" Preferred Stock to sell to EarlyFund.[108]

One year later, assume NewCo has successfully met its financial projections and is in need of additional financing. In consultation with EarlyFund, NewCo's managers determine that an additional $10,000,000 of capital is required to complete NewCo's product development. Through the assistance of EarlyFund, NewCo identifies a new VC investor, LaterFund, to lead this "Series B" financing. Although LaterFund will be the lead VC investor, EarlyFund also agrees to purchase its pro rata share in the Series B financing, or 33 percent of the $10,000,000 offering.[109] As discussed above, this commitment

106. *See* Lee F. Benton et al., *Hi-Tech Corporation: Amended and Restated Certificate of Incorporation*, *in* 1 VENTURE CAPITAL & PUBLIC OFFERING NEGOTIATION 8-1, 8-13 (Michael J. Halloran et al. eds., 3d ed. Supp. 2004) [hereinafter Hi-Tech Charter].

107. For a description of antidilution protection, see *infra* text accompanying note 153.

108. *See* Hi-Tech Charter, *supra* note 106, at 8-13.

109. Several studies have examined the tendency of VC investors to purchase their pro rata share of a later-stage offering. *See* Admati & Pfleiderer, *supra* note 18, at 373–74 (offering formal model for why VC investors tend to purchase their pro rata share in follow-on rounds of financing); Lerner, *supra* note 73, at 23–24 (examining tendency of VC investors to purchase their pro rata share in follow-on financings). For purposes of this example, EarlyFund's pro rata share is defined to mean the Series B investment amount that keeps its ownership stake in NewCo the same as before the financing. In actuality, the definition of pro rata share can be a subject of heated debate among a

assures LaterFund that EarlyFund supports the company's business. The commitment also allows EarlyFund to maintain a significant equity position in a company that is successfully executing its business plan.

As in the Series A financing, NewCo and LaterFund must negotiate the valuation of NewCo for the Series B financing. Given that NewCo has successfully met its financial projections, LaterFund agrees to a higher valuation of $30,000,000. Assuming NewCo has not issued stock since its last financing, this new valuation results in a price per share of $2.00.[110] In addition, LaterFund, like EarlyFund in the Series A financing, will demand that it purchase preferred stock in the financing to protect against potential agency risks. NewCo will therefore create a new class of Series B Preferred Stock to sell in the financing. As before, its terms will reflect the economic rights negotiated by LaterFund and will be tied to the $2.00 price per share. For example, if LaterFund negotiates the same liquidation preference provided to EarlyFund, each share of Series B Preferred Stock will be entitled to receive $2.00 per share prior to any payment on the company's common stock in the event of the company's liquidation or acquisition. Likewise, the Series B antidilution protection will apply only if the company issues stock at a price that is less than $2.00 per share.

Given EarlyFund's commitment to purchase its pro rata share, EarlyFund will purchase 1,666,667 shares of Series B Preferred Stock for approximately $3,333,333. LaterFund will purchase the remaining 3,333,333 shares for approximately $6,666,666. After the financing, the company's stockholders will therefore hold the following securities:

Figure 3: Capitalization of NewCo Following NewCo's Series B Financing

	Series A Preferred Stock		Series B Preferred Stock		Common Stock		Total	
Stockholder	*Shares*	%	*Shares*	%	*Shares*	%	*Shares*	%
EarlyFund	5,000,000	100%	1,666,667	33.3%	0	0%	6,666,667	33.3%
LaterFund	0	0%	3,333,333	66.6%	0	0%	3,333,333	16.7%
Founders	0	0%	0	0%	10,000,000	100%	10,000,000	50.0%
Total	5,000,000	100%	5,000,000	100%	10,000,000	100%	20,000,000	100%

company's investors. *See* Posting of Seth Levine to Feld Thoughts, What Does Pro-rata Mean?, http://www.feld.com/blog/archives/2004/09/what_does_prora.html (Sept. 3, 2004, 06:02 PST).

110. As in the initial financing, the price per share is determined by dividing the "pre-money" valuation (here, $30,000,000) by the total number of shares of common stock outstanding calculated on an as-converted-to-common stock basis. *See supra* note 105. NewCo has outstanding 10,000,000 shares of common stock and 5,000,000 shares of preferred stock, resulting in a total of 15,000,000 outstanding shares on an as-converted-to-common stock basis.

As shown in this example, the combination of staged investing and investment syndication results in EarlyFund and LaterFund holding significantly different amounts of the differently priced Series A and Series B Preferred Stock. Three factors typical of VC investment contributed to this outcome.

First, NewCo's valuation changed from the Series A financing to the Series B financing. A fundamental principle of VC investment is that the valuation of a company successfully meeting its milestones will increase at each stage of financing.[111] Conversely, a company failing to meet its milestones will experience a decline in valuation.

Second, LaterFund missed the opportunity to purchase securities at the Series A valuation; if it wanted to invest in the company, it could purchase only the Series B Preferred Stock at $2.00 per share. This is an obvious consequence of syndication. Each new investor will be limited to purchasing securities with a purchase price reflecting the current company valuation. In general, this means that new investors buy a new and differently priced security than a company's existing investors hold.

Lastly, LaterFund invested significantly more in the Series B financing than EarlyFund. A new investor commonly requires a company to offer it a significant portion of the later-round financing to ensure that it acquires a meaningful financial stake in the company.[112] Moreover, as the example illustrates, differential share ownership results even with full pro rata participation by EarlyFund. Assuming no additional shares of common stock are issued by NewCo and full pro rata participation by EarlyFund and LaterFund in future financings, EarlyFund will always hold 33.3 percent of any new issuance (but 100 percent of the Series A Preferred Stock) while LaterFund will hold 16.7 percent of any new issuance (but 66.6 percent of the Series B Preferred Stock).

In actuality, a number of factors cause VC investors to participate at less than their original pro rata share in future stages of financing. As a matter of

111. Prominent venture capitalists Alan Salzman (of VantagePoint Venture Partners) and John Doerr (of Kleiner Perkins Caufield & Byers) note, "If a company is successfully accomplishing and moving through its development cycle, its successive capital raise should become progressively less expensive (i.e., achieve a higher company valuation) as the company is able to eliminate or significantly reduce its major business risks." Alan E. Salzman & L. John Doerr, *The Venture Financing Process*, *in* 1 START-UP & EMERGING COMPANIES 7-1, 7-3 (Gregory C. Smith ed., 2005).

112. For this reason, a company's VC investors routinely waive their contractual preemptive rights in each round of financing in order to permit new investors to purchase a larger share of the financing round. *See* Jay K. Hachigian & Brooks Stough, *Venture Capital: Key Issues in Follow-On Financing Rounds*, *in* VENTURE CAPITAL: GETTING FINANCING IN A CHANGING ENVIRONMENT 725, 735–36 (Practising Law Institute 2001). Preemptive rights generally entitle the company's VC investors to purchase their pro rata share of any new securities issued by a start-up company. Absent a waiver of these rights, it may not be possible to issue securities in significant amounts to new investors.

simple mathematics, a VC investor's pro rata share will ordinarily decrease as a company matures. When NewCo hires additional employees to execute its business plan, it will generally compensate these employees with equity as discussed in Part I.A.2, thereby requiring the issuance of additional shares of common stock or common stock options.[113] As NewCo issues new common stock, the percentage ownership of EarlyFund and LaterFund will automatically decrease, causing a concomitant decrease in their respective pro rata shares of future offerings. For instance, if after the Series B financing NewCo adopted a stock option plan consisting of 10,000,000 shares, EarlyFund's pro rata share of future financings would decrease to 22.2 percent (6,666,667 ÷ 30,000,000), and LaterFund's pro rata share of future financings would decrease to 11.1 percent (3,333,333 ÷ 30,000,000).

In addition, a VC fund will ordinarily have a number of structural limitations on its ability to participate in future financings. For one, the capital-time investment constraint provides a practical limit on whether an investor can invest in a future financing. When a VC investor makes an initial investment in a start-up company, it allocates a reserve for follow-on investments that it must spread over all future financings. The size of this reserve is seldom more than the size of the original investment,[114] commonly resulting in a reduction in the size of each follow-on investment. More importantly, if a fund underallocates the amount of capital it needs for follow-on investments, the fund may run out of capital to support further investments in its portfolio.[115] A VC fund may also have limitations in its partnership agreement regarding the extent to which it may participate in future financings. For instance, VC

113. *See supra* Part I.A.2.

114. Prior to the 2001–2003 economic downturn, venture capitalists would often use a fifty-fifty or even a "two-thirds/one-third" principle for determining the size of a follow-on reserve. For example, a two-thirds/one-third principle would require two-thirds of a fund's committed capital to be allocated to new investments and one-third to all follow-on investments. *See* Carolina Braunschweig, *Staying Afloat: VCs Raise Annex Funds to Buoy Waning Portfolios*, VENTURE CAPITAL J., Aug. 2001, at 27, 28. Later-stage funds have historically allocated even less amounts to follow-on financings. *See, e.g.*, Robyn Kurdek, *FTV Banks $423M For Second Fund*, PRIVATE EQUITY WK., Jan. 14, 2002, at 9, 9 (noting that FTV, a later stage investor, reserved "significantly less than 50% of the capital . . . for follow-on financings").

115. Underallocation for follow-on financings became a widespread problem during the 2001–2003 economic downturn. The tendency of VC investors to allocate most of their capital toward initial investments resulted in many funds having to raise annex funds in 2001 and 2002 for the specific purpose of providing follow-on financing to start-up companies. During this time, venture-backed companies were unable to achieve exit events due to the lackluster financial markets. When companies were unable to raise financing from outside sources, existing investors were required to provide the much-needed capital, thereby putting significant stress on the traditional model for allocating reserves. *See* Braunschweig, *supra* note 114, at 3.

fund partnership agreements commonly have investment limitations that restrict the amount of capital a fund is permitted to invest in any one company.[116]

Even without these structural constraints, limiting a fund's investment to primarily early or later rounds of financing may be an important component of satisfying a fund's investment purpose. VC firms routinely market themselves to companies and LPs as focusing on either early-stage or late-stage investments.[117] For LPs, the distinction is of significant importance in understanding a VC firm's risk profile, and a VC investor may be wary of justifying to its LPs a significant departure from its stated investment objective. Thus, for any of these reasons, a company's existing VC investors often invest less in a new round of financing than investors leading the round.

Once again, FormFactor provides a true-life example of the manner in which a company's VC investors will hold differing combinations of a company's differently priced securities. Formed in 1993, FormFactor received its first VC investment in 1995 when Mohr Davidow Ventures (MDV), an "early stage venture capital firm,"[118] purchased 3,390,822 shares of Series B Preferred Stock at a price of $0.87 per share, for a total investment of nearly $3,000,000.[119] The company's next round of VC financing occurred in 1996 when it sold 3,298,161 shares of Series C Preferred Stock at $1.65 per share, of which MDV purchased 37 percent for approximately $2,000,000. A new "expansion stage" VC investor, Institutional Venture Partners (IVP),[120] led this round of financing and purchased 55 percent of the shares sold for $3,000,000.[121] Between 1997 and 1998, the company sold 5,552,973 shares of Series D Preferred Stock at $3.45 per share for gross proceeds of almost $20,000,000. Of this amount, MDV and IVP each purchased only 434,783 shares (8 percent of the offering) in

116. *See* Klausner & Litvak, *supra* note 9, at 70. Of course, the general partner of a fund may seek a waiver of these covenants, but the time and effort involved in obtaining the requisite LP approval may cause general partners to avoid waivers for all but the most promising investment opportunities.

117. *See, e.g.*, *infra* notes 118, 122.

118. Mohr Davidow Ventures (MDV), http://www.mdv.com (last visited Aug. 14, 2006) ("For more than 20 years, our mission as an early stage venture capital firm has been to identify, invest in, mentor and develop venture-backed companies that redefine how organizations and individuals apply new technologies and scientific advances.").

119. General information concerning FormFactor's financing history was obtained from the financial statements included as part of FormFactor's S-1 Registration Statement. *See* FormFactor Registration Statement, *supra* note 88. Information concerning individual holdings of VC investors was obtained from the company's Sixth Amended and Restated Rights Agreement. *See* FormFactor, Inc., Form S-1 Registration Statement, Exhibit 4.02 (Apr. 22, 2002), *available at* http://www.shareholder.com/Common/Edgar/1039399/891618-02-1883/02-00.pdf. FormFactor had previously raised $349,000 from management in 1995 by selling shares of Series A Preferred Stock at $0.05 per share. *See id*.

120. Institutional Venture Partners (IVP), http://www.ivp.com (last visited Aug. 14, 2006).

121. *See* FormFactor Registration Statement, *supra* note 88, at F-17 to F-18.

exchange for investments of $1,500,000 each. New investors Intel Corporation and later-stage VC investor Morgan Stanley Venture Partners (MSVP)[122] provided the majority of the investment, with Intel investing approximately $5,000,000 and MSVP investing approximately $7,000,000.

Following these financings, the company's three primary VC investors significantly curtailed their investments. In its Series E financing in 1999, FormFactor raised $20,000,000 by selling 2,666,666 shares of Series E Preferred Stock at a price of $7.50 per share. A group of the company's strategic partners led the financing; MDV, IVP and MSVP collectively invested only $849,000 in this round (4 percent of the offering).[123] MDV, IVP, and MSVP did not participate at all in the company's subsequent Series F or Series G financings in 2000 and 2001, respectively. Instead, a combination of individuals and corporations provided the investments by purchasing 633,130 shares of Series F Preferred Stock at $11.00 per share and 579,672 shares of Series G Preferred Stock at $15.00 per share. Figure 4 summarizes the investment history of FormFactor's three primary VC investors.

Figure 4: Summary of VC Investments in FormFactor, Inc.

Investor	Series B Price: $0.87 (Shares / Investment)	Series C Price: $1.65 (Shares / Investment)	Series D Price: $3.45 (Shares / Investment)	Series E Price: $7.50 (Shares / Investment)	Series F Price: $11.00 (Shares / Investment)	Series G Price: $15.00 (Shares / Investment)	Total Shares / Total Investment
MDV	3,390,822 / $2,950,015	1,220,731 / $2,014,206	434,783 / $1,500,001	46,584 / $349,380	0 / $0	0 / $0	5,092,920 / $6,813,603
IVP	0 / $0	1,818,182 / $3,000,000	434,783 / $1,500,001	33,334 / $250,005	0 / $0	0 / $0	2,286,299 / $4,750,007
MSVP	0 / $0	0 / $0	2,028,986 / $7,000,002	33,334 / $250,005	0 / $0	0 / $0	2,062,320 / $7,250,007

Thus, as FormFactor underwent multiple rounds of VC financing, its earlier investors significantly diminished their level of participation in each subsequent round. The result was a company capital structure in which each VC investor held a different amount of the company's differently priced securities. Having explained how this situation results from staged investing and investment syndication, it is now necessary to explain how this situation creates the potential for interinvestor conflict.

122. *See* Morgan Stanely Venture Partners (MSVP), http://www.morganstanley.com/institutional/venturepartners/faq.html?page=faq (last visited Aug. 14, 2006) ("We invest in companies whose products or services have demonstrated market value and have a sustainable competitive advantage . . . .").

123. MDV invested $349,000; IVP and MSVP each invested $250,000. FormFactor Registration Statement, *supra* note 88, at F-17 to F-18.

B. Interinvestor Conflicts

Differences in investor participation levels in each stage of company financing can give rise to a number of potential conflicts among a company's VC investors owing to VC fund structure. As this section demonstrates, VC investors are clearly aware of these potential conflicts and utilize VC contracts at each stage of financing to address them. Indeed, for a VC investor and its lawyer, resolving or containing these conflicts at each investment stage appears to be just as critical for successful VC investment as containing the conflict between managers and investors. Although interinvestor conflicts might arise in a variety of contexts,[124] the two that appear to play the largest role in VC contracts are those relating to a company's ultimate exit strategy and a company's future financing.

1. Conflicts Over Exit Events

a. How Conflicts Arise

VC investors ordinarily seek to exit company investments through one of two principal methods: the sale of shares into the public equity markets after a company's IPO or the acquisition of a company for cash or publicly traded securities.[125] In either case, differences in VC investors' stock ownership may create differences as to what constitutes an acceptable exit event for a company. As one prominent attorney in the industry notes, "[T]he actual exit strategy employed . . . may require cooperation from shareholders who will not (or may not) be in agreement with the timing, price or other terms as proposed by [a particular] VC."[126]

The source of these differences arises from the potentially different investment returns each VC investor in a start-up company will receive on a proposed exit. In FormFactor, for instance, investors who acquired shares of the company's Series G Preferred Stock at $15.00 per share would view less

124. *See supra* text accompanying notes 97–99.

125. *See* LEVIN, *supra* note 7, at 9-3.

126. *Id.* ¶ 105.6, at 1-11. The general partners of Blueprint Ventures echo a similar sentiment:

> Certainly, most VCs can recite the "IPO or M&A" exit strategy for each of their companies. But how many VCs agree, inside their partnerships and inside their investment syndicates, on an acceptable exit value of their investment? In many cases we know, venture investors many years into an investment will continue to politely disagree on the ideal exit amount for the company.

Bart Schachter & George Hoyem, *What VCs Can Learn from Their Cousins in Buyouts*, VENTURE CAPITAL J., Sept. 2004, at 41, 42.

favorably a proposed IPO in January 2003 at $10.00 per share than would MDV, whose average price paid per share was $1.34. MDV would stand to realize at this price a total return on investment of almost 650 percent, or an annual internal rate of return (IRR) of approximately 37 percent.[127] In contrast, a stockholder who only participated in the Series G financing would realize a total return on investment of –33 percent, or an annual IRR of approximately –27 percent.

The extent to which VC investors purchase their pro rata share in each stage of financing does little to mitigate the potential for divergent investment returns among VC investors. In the NewCo example, even though EarlyFund purchased its pro rata share of the Series B offering, its average price per share ($1.25) was $0.75 less than LaterFund's. As a result, following the Series B financing of NewCo, any acquisition of NewCo that valued the company at less than $40,000,000 (or $2.00 per share) but more than $25,000,000 (or $1.25 per share) would result in a negative return on investment for LaterFund but a positive return on investment for EarlyFund.

The structure of the VC market encourages VC investors to focus on achieving positive returns for several reasons. As a general matter, venture capitalists must offer LPs the prospect of significant investment returns in order to compensate them for the limited liquidity and significant risks associated with start-up investments. Among early-stage venture capitalists, for instance, it is generally assumed that an investment portfolio should yield an IRR of approximately 30 to 50 percent.[128] Moreover, because many of these investments will ultimately be written off, VC investors commonly make individual company investments with the expectation that each will produce a 40 to 50 percent projected IRR after accounting for the venture capitalist's fees and compensation.[129]

VC fund structure further accentuates this concern with investment returns owing to the capital-time investment constraint and the investment return incentives. First, the intense pressure to raise successive VC funds can encourage a venture capitalist to time exit events so as to accelerate positive returns and to delay negative returns. By exiting an investment with a significant return, a VC investor locks in a gain that helps lift the IRR of a portfolio likely to contain several losing investments. For a VC investor in the process of raising another fund, these early "home runs" may be critical to attracting

127. In general, an internal rate of return (IRR) measures the performance of an investment that requires and produces a number of cash flows over time. An IRR is the discount rate that equates the present value of all cash inflows associated with an investment with the sum of the present value of the cash outflows accruing from it and its present unrealized value.

128. *See* Salzman & Doerr, *supra* note 111, at 7-4.

129. *See id.*

LPs.[130] Moreover, under the prevailing industry valuation standards, VC investors generally carry a company investment at cost until an exit event or a subsequent financing.[131] IRR calculations will therefore be higher the sooner a fund liquidates a successful investment. For similar reasons, a VC investor faced with a losing investment may present a healthier picture of its overall portfolio to its current and prospective LPs by delaying an exit given that an investment valued at cost looks better to LPs than an investment loss.[132]

In addition to these marketing pressures, the carried interest also encourages venture capitalists to focus on accelerating positive returns and delaying negative returns. As noted above, the carried interest entitles a venture capitalist to receive a specified percentage (usually 20 percent) of the profits realized on a fund's start-up company investments.[133] A corollary of the carry is the so-called "claw-back" provision, which ensures that the venture capitalist receives no more than her specified percentage of fund profits upon the termination of a fund. This result can occur where a VC fund initially liquidates profitable investments and later liquidates losing investments—a common pattern among VC funds.[134] In such situations, the claw-back provision requires a venture capitalist to recontribute capital to the fund in order to avoid receiving excess compensation. Consequently, the ability of a venture capitalist to realize a profit rather than a loss on an investment may potentially mean the

130. *See, e.g.* GOMPERS & LERNER, *supra* note 9, at 377–80 (noting propensity among venture capitalists to "grandstand"—taking a start-up company public as quickly as possible—to facilitate fundraising among LPs); Lawrence Aragon, *Harvard Revs Up Ignition's Third Fund*, VENTURE CAPITAL J., Dec. 2004, at 18, 18 (reporting that for successful fundraising, it "isn't [about] who you know that counts; it's whether you can show a return on investment").

131. Most firms have adopted the valuation guidelines that were proposed to, but never adopted by, the NVCA in 1989. In general, these guidelines specify that a company investment should be carried at cost unless a different value is justified by the last round of financing (if the financing includes a new outside investor) or if the company otherwise experiences a material change in financial condition. *See* Colin Blaydon & Fred Wainwright, *The Stage Is Set*, PRIVATE EQUITY INT'L, May 2004, at 45. Concern among LPs regarding the usefulness of these standards resulted in the formation of the Private Equity Industry Guidelines Group in 2002 and the promulgation of the U.S. Private Equity Valuation Guidelines in 2004. These guidelines, if adopted by a fund, would require the fund to revalue its portfolio securities based on their "fair value." *See* PRIVATE EQUITY INDUS. GUIDELINES GROUP, U.S. PRIVATE EQUITY VALUATION GUIDELINES 6 (Sept. 2004), *available at* http://www.peigg.org/images/U.S._PE_Valuation_Guidelines_September_04.pdf.

132. Provided a VC investor believes an investment will not decrease further in value, delaying the liquidation of a losing investment will also help a fund's financial reports by virtue of the IRR calculation methodology. For instance, in the hypothetical IPO of FormFactor at $10.00 per share, delaying an IPO at $10.00 per share by two years would result in an IRR of –12 percent for a Series G investor, rather than an IRR of –27 percent.

133. *See supra* text accompanying note 102.

134. *See* Steven R. Franklin & Stig A. Colberg, *Evaluating and Managing a Potential Clawback Liability*, VENTURE CAPITAL J., Sept. 2002, at 34.

difference between receiving an incentive payment from the VC fund and having to recontribute capital to its LPs.[135]

Thus, because of staged investment and investment syndication, a venture capitalist who invests in a start-up company faces a discernable risk that it may disagree at some point with the company's other VC investors concerning what constitutes a proper exit event. In the highly volatile start-up markets, investors holding higher-priced securities may simply be more willing than holders of lower-priced securities to postpone an exit event until the next "up" market. Moreover, the challenge of achieving investor consensus on this issue is made more complicated by the limited life of VC funds. Because of the ten-year term of most funds, an early investor who has held an investment for several years may face a structural incentive to exit at a time when a company's later investors are not subject to these pressures. A company's earlier investors may therefore be less willing to forego a low-value exit yielding a return on investment, even if the investors believe the company could obtain a higher valuation in the long term.[136]

b. The Contractual Response

Given the risk that a company's VC investors may disagree over an acceptable exit event, an important aspect of VC contracting centers on mechanisms that contain this risk. The risk is especially acute for VC investors who have lost their original control rights in a company following multiple rounds of staged financing. Even where a new VC investor obtains significant control rights in a company, there can be no guarantee that an exit event will arise during the period in which the investor controls the company. For instance, the company may have to undergo additional rounds of financing before an exit event appears likely, by which time the investor's control may be significantly diminished through dilution. As a result, a VC investor will ordinarily seek specific contract rights that protect its preferences

135. The following hypothetical demonstrates the incentive effect of the claw-back. Assume a fund makes two investments of $100 each and provides for a 20 percent carry. If the first investment is sold for $1000, the fund must first return $100 to LPs as return of capital. Thereafter, it may distribute the $900 of profits 80 percent to LPs ($720) and 20 percent to the venture capitalist as carry ($180). If the second investment is written off as worthless, the net profit of the fund will be $800 ($1000 – $200), requiring the venture capitalist to recontribute $20 to the LPs to ensure its carried interest does not exceed 20 percent of fund profits. If the fund had sold the second investment at cost ($100), the net profit of the fund would have been $900 ($1100 – $200), thereby avoiding any claw-back liability. *See id*.

136. For a discussion on the challenges that an early-stage investor faces due to the limited term of a fund, see Ravi Chiruvolu, *Before You Do That 'Amazing' Biotech Deal, Read This Story*, VENTURE CAPITAL J., Aug. 2002, at 36.

concerning the proper timing and amount of an exit regardless of the level of control it possesses as a result of its equity holdings. In the words of one leading VC lawyer, "[C]ontracts signed at the time of VC's initial investment will generally give VC certain future rights to control its exit strategy. This is especially important where VC will not (or may not) control [the] portfolio company at the back end when the exit strategy is executed."[137]

In the context of an IPO, a VC investor will ordinarily obtain these special control rights by demanding a veto right over the completion of an IPO at an unacceptably low price per share. VC investors accomplish this by relying on the virtually universal practice among investment bankers that, prior to completing an IPO, all shares of a company's preferred stock must convert into common stock.[138] Because of this industry practice, the preferred stock purchased by VC investors will generally have a provision requiring the automatic conversion of preferred stock upon either an IPO at a pre-specified price per share or the requisite vote of preferred stockholders.[139] For many investors, a condition to making a company investment will be setting the automatic conversion price of its preferred stock to a price that equals or exceeds its purchase price. Likewise, with regard to an automatic conversion by means of a stockholder vote, VC investors commonly seek a special veto right with respect to the conversion of its shares of preferred stock.[140] As a result of these two provisions, a VC investor can block the conversion of its preferred stock on an IPO—and thereby block the IPO entirely—if the offering price is less than the investor's purchase price.

An example of each of these techniques appears in FormFactor's charter. Under FormFactor's charter, shares of Series A, Series B, Series C, and Series D Preferred Stock would automatically convert into common stock at an IPO having a price per share of at least $6.90—a price well in excess of the per-share purchase price of each series. For the higher-priced Series E, Series F, and Series G Preferred Stock, the minimum IPO price for automatic conversion of each series was set at exactly its per-share purchase price ($7.50, $11.00, and $15.00, respectively).[141] To convert any series of FormFactor's preferred stock by means of a stockholder vote, it was necessary to obtain the approval of two-thirds of the outstanding shares of each series.[142]

137. LEVIN, *supra* note 7, ¶ 105.6, at 1-11.

138. *See* Maha Ibrahim, Caine Moss & Kurt Berney, *Illustrative Venture Investment Term Sheet*, *in* PRIVATE EQUITY & VENTURE CAPITAL INVESTING 247 (Practising Law Institute 2001).

139. *See, e.g.*, Kaplan & Strömberg, *supra* note 10, at 289 (finding automatic conversion provisions in 95 percent of the financing rounds examined).

140. *See* Hi-Tech Charter, *supra* note 106, at 8-36 to 8-37.

141. *See* FormFactor Certificate, *supra* note 90, at 5–6.

142. *See id.*

A VC investor will also seek to protect its particular economic preferences concerning the price and timing of a company acquisition. These protections may take the form of either special veto rights or special liquidation preferences. With regard to veto rights, a VC investor may seek specific class veto rights that guarantee it a blocking right over a company's acquisition. Alternatively, where existing investors already hold an approval right over an acquisition, a later-stage investor may seek to increase the voting threshold required for approving an acquisition to ensure that its vote is required.

In addition to veto rights, a new VC investor may seek to protect its preferences concerning an exit event through a senior liquidation preference. As noted above, a liquidation preference entitles a stockholder to a specified preferential return (ordinarily, an investor's purchase price) on its preferred shares prior to any common stock payments in the event of a company's acquisition.[143] A senior liquidation preference entitles one VC investor to receive its liquidation preference in advance of other VC investors. According to one attorney in the industry:

> [L]ater investors typically want to be first in line to get their original investment (and hopefully their return on investment) out. By subordinating the liquidation preferences of earlier investors, later round investors ensure their priority directly behind creditors and ahead of other equity investors including those who invested in earlier rounds, as well as angel investors, founders and employees.[144]

Unfortunately, the manner in which VC investors seek to protect their particular preferences regarding a company's exit strategy is not always easy to discern. The ability to identify how VC investors resolve potential conflicts over a company exit event requires an analysis of VC investor stock ownership, as well as an understanding of how voting rights and liquidation preferences can work in tandem to create a system of reciprocal veto rights. For instance,

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143. *See supra* text accompanying note 106.

144. Audrey A. Rohan, *Financing in the Current Economy*, *in* PATENTS, COPYRIGHTS, TRADEMARKS, AND LITERARY PROPERTY COURSE HANDBOOK SERIES 537, 548 (Practising Law Institute 2003); *see also* Mo, *infra* note 177, at 202 ("Later stage investors encounter aggregate liquidation preferences requiring major increases in the companies' enterprise values before they can realize their preference or expected investment returns. To protect against this outcome, some new investors are increasingly seeking to obtain a preference above and beyond that of the existing preferred stockholders."); Barry Kramer, *Trends in Legal Terms in Venture Financing in the San Francisco Bay Area (First and Second Quarters 2002)*, *in* FOURTH ANNUAL PRIVATE EQUITY FORUM: LEGAL & FINANCIAL STRATEGIES FOR DEALMAKING IN THE CURRENT MARKET 591, 595 (Practising Law Institute 2002) (presenting evidence from a survey of VC financings that the "liquidation preference in 62% of the financings was senior to the previously outstanding liquidation preferences. Senior liquidation preferences were also concentrated in later rounds, with 44% of the Series B, 62% of the Series C, 69% of the Series D and 100% of Series E and higher providing for a senior liquidation preference.").

a straightforward analysis of FormFactor's charter might suggest its VC investors are generally aligned in their preference concerning the company's acquisition. Under its charter, the protective provisions provide merely that an acquisition of the company must be approved by the holders of a majority of the shares of Series B through Series G Preferred Stock.[145] However, analysis of the VC investors' stock ownership reveals a more complicated story: This voting threshold ensured that no acquisition could occur without the collective approval of MDV, IVP, and MSVP.[146]

The voting threshold clearly provided less protection to the Series E through Series G investors, as MDV, IVP, and MSVP could approve an acquisition without their consent. How did these investors protect against the risk that MDV, IVP, and MSVP would approve a low-value acquisition? The answer is in the liquidation preferences negotiated by these investors: The company's charter granted to the holders of Series D through Series G Preferred Stock a senior liquidation preference. This liquidation preference guaranteed that if MDV, IVP, and MSVP approved a low-value acquisition, no proceeds could be paid on their shares of Series B and Series C Preferred Stock until each share of Series D through Series G Preferred Stock had been distributed an amount equal to the share's original cost ($3.45, $7.50, $11.00, and $15.00, respectively). In other words, no VC investor was at risk that an acquisition would be approved against its will where the investor did not receive back at least its original investment cost.

As analysis of FormFactor's charter reveals, the common use among VC investors of series veto rights and liquidation preferences seeks to address a fundamental challenge of VC investment. It is a challenge unrelated to concerns about whether managers will act as good agents. Rather, it is a challenge arising from the potentially conflicting interests among VC investors concerning what constitutes a proper exit event for a start-up company.

2. Conflicts Over Future Financings

a. How Conflicts Arise

In addition to addressing conflicts over exit events, upon investing in a start-up company, a VC investor must also address the potentially different

145. *See* FormFactor Certificate, *supra* note 90, at 14–15.

146. Theoretically, this voting threshold would also permit an acquisition if approved by MDV and several later-stage investors. However, given the relatively low price per share of IVP and MSVP compared to that of the later-stage investors, it seems highly unlikely that any acquisition approved by MDV and a coalition of later-stage investors would not also be approved by IVP and MSVP.

preferences among investors concerning future funding commitments to the company and the price at which the company completes a future financing.

First, a VC investor in a company may have concerns that its co-investors will be unwilling to provide future financing to the company. These concerns are likely to be especially pronounced where the company's VC investors have invested at different times due to the capital-time investment constraint of VC funds. In comparison to a late-stage investor, a company's early-stage investor may more quickly expend its internal funding allocation to the company, or its fund may simply lack the capital to make additional investments.[147]

Second, differences in the prices at which a company's VC investors acquire their securities may create different sensitivities concerning the price at which the company issues securities in the future. All other things being equal, a VC investor will ordinarily expect—indeed, even hope—that a company will issue stock to subsequent investors at a higher price than the VC investor paid for its own shares, notwithstanding the dilutive effect of the new issuance. Although its percentage ownership of the company will diminish, the value of the existing investor's ownership interest will generally be the same or greater after the issuance. This is because the higher-price stock issuance means that the company has a greater enterprise valuation than it did at the time of issuing the existing investor's lower-priced securities.[148] Accordingly, under prevailing portfolio valuation practices, the completion of a company financing at a higher valuation will justify a write-up of the investment in the VC investor's LP financial reports.[149]

In contrast, when a company issues stock below the price paid by the VC investor, the dilution suffered by the investor is costly for two reasons. First, the lower price of the new stock relative to the shares held by the VC investor indicates that the value of its investment has decreased since it acquired its securities. As a result, the VC investor may be required to report a decrease in the value of its investment in its LP financial reports.[150] Second, the lower price of the new stock will cause the company to sell a greater number of shares of preferred stock than the VC investor could have purchased with its own investment, thereby diluting the investor's ownership interest. Unless the VC investor is willing and able to purchase its pro rata share of the

147. *See supra* text accompanying notes 114–115.

148. *See* Robert P. Bartlett, III, *Understanding Price-Based Antidilution Protection: Five Principles to Apply When Negotiating a Down-Round Financing*, 59 BUS. LAW. 23, 24–25 (2003). To maintain their prefinancing ownership percentage, VC investors must purchase their pro rata share of the financing. *See supra* text accompanying note 109.

149. *See supra* note 131.

150. *See id.*

issuance, the dilution may significantly decrease its prospective return on investment. Thus, a holder of primarily lower-priced stock will ordinarily hold different preferences than holders of higher-priced stock regarding the desirability of the company issuing securities at particular prices.

b. The Contractual Response

Given these potentially divergent preferences, a new VC investor will often seek contractual rights that protect its particular preferences concerning future financings. With regard to the risk that a company's VC investors may stop funding the company in the future, a VC investor may seek to implement the pay-to-play provision discussed earlier.[151] By forcibly stripping a nonparticipating investor of its preferred rights, a pay-to-play provision provides a significant deterrent against failing to participate in a financing that triggers the provision. Likewise, the willingness of an existing VC investor to agree to the provision provides a positive signal regarding its commitment to finance the company in the future.

With regard to the risk that the company will complete a low-priced financing, a VC investor will often request upon making an investment a combination of stockholder veto rights and price-based antidilution protection. As before, FormFactor provides a concrete illustration of these latter two techniques. FormFactor's charter provided that the approval of the holders of a majority of the shares of Series B through Series G Preferred Stock would be required for the company to authorize or issue any security that was senior to or on a parity with the existing preferred stock.[152] Analysis of the company's stock ownership records indicates that this voting threshold effectively gave MDV, IVP, and MSVP the collective power to approve (or disapprove) a future financing of FormFactor. As with the veto rights over FormFactor's acquisition, this voting provision appears to place at risk the interests of FormFactor's later-stage investors who held higher-priced shares of preferred stock. Given that MDV, IVP, and MSVP held relatively lower-priced shares, they might approve a financing at a price per share that would be unacceptably low to the company's later-stage investors. These later-stage investors might prefer that the company negotiate harder for a better valuation of the company.

To protect against this potential conflict, FormFactor's later-stage investors obtained price-based antidilution protection. Antidilution protection diminishes the dilutive effect of a lower-price stock issuance by increasing, upon the

151. *See supra* text accompanying notes 80–81.
152. *See* FormFactor Certificate, *supra* note 90, at 14–15.

issuance of the lower-priced stock, the ratio at which each share of the VC investor's higher-priced preferred stock converts into common stock. As a result, the VC investor's preferred stock will convert into a greater number of shares of common stock than prior to the issuance, and on an as-converted-to-common stock basis, the preferred stockholder will suffer less dilution from the new stock issuance than if no adjustment had been made.[153] In FormFactor, the Series D through Series G Preferred Stock each contained weighted-average antidilution protection that was tied to the purchase price of each series. For instance, if the company issued stock between $11.00 and $15.00 per share, the Series G Preferred Stock—and only the Series G Preferred Stock—would receive an increase in its common stock conversion rate. This adjustment would diminish the dilutive effect of the stock issuance by allowing the Series G Preferred Stock to convert into more shares of common stock. Likewise, if the company issued stock between $7.50 and $11.00 per share, both the Series F and Series G Preferred Stock would receive an antidilution adjustment. Similar adjustments would occur for the Series D and Series E Preferred Stock should the company issue stock below their original issuance prices. Thus, through a combination of veto rights and antidilution protection, FormFactor's VC investors were contractually protected against the risk that the company would complete a financing at an unacceptable valuation.

3. Some Imperfections in the Contract Provisions Protecting Against Interinvestor Conflict

As the foregoing discussion indicates, in contrast to most accounts of VC investment, the specific provisions that appear in VC contracts are not just about controlling agency risks with company managers. Clearly, VC investors demand special contract rights to protect against these agency risks. But they also demand provisions that address the potential conflicts among a company's VC investors over the exercise of those contract rights. VC investors may be in agreement that they should have a vote on the sale or financing of a company; however, getting them all to agree on what constitutes a proper sale or financing is an entirely different matter.

153. The extent of the adjustment will depend on the type of antidilution formula given to the preferred stock. For instance, a ratchet formula results in complete price protection against a future issuance of lower-priced stock. Under this formula, the protected investor is placed in the same position upon conversion of its preferred stock into common stock as if the investor purchased the shares of underlying common stock at the new, lower price. Milder weighted-average formulas result in a less extreme increase in the conversion rate of the investor's preferred stock. For a description of the various antidilution formulas, see *infra* text accompanying notes 171–174.

In describing the manner in which a company's VC investors seek to control potential interinvestor conflicts, it should also be clear that the existing system is far from perfect. The provisions described above do little to eliminate the underlying potential for interinvestor disputes. For instance, the senior liquidation preference held by FormFactor's later-stage investors might permit a low-value acquisition proposal to be acceptable to these later-stage investors, but unacceptable to MDV, IVP, and MSVP who might receive little or no proceeds due to this provision.[154]

Moreover, the provisions described above might actually increase the risk for interinvestor conflict. Even with a pay-to-play provision, investors may continue to develop divergent opinions regarding the desirability of continuing to finance a company. Instead of easing investor concerns, the provision increases the stakes of these debates by actively punishing nonparticipating investors. Likewise, the use of antidilution protection can turn divergent investor preferences regarding the price at which a company issues its securities into concrete investor conflicts. In the case of FormFactor, a stock issuance that resulted in an antidilution adjustment to the Series G Preferred Stock would have effectively diluted all shares of common stock and preferred stock that did not receive an adjustment. For MDV and IVP, an antidilution adjustment of the later-issued stock would have resulted in a reduction in the value of their primary investment in the company's unprotected Series B and Series C Preferred Stock. Arguably, MDV and IVP could protect themselves from this risk through exercising their negotiated veto right over company financings, but veto rights themselves give rise to the possibility that they might be used opportunistically. Couldn't MDV and IVP threaten to use their veto rights to force a waiver of all or part of the later-stage investors' preferential rights?

It was these unresolved potential interinvestor conflicts that laid the foundation for the unprecedented interinvestor disputes that erupted following the collapse of the Internet economy.

III. PATHOLOGICAL VC INVESTMENT: 2001–2003

In the months following the collapse of the Internet economy, a relatively new investment risk began to concern many venture capitalists: the fear of suit by other VC investors. Lawsuits against VC investors by company managers had occurred in the past, but the notion that a VC investor would bring suit

154. *Cf.* Hachigian & Stough, *supra* note 112, at 741 (noting that because of senior liquidation preferences, a situation may arise "in which a junior preferred stockholder will not vote for a sale transaction yielding less than a certain amount of proceeds because such a transaction would not benefit the junior preferred stockholder").

against a co-investor in a start-up company was an entirely novel phenomenon. The source of this new risk was the flawed nature in which VC investors had traditionally resolved potential interinvestor conflicts. In particular, the economic climate encouraged highly dilutive company financings in which lead investors demanded greater preferential rights to protect their economic interests at the same time that many of the company's existing VC investors lacked the ability to participate. These preferential rights created the potential for controlling VC investors to extract private benefits of control at the expense of both nonparticipating investors and common stockholders. Simultaneously, nonparticipating investors often sought to utilize whatever control rights they had previously negotiated to minimize the extent to which they were harmed in the financing or to otherwise force private concessions from the company and its participating investors.

A. The Rise of the Down-Round Financing

The year 2001 represented a significant turning point in the VC industry. The first sign of the new economic climate came with the abrupt halt of the formerly robust IPO market for start-up companies. Whereas 264 venture-backed companies completed an IPO in 2000, by 2001 the number of venture-backed IPOs fell to 41, which fell further to 24 in 2002.[155] Likewise, the number of opportunities for start-up companies to exit by means of a meaningful acquisition also plummeted. As shown in Figure 5, although the annual number of acquisitions of venture-backed companies was relatively constant from 2000 through 2002, the aggregate value of these transactions fell from $68.3 billion in 2000 to $16.8 billion in 2001 to $7.9 billion in 2002.[156]

Figure 5: Liquidity Events by Year for Venture-Backed Start-up Companies

	Mergers and Acquisitions				*IPOs*	
Year	Total Deals	Deals with Disclosed Values	Total Disclosed Value ($M)	Average Deal Size ($M)	Number of IPOs	Total Offer Amount ($M)
2000	311	202	$68,323	$338	264	$25,499
2001	344	165	$17,137	$102	41	$3490
2002	306	151	$7824	$52	24	$2474

155. *See* Press Release, Nat'l Venture Capital Ass'n, Q3 Doubling of Venture-Backed IPO Activity Not Enough to Recover from Dismal First Half Says "Exit Poll" (Oct. 3, 2005), *available at* http://www.nvca.org/pdf/2005Q3IPOreleasefinal.pdf.

156. *See* Sanjay Subhedar, *Relief Is Finally Coming with a Rise in M&A*, VENTURE CAPITAL J., July 1, 2003, at 48, 49.

Given the diminished opportunities for start-up companies to seek financing through an IPO or acquisition, companies sought financing primarily through VC investment. Yet, after years of record investment levels, VC investors quickly began to return to prebubble investment trends. In contrast to the 7812 VC investments made in 2000 (representing a total of $104.4 billion invested), VC investors made only 4451 investments in 2001 (representing a total of $40.5 billion invested) and 3053 investments in 2002 (representing a total of $21.7 billion invested).[157] Significantly, for most VC investors, the bulk of these investments represented follow-on investments in existing portfolio companies rather than first-time investments in other start-up companies.[158] VC investors attributed their reluctance to make new first-time investments to the need to engage in time-consuming "portfolio triage"—the resuscitation of failed business plans and the restructuring of company cash-flow needs.[159] For start-up companies seeking financing, finding a new VC investor to lead a financing became increasingly difficult, requiring many companies to rely exclusively on their existing VC investors for continued funding.

Even when a start-up company could secure VC investment—whether from existing investors or from an outside investor—the terms were likely to be severe. The run-up in IPO valuations during the bubble years of 1999 and 2000 was accompanied by a concomitant run-up in the valuations of private start-up companies.[160] After 2000, VC investments in established start-up companies represented a marked departure from this trend. Most were completed at a significantly lower valuation than a company's prior round of financing.[161] As a result, these financings—generally referred to as "down-rounds"—commonly triggered VC investors' antidilution protection.

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157. *See* Nat'l Venture Capital Ass'n, Industry Statistics, http://www.nvca.org/ffax.html (last visited Aug. 14, 2006).

158. *See* Press Release, Nat'l Venture Capital Ass'n, Venture Capital Investments in Q2 2002 Continue To Slide Back Toward Pre-Bubble 1998 Levels (July 30, 2002), *available at* http://www.nvca.org/nvca07_30_02.html (noting that "[f]or every dollar invested in a new company, five to seven dollars are invested in existing portfolio companies").

159. *See, e.g.*, *Entrepreneur Roundtable: Entrepreneurs Sound Off On Perils of Fund-Raising*, VENTURE CAPITAL J., Jan. 2002, at 18, 18 (noting that following the "tech wreck" in 2001, "the traditional VCs were either in shock, crying or running away or just figuring out what to do with their portfolio"); John J. Egan & Mark Selinger, *Down Round Doldrums*, VENTURE CAPITAL J., Feb. 2001, at 40, 40 ("[V]enture financing for start-ups has become increasingly scarce as venture capitalists focus on sheparding their existing portfolio companies through this difficult financing market.").

160. *See, e.g.*, Alistair Christopher, *University of Washington*, VENTURE CAPITAL J., May 2001, at 50, 50 ("Before the [Internet] bubble burst, sky high valuations for developing information technology companies were not mocked as preposterous, they were, simply, business as usual for firms that invested in the sector.").

161. Fenwick & West, LLP, a prominent law firm within the VC industry, commenced a quarterly survey of VC financing terms in 2002. According to this survey, the percentage of financings

The combination of a low valuation and the triggering of investors' antidilution protection ensured that a down-round financing significantly diluted the value of company capital stock that lacked antidilution protection. This was especially true for shares of common stock held by a company's managers, and down-round financings quickly became famous for accentuating the divergent interests of a company's managers and its multiple VC investors.[162] Consider, for instance, a down-round financing of NewCo following its Series B financing. Assume that NewCo, in desperate need for capital, agreed to a $5,000,000 Series C financing at a $15,000,000 valuation. Assume further that EarlyFund and LaterFund each agreed to purchase their pro rata share in the financing. Ordinarily, the holders of common stock (presumably management) would see their equity stake in NewCo shrink from 50 percent to 37.5 percent, while EarlyFund and LaterFund would see their stakes remain the same at 33.3 percent and 16.7 percent, respectively.[163] However, because the financing would trigger the Series A and Series B antidilution protection, the equity stake of the common stock would actually be reduced to 34.9 percent, while the equity stakes of EarlyFund and LaterFund would *increase* to 34.3 percent and 18.2 percent, respectively.[164]

Even among EarlyFund and LaterFund, the down-round financing would be more costly to EarlyFund than to LaterFund due to their different security ownership. Although both the Series A Preferred Stock and the Series B Preferred Stock would receive an antidilution adjustment, the higher-cost Series B Preferred Stock would receive a greater adjustment than

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that were completed at a valuation lower than a company's prior financing were as follows for each quarter of 2002: 57 percent, 52 percent, 67 percent, and 68 percent. Fenwick & West LLP, Trends in Legal Terms in Venture Financings In the San Francisco Bay Area (2d Qtr. 2004), *available at* http://www.fenwick.com/docstore/VCSurvey/Q204_VC_Terms_Report.pdf [hereinafter F&W Survey]. Anecdotal evidence confirms that down-round financings were equally prevalent during 2001. *See, e.g.*, Alistair Christopher, *VC and the Law: Potential Legal Hurdles Involved in Funding the Next Big Thing*, VENTURE CAPITAL J., Feb. 2001, at 43, 44 ("In today's market, down rounds, their more nefarious sibling inside down rounds, and the resulting dilution of ownership are a fact of life in the venture world."); Charles R. Fellers, *A Rocky Venture Environment Shapes The Legal Landscape*, VENTURE CAPITAL J., Mar. 2002, at 40, 40 ("The really good companies [in 2001] were doing down rounds, or if they're really lucky, flat rounds.") (quoting Chris Aidun, VC Practice, Weil, Gotshal & Manges, LLP).

162. *See* Fellers, *supra* note 161.

163. In general, the pre-existing ownership interest of every stockholder would be reduced by 25 percent ($5,000,000 investment ÷ ($15,000,000 pre-money valuation + $5,000,000 investment)).

164. Figures relating to NewCo's antidilution adjustments are based on antidilution analyses independently conducted by the author. For simplicity, the analyses assume a capitalization of NewCo as it existed following the Series B financing. *See supra* text accompanying notes 109–110. The antidilution analyses are available upon request.

the lower-cost Series A Preferred Stock.[165] As a result, following the antidilution adjustments, the percentage increase in LaterFund's equity stake would be 6 percent more than the increase in EarlyFund's equity stake.[166]

Down-round financings also included a number of preferential terms that accentuated the potential conflict between participating VC investors, nonparticipating VC investors, and management. As Figure 6 shows,[167] VC investors often demanded a variety of preferential rights in down-round financings to preserve "as much of an economic interest in the company as possible after a subsequent round at a lower valuation . . . at the expense of junior preferred holders, common shareholders and option holders."[168] First, VC investors increasingly demanded preferred stock having a multiple, senior liquidation preference, often with multiples of up to two or three times the original investment cost.[169] VC investors also purchased more participating convertible preferred stock in lieu of traditional nonparticipating convertible preferred stock. As noted above, traditional preferred stock entitles a holder to a preferential payment upon a liquidation or acquisition of a start-up company, but no more. In order for a holder to receive more than its stated liquidation preference, the holder must convert its preferred stock into common stock. In contrast, participating convertible preferred stock permits a preferred stockholder to receive the stated liquidation preference and, thereafter, further share (or "participate") in the proceeds payable on shares of the company's common stock without any need for the holder to convert into common stock. These preferential terms allowed VC investors the opportunity to realize significant returns on their investment should a start-up company be acquired even at the prevailing acquisition values. The downside was that after

165. In general, each series of preferred stock would receive an antidilution adjustment based on the difference between the original issue price of the series and the price of the newly issued stock. As a result, the Series B Preferred Stock (having an issue price of $2.00 per share) would receive a greater antidilution adjustment than the lower-priced Series A Preferred Stock (having an issue price of $1.00 per share). For an analysis of this issue, see Bartlett, *supra* note 148, at 33.

166. The divergent effect of the financing on EarlyFund and LaterFund is especially clear where the price of the down-round financing results in an antidilution adjustment to the Series B Preferred Stock but not to the Series A Preferred Stock. For instance, had the premoney valuation of NewCo been $25,000,000, EarlyFund's equity stake (assuming full pro rata participation) would remain at 33.3 percent, while LaterFund's equity stake would *increase* from 16.67 percent to 17.38 percent.

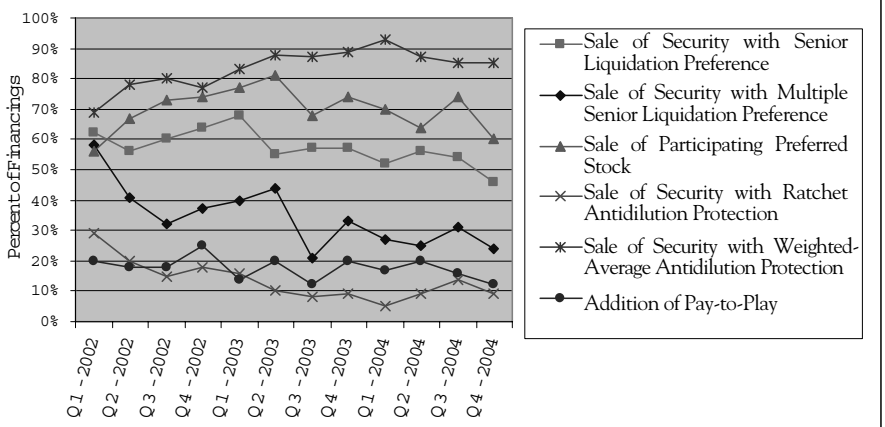
167. Figure 6 is derived from the F&W Survey, *supra* note 161.

168. Stephen M. Davis & Kenneth Drake, *United States: Protecting the Private Equity Investment Without Killing the Golden Goose*, INT'L FIN. L. REV., Supp. 2003, at 2.

169. *See* Hi-Tech Charter, *supra* note 106, at 8-12 to 8-13. For instance, if a VC investor purchased for $1.00 a share of preferred stock having a "3X" senior liquidation preference, it would be entitled to $3.00—rather than $1.00—upon an acquisition of the company prior to any proceeds being paid on other shares of company capital stock.

payment of the preferred stock liquidation preferences, there was often little left to split among the participating preferred stock, the junior-ranking preferred stock, and the common stock.[170]

Figure 6: VC Financing Terms (2002–2004)



VC investors also demanded stronger forms of antidilution protection. In particular, VC investors increasingly purchased securities with full-ratchet antidilution protection rather than the historically standard weighted-average antidilution protection.[171] Full-ratchet antidilution protection effectively reprices the protected preferred stock to the price of any future, lower-priced issuance.[172] Indeed, under most formulations, the issuance of even a single share of lower-priced stock requires repricing all protected preferred stock to the lower price. The result is in stark contrast to weighted-average formulas, which reprice protected preferred stock based on the price *and quantity* of the

170. Not surprisingly, the use of preferred stock with generous liquidation preferences has been one of the primary sources of potential litigation in recent years among VC investors. As one commentator notes, the "'pain' of the early investors in seeing later-stage investors benefit from the liquidation event disproportionately [on account of liquidation preferences] may equate to 'litigation' against the [later-stage] fund and its managers." Pamela W. Mason, *Are We Covered?*, VENTURE CAPITAL J., Mar. 2005, at 62, 62.

171. *See supra* Figure 6; *see also* Carolina Braunschweig, *No More Easy Street: VCs Tighten the Purse Strings*, VENTURE CAPITAL J., May 2001, at 36, 37 ("According to one Silicon Valley VC, full-ratchet anti-dilution provisions are appearing on 5 percent to 10 percent of term sheets for early-stage companies and on 60 percent to 70 percent of later-stage deals. Compared with two years ago, he estimates that only 10 percent of later-stage deals had full-ratchet provisions and virtually no West Coast VC had them on early-stage deals.").

172. Technically, the issuance of lower-priced stock requires the conversion price of the protected preferred stock to be reduced to the price of the new issuance.

new issuance. As a result, a future down-round financing could create significant conflicts between VC investors holding shares of preferred stock with full-ratchet antidilution protection and those stockholders who held unprotected securities or securities having milder forms of antidilution protection. Imagine, for example, that NewCo's Series B Preferred Stock had come with full-ratchet antidilution protection in the company's Series B financing. Assuming NewCo completed a $5,000,000 Series C financing at a $15,000,000 valuation, the Series B full-ratchet antidilution protection would have resulted in LaterFund becoming the largest shareholder of NewCo—even with full pro rata participation in the Series C financing by both LaterFund and EarlyFund. Specifically, LaterFund's equity stake would have increased from 16.7 percent to 37.5 percent, while EarlyFund's equity stake would have increased from 33.3 percent to only 35.7 percent.

Lastly, many down-round financings involved a related recapitalization, often with significant adverse changes to the terms of existing preferred stock. In many cases, a recapitalization of a company's existing preferred stock was necessary due to the triggering of preferred stock antidilution protection. Companies that raised capital at high valuations during the late 1990s found that raising capital at lower valuations during the ensuing economic recession might trigger an "antidilution death spiral," particularly where a company had issued stock with full-ratchet antidilution protection.[173] In these instances, the antidilution adjustments required such significant adjustments to the common stock conversion rates of the protected preferred stock that it was mathematically impossible to honor the antidilution protection at particular valuations.[174] The only possibility for completing a financing at the specified valuation was to restructure the preferred stock.

At the same time, VC investors recognized the adverse effect that a down-round financing could have on the financial incentives of company managers. The significant dilution resulting from the drop in a company's valuation—especially when combined with investors' antidilution protection—often left common stockholders with no meaningful equity stake.[175] The large liquidation preferences demanded by VC investors compounded the problem. Most managers were aware that the most likely liquidity event during this period was an acquisition. But given the depressed acquisition valuations of start-up companies, investors' aggregate liquidation preferences threatened

173. Timothy J. Harris, *The Antidilution Death Spiral*, J. PRIVATE EQUITY, Spring 2002, at 35.

174. For an analysis of how these adjustments could result in such situations, see Bartlett, *supra* note 148, at 31–34.

175. *See id*.

to absorb most, if not all, of the probable acquisition proceeds.[176] Thus, to make a company "fundable," a company's existing VC investors often had to agree to a reduction of existing liquidation preferences or even the conversion of some or all of their preferred stock into common stock.[177] In many cases, existing VC investors consented to these adverse changes, hoping to recoup their investment in the company through the rights of the newly issued securities. For many investors, however, the adverse changes were forced upon them due to insufficient veto rights or the existence of a pay-to-play provision.[178]

Arguably, to the extent all existing VC investors participated in these financings, many conflicts might be diminished given that all investors would receive the new preferential rights. A principal challenge for a down-round financing, however, was that not all VC investors could—or would—participate in it. For many early backers of a company, the capital-time investment constraint prevented them from investing more in the company.[179] In other cases, VC investors simply appear to have been reluctant to throw good money after bad. As one venture capitalist remarked in 2001, "Our position is that, if financing will not last the company one year, and if the company is not profitable after that, we will not invest. You have to make tough decisions in this environment, and sometimes you just have to walk."[180]

Not surprisingly, the rise of down-round financings quickly exposed the latent interinvestor conflicts arising from the combination of staged financing and investment syndication. Negotiations between a company's participating and nonparticipating investors over "how to split the equity"[181] were difficult owing to the presence of investors' reciprocal veto rights. Commenting on the rise of down-round financings, the *Venture Capital Journal* began a series of stories detailing the challenges of these financings, noting that "[n]ew investors structuring protective measures and lower valuations into the term sheet are pushing existing venture backers into defensive positions, forcing some to dig in their heels."[182] In some cases, the prevalence of reciprocal veto rights

176. *See* Ravi Chiruvolu, *It May Be Time To Hit the Reset Button On Liquidation Preferences*, VENTURE CAPITAL J., July 2002, at 28.

177. Curtis L. Mo, *Recent Trends in Venture Capital Financing*, *in* 2 35TH ANNUAL INSTITUTE ON SECURITIES REGULATION 193, 229 (Practicing Law Institute 2003).

178. *See* Joan L. Lesser & Carrie E. Johnson, *Financing Troubled Companies: Highly Dilutive (Down Round) Financings*, COMPUTER & INTERNET LAW., Jan. 2003, at 1.

179. *See supra* notes 114–115.

180. John F. Ince, *Where Is the Money?*, UPSIDE, July 2001, at 60 (quoting general partner of SI Ventures).

181. Fellers, *supra* note 161, at 40.

182. Braunschweig, *supra* note 171, at 36.

could give rise to strategic behavior among investors. A story of one such negotiation recounted by a prominent VC attorney illustrates the holdup potential of investors' veto rights:

> The case I am citing involved a shareholder exercising veto rights over a salvage round of financing, one the company needed in order to survive. Through negative covenants in that shareholder's particular series of preferred stock, the shareholder in question was demanding special consideration, in this case cash, to surrender the veto right . . . even though the shareholder had no plans to participate (although invited) in the salvage round.[183]

Having previously negotiated contract provisions that protected their particular financial interests, VC investors now witnessed how these provisions created rifts among investors owing to their uneven distribution among a company's security holders. In the economic climate of 2001–2003, antidilution protection and liquidation preferences produced seeming windfalls for some investors while destroying the investment of others. Simultaneously, the control rights and veto powers granted to a VC investor in better times were used both defensively and offensively to advance an investor's particular economic interests.

Moreover, even where a VC investor on the losing side of a financing or acquisition lacked effective veto power, it might nonetheless seek to upset the transaction through a court-based challenge. The conflict of interest among investors concerning a down-round financing raised difficult questions regarding the board's fiduciary duties and the fairness of approving a down-round financing. A director representing a VC investor who would be participating in the financing had a "financial interest" in the transaction,[184] requiring careful procedural precautions in order to discharge the director's duty of loyalty.[185] Lawyers representing companies undergoing a down-round financing were quick to qualify once standard legal opinions concerning the enforceability of the transaction documents and to exclude entirely any opinions regarding

183. Joseph Bartlett, *Buzz Archive: Shadow Directors and Controlling Shareholders: Duties and Liability*, VC EXPERTS, Sept. 30, 2003, http://vcexperts.com/vce/news/buzz/archive_view.asp?id=181.

184. DEL. CODE ANN. tit. 8, § 144(a) (1998).

185. *See, e.g.*, Lesser & Johnson, *supra* note 178, at 3 ("If the company later becomes successful, these deemed conflicts of interest may prompt claims by existing shareholders who suffer substantial dilution in the down round . . . that the 'interested directors' breached their fiduciary duties to the company's shareholders by approving the transaction."); Stephan J. Mallenbaum & Sheila Saegh, *Pay-to-Play Structure Increases Investors' Leverage in Business*, N.Y. L.J., Dec. 3, 2001, at 54, 55 ("To the extent the director approves a down-round transaction, he becomes susceptible to the accusation that his actions advantaged those participating stockholders at the expense of non-participating stockholders and, therefore, that he was self-dealing, forfeiting the presumptive protection of the business judgment rule.").

the board's compliance with its fiduciary duties.[186] A board's approval of a company's acquisition during this time likewise required the ability to navigate among conflicting investor interests. As one attorney noted, in the event of a sale, directors were cautioned to examine not only the distribution of acquisition proceeds between preferred stockholders and common stockholders, but also "how . . . the conflict of interest [is] affected if the preferred stockholders themselves have differing economic interests—e.g., if one venture fund is senior in its liquidation preferences to the others, such that the most senior venture fund receives the vast majority of the liquidation distributions."[187]

In sum, the down-round financings of 2001–2003 exposed not only the prevalence of interinvestor conflicts of interest but also the imperfections of the prevailing methods of containing them. Not surprisingly, warnings quickly became commonplace in the VC industry that the "potential for liability [for VC investors] in downrounds is very real and . . . the risks do not go away once the financing is completed."[188]

B. The Realization of Conflict: *Benchmark Capital Partners IV, L.P. v. Vague*

In the summer of 2002, the potential intensity of interinvestor conflict became vividly public in *Benchmark Capital Partners IV, L.P. v. Vague*.[189] As noted earlier, the case arose from an attempt by Benchmark Capital to enjoin one of its start-up companies, Juniper Financial, and a co-investor in the company, the Canadian Imperial Bank of Commerce (CIBC), from consummating a down-round financing of Juniper. Although the case has received some scholarly attention,[190] no one has yet examined why syndicated VC investment in Juniper should have resulted in such disastrous consequences. As the analysis below demonstrates, the case was fundamentally the result of Benchmark and CIBC implementing the strategies outlined in Part I in an economic environment that accentuated the potential interinvestor conflict

186. *See* Kurt Berney, Page Mailliard & Randy Lewis, *Dilutive Venture Capital Financings*, *in* PRIVATE EQUITY & VENTURE CAPITAL INVESTING, *supra* note 138, at 163, 193–94.

187. Matthew P. Quilter & Austin Choi, *Duties of Directors: Venture Capitalist Board Representatives and Conflicts of Interest*, *in* VENTURE CAPITAL, *supra* note 112, at 889, 905.

188. Egan & Selinger, *supra* note 159, at 41.

189. No. Civ. A. 19719, 2002 WL 1732423 (Del. Ch. July 15, 2002), *aff'd sub nom.* Benchmark Capital Partners IV, L.P. v. Juniper Fin. Corp., 822 A.2d 396 (Del. 2003).

190. *See* D. Gordon Smith, *Independent Legal Significance, Good Faith and the Interpretation of Venture Capital Contracts*, 40 WILLAMETTE L. REV. 825 (2004). In his article, Professor Smith focuses primarily on analyzing the doctrine of independent legal significance rather than the causes underlying Benchmark's suit.

those strategies can create. At the same time, Benchmark lacked the veto power it believed it had secured to keep this conflict in check.

In many ways, the history of Benchmark's investment in Juniper was representative of the VC investment strategies described in Part I.A. As an early-stage investor, Benchmark made its initial $20 million investment in Juniper shortly after Juniper's incorporation in January 2000 as an online bank.[191] Typical of VC investment, Benchmark acquired shares of Series A Preferred Stock and received a number of control and monitoring rights. These included, most notably, representation on the company's board of directors and several stockholder veto rights.[192] Benchmark also engaged in staged financing and syndication. When Juniper next needed capital in September 2000, Benchmark helped arrange a $95.5 million Series B financing to be led by another investor, J. & W. Seligman, and further agreed to invest $5 million in it. When Juniper required additional capital the following year, Benchmark again assisted the company by approving a $145 million Series C financing. In contrast to the Series B financing, however, Juniper raised the full $145 million without participation by Benchmark, selling all shares of Series C Preferred Stock to CIBC.[193]

Like Benchmark, CIBC also engaged in the VC investment strategies outlined in Part I.A. First, as the company's largest VC investor, CIBC demanded the right to select six of the eleven members of Juniper's board of directors. CIBC also obtained majority voting power of the company through its purchase of the Series C Preferred Stock, although exercise of this power would be subject to the Series A and Series B stockholder veto rights. Benchmark and Seligman, aware of the potential interinvestor conflicts that might arise with CIBC, had approved the Series C financing on the condition of retaining these reciprocal veto rights.[194] Although CIBC appeared to accept this arrangement, it demanded an important concession from the existing stockholders. Specifically, it obtained the right to waive these veto rights, provided the waiver did not "diminish or alter the liquidation preference or other financial or economic rights" of the Series A Preferred Stock or Series B Preferred Stock.[195] In addition to CIBC's control rights, the terms of the Series C Preferred Stock contained a number of beneficial economic rights, such as a senior liquidation preference and full-ratchet antidilution

191. *See Benchmark*, 2002 WL 1732423, at *2.
192. *See id.* at *2–*3.
193. *See id.* at *2.
194. *See infra* text accompanying note 234.
195. *Benchmark*, 2002 WL 1732423, at *3.

protection.[196] As described in Part III.A, these preferential rights might harm the interests of Benchmark and Seligman, but Benchmark and Seligman appear to have consented to the terms on the assumption that the Series C financing would be the company's final round of equity financing.[197]

Unfortunately for Benchmark and Seligman, this proved to be a disastrous assumption. Notwithstanding the size of the Series C financing, Juniper notified its investors in early 2002 that even more capital would be required to sustain the company.[198] The significant capital needs of Juniper stemmed largely from federal banking regulations that required the company to maintain a well-capitalized status.[199] Failure to do so could result in the company becoming subject to a number of regulatory remedies, such as the loss of the right to issue Visa cards, which represented the company's primary line of business.[200] With the assistance of an investment banking firm, Juniper sought financing from a number of outside VC firms as well as from its existing investors. Ultimately, however, these efforts were unsuccessful except with respect to CIBC, which proposed a $50 million Series D financing.

The proposed financing from CIBC was a down-round financing that would result in a number of adverse consequences to the Series A and Series B Preferred Stock. First, the Series D Preferred Stock would be issued at a discounted price, triggering CIBC's full-ratchet antidilution protection.[201] As a result, CIBC would hold more than 90 percent of Juniper's voting power following the financing while the collective equity interests of the Series A and Series B Preferred Stock would drop from 29 percent to 7 percent.[202] Second, the Series D Preferred Stock would rank senior to the Series A and Series B Preferred Stock in terms of liquidation rights, redemption rights, and

196. The Series A and Series B Preferred Stock were entitled to more mild weighted-average antidilution protection. *See* Verified Complaint at 21, 37, Benchmark Capital Partners IV, L.P. v. Vague, C.A. No. 19719NC, 2002 WL 32925981 (Del. Ch. July 1, 2002).

197. *See Benchmark*, 2002 WL 1732423, at *3.

198. *See id.* at *4.

199. *See id.*

200. *See id.*

201. This conclusion is drawn from a statement in the subsequently issued Delaware Chancery Court opinion that, following the Series D financing: (1) CIBC would hold over 90 percent of the company's voting power on a fully diluted basis; and (2) its $50 million Series D investment would give CIBC "an additional 23% of Juniper on a fully-diluted basis." *Id.* at *4–*5. This latter statement implies a valuation of Juniper following the financing of $217 million ($50 million ÷ 23 percent). If triggered, CIBC's full-ratchet antidilution protection would have effectively repriced its $145 million Series C investment at the Series D valuation, turning the Series C investment into equity representing 67 percent of the company on a fully diluted basis ($145 million ÷ $217 million). Thus, the only means for CIBC to obtain 90 percent of the company's voting power after the Series D financing was through application of its Series C full-ratchet antidilution protection.

202. *See id.* at *5.

dividend rights.[203] Given that the Series C Preferred Stock was also senior to the Series A and Series B Preferred Stock, Benchmark and Seligman would receive nothing in an acquisition of the company unless the consideration was sufficient to satisfy $195 million of Series C and Series D liquidation preferences. In addition, the proposal also required the recapitalization of the company's Series A and Series B Preferred Stock to reduce the aggregate liquidation preference on these shares from $115 million to $15 million.[204]

Not surprisingly, Benchmark objected to the proposal. Arguing that Juniper's financial problems could be solved through further cost reductions, Benchmark sought to prevent the financing by exercising its stockholder veto rights. Many of the terms of the proposed financing appeared to fall within the scope of Benchmark's retained veto rights. Both the Series A and Series B Preferred Stock were entitled to a class vote on corporate actions that would "[m]aterially adversely change the rights, preferences, and privileges" of the relevant series of preferred stock.[205] In addition, the Series A and Series B stockholders also held a class veto over the authorization or issuance of "any other equity security . . . senior to or on a parity with the Series A Preferred Stock or Series B Preferred Stock as to dividend rights or redemption rights, voting rights or liquidation preferences."[206]

Recognizing Benchmark's veto rights, CIBC and Juniper sought to avoid a Benchmark vote by completing the authorization of the financing and the preferred stock recapitalization through a merger of Juniper with a wholly owned subsidiary. Under section 251 of the Delaware General Corporation Law, a merger could be used to modify Juniper's charter documents,[207] and CIBC and Juniper contended that the Series A and Series B veto rights applied only to modifications of the preferred stock through a direct amendment of the company's charter. Although the Series A and Series B Preferred Stock held a class veto right over a merger of Juniper, a merger with a wholly owned subsidiary was specifically excluded from the veto right. Once the merger was completed, Juniper would then issue the newly authorized Series D Preferred Stock to CIBC.

Benchmark filed suit to enjoin the merger and the subsequent issuance of the Series D Preferred Stock. Its case rested on two distinct arguments. First, Benchmark argued that the merger would violate the Series A and Series B veto rights because the merger was a corporate action that would "materially adversely change the rights, preferences, and privileges" of the Series A and

203. *See id.*
204. *See id.* at *5 n.20.
205. *Id.* at *1 (citation omitted).
206. *Id.* at *3.
207. DEL. CODE ANN. tit. 8, § 251(b) (Supp. 2004).

Series B Preferred Stock.[208] Second, Benchmark argued that both the merger—by authorizing the Series D Preferred Stock—and the company's execution of a stock purchase agreement obligating itself to issue the Series D Preferred Stock violated Benchmark's veto rights over the authorization or issuance of a senior security.[209] Benchmark acknowledged that CIBC had the authority to waive these veto rights; however, it argued that pursuant to its agreement with CIBC a waiver was prohibited if it would "diminish or alter the liquidation preference or other financial or economic rights" of the Series A or Series B Preferred Stock.[210] Because the merger and the issuance of the senior Series D Preferred Stock diminished the economic rights of the Series A and Series B Preferred Stock, the waiver could not apply.

These arguments were rejected in an opinion written by Vice Chancellor Noble. With respect to Benchmark's first argument, Vice Chancellor Noble noted that Benchmark's challenge was confronted by "a long line of Delaware cases" holding that "protective provisions drafted to provide a class of preferred stock with a class vote before those shares' rights, preferences and privileges may be altered or modified do not fulfill their apparent purpose of assuring a class vote if adverse consequences flow from a merger and the protective provisions do not expressly afford protection against a merger."[211] Had Benchmark intended the veto rights to cover material adverse changes accomplished through a subsidiary merger, Benchmark should have added this restriction. As a consequence, the court concluded, "[T]o the extent that the merger adversely affects the rights, preferences and privileges of either the Series A Preferred or Series B Preferred Stock, those consequences are the product of a merger, a corporate event which the drafters of the protective provision could have addressed, but did not."[212] The recapitalization of the Series A and Series B Preferred Stock could therefore proceed without a class vote.

The court similarly rejected Benchmark's challenge to the authorization and issuance of the Series D Preferred Stock. The court acknowledged that the class veto right over authorization of senior securities did not implicate the distinction between direct modification to preferred stock accomplished through a charter amendment and indirect modifications effected through a merger. However, it concluded that the use of a merger to authorize the Series D Preferred Stock was nonetheless fatal to Benchmark's challenge. The court cited established concerns with reading "[g]eneral language" concerning

208. *Benchmark*, 2002 WL 1732423, at *7.
209. *See id.* at *9.
210. *Id.* at *12.
211. *Id.* at *7.
212. *Id.* at *9.

preferred stock voting rights to require a class vote on a merger and a merger's "integral and accompanying modifications to the corporate charter and the corporation's capital structure" where none was intended.[213] Rather, the court concluded that "[t]o protect against the potential negative effects of a merger, those who draft protective provisions have been instructed to make clear that those protective provisions specifically and directly limit the mischief that can otherwise be accomplished through a merger under 8 Del. C. § 251."[214]

The court's concern with creating inadvertent veto rights also led it to reject Benchmark's argument that CIBC had no authority to waive its right to veto the issuance of the Series D Preferred Stock. Because the issuance was not accomplished through the merger, Benchmark's veto right over issuances of senior securities would apply unless CIBC could waive it. The court, however, accepted CIBC's argument that the simple issuance of a senior security by Juniper did not diminish the "financial or economic rights" of the Series A and Series B Preferred Stock, thereby entitling CIBC to waive the veto right. Although the court admitted that the scope of the waiver was ambiguous, it reasoned that "where (at least) an ambiguity exists, our law requires that it be resolved *against* creating the preference."[215] CIBC and Juniper could therefore complete the proposed Series D financing notwithstanding its adverse economic effect on Benchmark and Seligman.

IV. RECONSIDERING *BENCHMARK*, PREFERRED STOCK, AND MODERN CORPORATE SCHOLARSHIP

By demonstrating the potential intensity of interinvestor conflict, the *Benchmark* lawsuit quickly became one of the most well-known legal disputes concerning the VC industry. For journalists seeking to examine the implications of the dot-com meltdown, the case represented a symbolic shift in the operations of the VC market. The *Wall Street Journal* interpreted the case as a concrete example of the "tensions . . . appear[ing] in the once-clubby world of venture capital, as investors fight to wring value from troubled investments made during the Internet bubble."[216] For VC investors and their lawyers, the case represented an important example of a VC firm that failed to protect itself against the risk of interinvestor conflict. For them, the lesson to be learned from *Benchmark* was clear: VC investors should draft better protective provisions.[217]

213. *Id.* at *10.
214. *Id.*
215. *Id.* at *13.
216. Branstен, *supra* note 2, at C5.
217. *See infra* text accompanying note 227.

Outside the VC industry, however, the *Benchmark* case has received only scant attention. This is unfortunate, for there are broader lessons to be drawn from the case. First, the case clearly demonstrates the manner in which VC investors seek to utilize preferred stock to manage contractually interinvestor conflicts. As such, it suggests the need for a reconsideration of the *Benchmark* court's refusal to apply ordinary contract principles in interpreting the terms of Benchmark's preferred stock rights. Second, the conflict between Benchmark and CIBC provides a concrete illustration of the dynamic agency costs confronted by VC investors. By seeking to control investor-manager agency risk, Benchmark and CIBC created a dimension of interinvestor agency risk that ultimately created the conflict underlying the lawsuit. In so doing, *Benchmark* emphasizes the need to advance a theory of the firm capable of accounting for the dynamic development of multidimensional agency problems within a firm.

A. The Contractual Nature of Preferred Stock Rights

1. Using Preferred Stock to Manage Interinvestor Conflict

Although journalistic accounts of *Benchmark* focused on the rise of interinvestor tensions following the dot-com meltdown, the existence of interinvestor conflict was hardly a new development. As discussed in Part II, the potential for interinvestor conflict is an endemic feature of VC investment owing to staged investment and investment syndication. Nor was it particularly novel that a controlling shareholder in a private corporation should engage in allegedly rent-seeking behavior at the expense of Benchmark, a noncontrolling shareholder. The American history of the private corporation is replete with stories of minority shareholder "oppression."[218]

Indeed, in this light perhaps the most intriguing question about *Benchmark* isn't "why did the lawsuit occur?" but "why aren't there more lawsuits like it?" This is particularly true of the period following 2001 when interinvestor tensions were especially pronounced. Yet public disputes—let alone lawsuits—among VC investors have remained exceedingly rare. Although several interinvestor lawsuits have arisen since 2002, the number of lawsuits is surprisingly small relative to the number of down-round financings.[219] Moreover, the small number of lawsuits is in marked contrast to the dire warnings during the 2001–2003 economic downturn concerning the potential

218. *See* Robert B. Thompson, *The Shareholder's Cause of Action for Oppression*, 48 BUS. LAW. 699, 702–03 (1993); *see also infra* text accompanying notes 283–285.

219. *See supra* notes 92–94.

legal liability for VC investors participating in down-round financings.[220] What explains the dearth of interinvestor disputes?

One potential answer to this question is that VC investing is fundamentally a species of relational contracting. As such, VC investors presumably rely on reputational sanctions to deter both rent-seeking actions by controlling investors as well as lawsuits by noncontrolling investors.[221] It is commonly argued that a VC firm's concern about preserving its reputation for fair dealing among managers of start-up companies constrains its willingness to act opportunistically toward management.[222] It might therefore be supposed that a similar dynamic constrains one VC investor from acting opportunistically toward another investor. Under this theory, a VC investor who acts aggressively toward another investor may develop a tarnished reputation among fellow investors for being untrustworthy and opportunistic. As a consequence, the investor might receive fewer invitations to participate in promising start-up companies, which will ultimately harm the firm's long-term financial performance. Thus, a VC investor's desire for deal flow may create an incentive for developing a reputation for fair dealing and nonlitigiousness within the VC community.

While there is evidence that reputational concerns do encourage cooperative behavior among VC investors,[223] they cannot entirely explain the resilience of this cooperation. The significant growth of the VC industry over the past decade makes it unlikely that the VC community resembles those communities where norm-based reputational sanctions have come to

220. *See supra* text accompanying note 188.

221. A large literature exists regarding the power of reputation to curb contracting parties' opportunistic behavior. *See, e.g.*, Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724, 1739 (2001) (examining role of reputational sanctions within the cotton industry); David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 373, 408 (1990) (noting general effectiveness of threatening to destroy a contracting party's reputation within the business community as a contractual enforcement device); Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615, 616 (1981) (noting that a party's desire to maintain a positive business reputation and brand functions as a "private device[ ] which provides incentives that assure contract performance in the absence of any third-party enforcer"); Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 63 (1963) (stating that the most obvious nonlegal sanction is the "concern[ ] with both the reaction of the other party . . . and with his own general business reputation").

222. *See supra* note 78.

223. Anecdotal evidence suggests that venture capitalists are well aware of the importance of maintaining a positive reputation among fellow VC investors. For instance, one nineteen-year veteran venture capitalist cautions younger venture capitalists to "[t]reat everyone with fairness and dignity. That goes for founders, management, co-investors and service providers. Failure to treat people with respect will damage your reputation and turn off your deal flow." Fred Dotzler, *Top 10 Tips for New VCs from an Old Hand*, VENTURE CAPITAL J., Oct. 2003, at 50, 50.

displace legal sanctions.[224] At the same time, the growth of the industry during the 1990s followed by the ensuing economic downturn accentuated the tension between short-term financial gain and long-term deal flow. With the growth of the industry, VC firms have raised larger investment funds, causing the size of individual investments to increase significantly.[225] With greater amounts of capital at stake in each start-up company, the incentive to protect these investments in the face of the significant interinvestor conflicts outlined in Parts II and III undoubtedly strained any reputational incentives promoting cooperation.[226] This appears to have been precisely the case in *Benchmark*. Not only did CIBC negotiate provisions that accentuated the conflict with Benchmark, but CIBC and Benchmark both invested considerable sums in Juniper.

In these situations, an investor—no longer able to rely on reputational incentives to constrain rent-seeking behavior—must rely instead on negotiated contract provisions to minimize the risks posed by interinvestor conflicts. Of particular importance in this regard are the veto rights—or quasi-veto rights (such as liquidation preferences and antidilution rights)—described in Part II. These rights protect a VC investor against corporate actions adverse to its particular economic interests, especially when control of a company is in the hands of other VC investors who have financial incentives to take such actions. Indeed, a tremendous amount of practitioner commentary following *Benchmark* focused on advising VC firms on how to avoid loopholes in their protective provisions, underscoring the importance of these veto rights within the VC industry.[227]

224. In general, social norms appear to work best as a nonlegal sanction within a closely knit community, defined as a network in which power is broadly distributed and information circulates easily among network members. *See* ROBERT C. ELLICKSON, ORDER WITHOUT LAW 177 (1991). The VC industry, in contrast, has undergone considerable expansion in recent years. The membership of the NVCA alone has grown from eighty-nine firms in 1980 to over 900 firms in 2003, with over 9000 investment principals. *See* NVCA YEARBOOK, *supra* note 97, at 18–19. Indeed, veteran venture capitalists occasionally lament the changing world of VC "[f]rom a gang of investors and entrepreneurs who were joined at the hip . . . into an industry that requires nametags." Michael Copeland, *Protect Thyself*, VENTURE CAPITAL J., Dec. 2002, at 18, 18.

225. For instance, for all of the primary VC investment sectors, the average size of a first-round equity financing increased from approximately $1 million in 1980 to over $5.2 million in 2003 in inflation-adjusted dollars. *See* NVCA YEARBOOK, *supra* note 97, at 32, 40.

226. Industry insiders often explain the handful of interinvestor lawsuits as reflecting a new attitude among VC investors regarding the need to salvage large, sunk investments. As one prominent attorney summarized in 2003: "In the past, venture capitalists made a point of getting along with others because they might need that person in a future situation . . . . But that paradigm is busted. VCs have train wrecks for performance." Janet Whitman, *Squeezed Early Investors Are Fit to Sue*, WALL ST. J., Mar. 5, 2003, at 1 (quoting Joseph Bartlett, Attorney, Morrison & Foerster LLP, N.Y.).

227. *See, e.g.*, LeClaire et al., *supra* note 80; Orrick, Corporate Law Update: Benchmark Capital Partners IV, L.P. v. Vague (Jan. 1, 2004), http://www.orrick.com/publications/index.asp?action=article&articleID=235.

That these veto rights are drafted as preferred stock rights should in no way diminish their fundamentally contractual nature as agreements among a company's VC investors. The one document a company's VC investors are likely to read carefully—the nonbinding term sheet—often lumps the allocation of investor veto rights under a general heading entitled "Protective Provisions."[228] In turning the term sheet into VC contracts, most of these veto rights are set forth in the company's charter as preferred stock rights. Many may also appear in other, more explicitly "contractual" documents, such as the Investors' Rights Agreement or the Voting Agreement.[229] The decision ordinarily turns on issues of practicality, such as whether the veto right should be controlled by vote of a particular VC investor's board designee or by a particular group of preferred stockholders.[230]

As discussed previously, stockholder veto rights are hardly a perfect fix for remedying interinvestor conflicts, particularly in light of their holdup potential that was brought to light during the 2001–2003 economic downturn. Yet the paucity of investor lawsuits alleging opportunistic exercise of these rights, combined with the persistent usage of preferred stock veto rights by VC investors, stand as telling signs that on balance, these provisions have worked reasonably well to contain interinvestor conflict. No doubt, much of the success of VC investors in minimizing the risk of holdups stems from the fact that these veto rights are drafted not as contract rights allocated to individually named VC investors but as preferred stock rights allocated to particular series of preferred stock.[231] The use of reciprocal veto rights to control interinvestor conflict would pose an especially acute risk of investor holdups

228. *See, e.g.*, Natl. Venture Capital Ass'n, Term Sheet 6 (Jan. 7, 2004), http://www.nvca.org/model_documents/Term_Sheet.DOC.

229. *See* Thomas Klaus Gump, *Down Round Financings*, *in* 1 VENTURE CAPITAL & PUBLIC OFFERING NEGOTIATION 10A-1, 10A-11 (Michael J. Halloran et al. eds., 3d ed. Supp. 2005) (noting that investor veto rights "may be found in a stockholders' agreement between the company and all or part of its shareholders or, as is typically preferred by investors, in the publicly filed certificate or articles of incorporation of the issuer").

230. For instance, the NVCA Model Investors' Rights Agreement provides for a number of "Matters Requiring Investor Director Approval" that largely track the protective provisions specified in the Model Term Sheet. *See* Nat'l Venture Capital Ass'n, Amended and Restated Investors' Rights Agreement 29–30 (May 2006), http://www.nvca.org/model_documents/IRA%20Rev%203.DOC. A footnote comment emphasizes that the provision is often included as a means of negotiation expediency: "In many cases, the investors won't go forward without this provision. In other cases, the topics of concern would otherwise be added to the Certificate of Incorporation and require a shareholder vote. The company might find the director approval approach more attractive as a compromise." *Id.* at 28 n.46.

231. *See* Hi-Tech Charter, *supra* note 106, at 8-55 to 8-57 (providing for protective provisions that may be approved by vote of two-thirds of all shares of preferred stock and for protective provisions that may only be approved by two-thirds vote of each series of preferred stock); NVCA Model Charter, *supra* note 62, at 17–18 (providing for "Series A Preferred Stock Protective Provisions").

were each VC investor to receive separate veto rights. Allocating rights based on preferred stock ownership diminishes this risk. As discussed in Part II, interinvestor conflicts arise from the fact that a company's VC investors purchase securities issued at different times and different prices. By creating a new series of preferred stock at each issuance, a company and its VC investors create a means by which to group investors whose economic interests should generally be aligned. For example, recall again the manner in which FormFactor's earliest VC investors used preferred stock to retain a separate veto right over the company's acquisition and future financing.[232] By setting the voting threshold for approving these transactions at a majority of the Series B through Series G Preferred Stock, FormFactor's three earliest VC investors protected their collective economic interests vis-à-vis FormFactor's later investors without the risk that any one investor could individually hold up a potential transaction. Allocating investor rights by series of preferred stock therefore allows each group of investors having similar economic interests to protect their collective interests while diminishing the risk that any one investor can engage in rent-seeking behavior through opportunistic exercise of a veto right.[233]

In short, VC investors have few legal disputes because, when reputational incentives for cooperation fail, they have negotiated an elaborate set of contracts to address the risk of interinvestor conflict. It was thus hardly surprising that when Benchmark and Seligman recognized the potential interinvestor conflicts created by Juniper's Series C financing, they sought to protect their economic interests through negotiating specific preferred stock protective provisions. As Benchmark stated in its complaint:

> Benchmark and other investors in Juniper had several concerns regarding [the financing's] terms, particularly the possible abuse by CIBC of the voting power CIBC would acquire . . . . After negotiation, Benchmark secured the agreement that CIBC would not, among other things, use the Series C Trump (a) to diminish or alter the liquidation preference or other financial or economic rights of the [Series] A and B

232. *See supra* text accompanying notes 145–146, 152–153.

233. Of course, the risk for opportunistic rent-seeking is not eliminated by the creation of preferred stock voting blocks. On the contrary, the block itself may engage in rent-seeking activities. In most circumstances, however, the existence of reciprocal veto rights should create a mutual-hostage situation that forces VC investors to negotiate cooperatively to resolve interinvestor disputes. *See* Robert P. Bartlett, III, Conflict and Cooperation in Venture Capital Contracting 69–83 (Mar. 31, 2005) (unpublished manuscript, on file with author); *cf*. Oliver Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. REV. 519, 530 (1983) (discussing incentives for cooperative dispute resolution in ventures where a "mutual hostage" situation exists).

> Preferred, nor modify their registration rights, (b) add to the obligations, indemnities or liabilities of the [Series] A and B Preferred or (c) authorize, approve or waive any action that would violate any fiduciary duties owed by the Series C Preferred to the Series A and Series B Preferred.[234]

The problem for Benchmark and Seligman, however, was their failure to appreciate the fact that by memorializing this agreement as a preferred stock voting right, Delaware courts would interpret it differently than if it had been memorialized in an ordinary contract.

2. Reassessing Delaware's Refusal to Treat Preferred Stock as Contract

A primary failure of the *Benchmark* opinion—and of Delaware corporate jurisprudence in general—is the refusal to apply ordinary contract principles in interpreting the terms of preferred stock rights. To be sure, Delaware courts do recognize the contractual nature of the rights set forth in a company's certificate of incorporation. As the *Benchmark* court noted:

> Certificates of incorporation define contractual relationships not only among the corporation and its stockholders but also among the stockholders. Thus, [Juniper's] Certificate defines, as a matter of contract, both the relationship between Benchmark and Juniper and the relative relationship between Benchmark, as a holder of junior preferred stock, and CIBC, as the holder of senior preferred stock. For these reasons, courts look to general principles of contract construction in construing certificates of incorporation.[235]

In ascertaining the scope of preferred stock rights, however, the court cited a further Delaware principle concerning preferred stock. According to this principle, a court's function in interpreting the rights of preferred stockholders

> is essentially one of contract interpretation against the background of Delaware precedent. These precedential parameters are simply stated: Any rights, preferences and limitations of preferred stock that distinguish that stock from common stock must be expressly and clearly stated, as provided by statute. Therefore, these rights, preferences and liquidations will not be presumed or implied.[236]

Although these "precedential parameters" would seem to apply only to the "rights, preferences and limitations of preferred stock that distinguish that

234. Verified Complaint, *supra* note 196, at 11.

235. Benchmark Capital Partners IV, L.P. v. Vague, No. Civ. A. 19719, 2002 WL 1732423, at *6 (Del. Ch. July 15, 2002), *aff'd sub nom.* Benchmark Capital Partners IV, L.P. v. Juniper Tin Corp., 822 A.2d 396 (Del. 2003).

236. *Id.* (quoting Elliot Assocs., L.P. v. Avatex Corp., 715 A.2d 843, 852–53 (Del. Ch. 1998)).

stock from common stock," Judge Noble had little difficulty summarily concluding that "[t]hese principles also apply in construing the relative rights of holders of different series of preferred stock."[237]

Armed with these precedential parameters, Judge Noble thus disposed of Benchmark's workmanlike attempt to interpret its preferred stock rights using ordinary contract principles. As noted above, Benchmark focused on the broad wording of its veto power to conclude that it held a veto right over Juniper's proposed merger—a corporate action that would seem to "materially adversely change the rights, preferences and privileges" of the Series A and Series B Preferred Stock.[238] Although this straightforward analysis might satisfy a Delaware court interpreting an ordinary contract,[239] the problem for Benchmark was the need to interpret the veto against the "background of Delaware precedent." This precedent includes *Warner Communications, Inc. v. Chris-Craft Industries, Inc.*,[240] which concluded that a veto right over adverse modifications to preferred stock rights does not apply if the adverse modifications result from a merger and the veto right does not expressly afford protection against a merger.[241]

Yet while *Warner* may have been fatal to Benchmark's attempt to veto the merger of Juniper, *Warner* did not dictate the outcome of Benchmark's other contract arguments concerning its right to veto the authorization and issuance of the Series D Preferred Stock. With regard to the authorization of the Series D Preferred Stock, Juniper's charter gave Benchmark the right to veto its authorization regardless of whether it was created by Juniper's merger or otherwise. Judge Noble refused to read this veto right generally, however, based on established Delaware precedent that protective rights "'must . . . be clearly expressed and will not be presumed.'"[242] With regard to Benchmark's attempt to veto the issuance of the Series D Preferred Stock, Judge Noble

237. *Id.* at *7.

238. *See supra* text accompanying notes 208–210.

239. In general, Delaware courts interpret ordinary contracts using the "plain meaning rule." *See* Watkins v. Beatrice Cos., 560 A.2d 1016, 1021 (Del. 1989). Under Delaware's version of this rule, "[c]ontracts must be construed as a whole, to give effect to the intentions of the parties." Nw. Nat'l Ins. Co. v. Esmark, Inc., 672 A.2d 41, 43 (Del. 1996). To discern the parties' intent, courts look first to the express language of the contract: "Where the contract language is clear and unambiguous, the parties' intent is ascertained by giving the language its ordinary and usual meaning." *Id.* at 45. Delaware courts look to extrinsic evidence to discern contractual intent only "if there is an ambiguity in the contract." *Id.*

240. 583 A.2d 962 (Del. Ch. 1989), *aff'd*, 567 A.2d 419 (Del. 1989).

241. *See id.* at 969–70.

242. *Benchmark*, 2002 WL 1732423, at *10 (quoting Elliott Assocs., L.P. v. Avatex Corp., 715 A.2d 843, 853 n.45 (Del. 1998)).

likewise turned to this interpretive principle to address the argument. As noted earlier, the primary issue was whether the issuance would "diminish or alter . . . [the] financial and economic rights" of the Series A and Series B Preferred Stock.[243] Judge Noble conceded that an ambiguity existed in the meaning of this language and that it could "easily be given the broad interpretation suggested by Benchmark."[244] He ultimately concluded, however, that "where (at least) an ambiguity exists, our law requires that it be resolved *against* creating the preference."[245]

One might expect that given the importance of this preferred stock presumption in *Benchmark*, it would have a precedential pedigree of unquestionable authority. Even a cursory analysis of its historical roots, however, reveals the presumption to be primarily a judicial enshrinement of specious dicta contained in a 1930 Delaware Chancery Court decision, *Penington v. Commonwealth Hotel Construction Co.*[246] In *Penington*, the receiver of a liquidated corporation asked the Delaware Chancery Court to determine the proper allocation of the corporation's remaining assets between its common and preferred stockholders. The corporation's charter provided that in the event of its liquidation, the preferred holders were to receive before the common holders the "par value [of such preferred stock], and all unpaid dividends accrued thereon."[247] Although no preferred dividends had been declared by the company, the charter provided that the preferred stock was entitled to annual, cumulative dividends of 7 percent.[248] At issue was whether the liquidated corporation could pay preferred stockholders these accumulated preferred dividends specified in the charter when it had never turned a profit and no capital surplus existed. The court recognized that the charter essentially represented a contractual agreement between the preferred and common

243. *See supra* note 210.
244. *Benchmark*, 2002 WL 1732423, at *13.
245. *Id.*
246. 151 A. 228 (Del. Ch. 1938).
247. *Id.* at 230.
248. *See id.* at 229–30. The relevant language of the charter reads as follows:

> The holders of the preferred stock of this corporation shall be entitled to receive and the corporation shall be obligated to pay thereon out of the surplus or net profits of the business of the corporation in each year dividends at the rate of seven per centum (7%) per annum and no more payable on such dates as may be fixed by the Board of Directors. Such dividends on the preferred stock shall be payable before any dividends shall be payable or set apart on the common stock and shall be cumulative, so that if dividends for any past dividend period at the rate of seven per centum (7%) per annum shall not have been paid thereon or set apart therefor, the deficiency shall be fully paid or set apart, but without interest, before any dividend shall be paid or set apart for the common stock.

Id.

stockholders over the distribution of liquidation proceeds and proceeded to "consider the question as solely one of contract between the common owners of a fund."[249] In what can only be described as a tortured interpretation of the charter, the court concluded that the phrase "unpaid dividends accrued thereon" meant only those preferential dividends that were required to have been paid out of net profits or surplus while the company was a going concern but went unpaid for some reason.[250]

Not content with this questionable contractual interpretation, the court added in dicta:

> The general rule is that preferred stock enjoys only those preferences which are specifically defined and that as to all matters lying outside the field of defined preferences, preferred stock has no rights which are not shared equally with the common stock. Hence if dividends in arrear are not made a specific charge on the assets representing capital paid in, they cannot be paid out of such assets on liquidation.[251]

In support of this proposition, the court cited a 1929 chancery court opinion, *Gaskill v. Gladys Belle Oil Co.*[252] Only the loosest reading of *Gaskill*, however, could support this broad pronunciation. *Gaskill* concerned the narrow issue of whether the rights of preferred stock could be set forth in a corporation's bylaws as opposed to its charter. The chancery court in *Gaskill* focused primarily on Section 13 of the Delaware corporate statute of 1919, which provided that "[e]very corporation shall have power to create two or more classes of stock, with such designations, preferences and voting powers, or restrictions or qualifications thereof, as shall be stated and expressed in the Certificate of Incorporation."[253] Given this language, the *Gaskill* court concluded that the preferred stock rights should have been set forth in the charter and not the bylaws.[254]

Nothing in *Gaskill* suggests that, had these rights been expressed in the charter, the court would have applied anything other than ordinary contract principles in interpreting them.[255] Nonetheless, *Penington* became the first of a long line of cases to place a broad judicial gloss on *Gaskill*. By 1937, *Gaskill* was construed to require that preferred stock rights not only be expressed in

249. *Id.* at 232.
250. *Id.* at 234.
251. *Id.*
252. 146 A. 337 (Del. Ch. 1929).
253. *Id.* at 339.
254. *See id.* at 340–41.
255. *See id.* at 339 ("It is elementary that the rights of stockholders are contract rights . . . . The holder of preferred stock must therefore refer to the appropriate language of the corporate contract for the ascertainment of his rights.").

the charter but "clearly" expressed;[256] and by 1943, *Gaskill* and its progeny required that preferred stock rights "must be strictly construed."[257] This doctrine of "strict construction" continued until 1998 when the Delaware Supreme Court disapproved the continued use of the phrase.[258] The court nonetheless continued to endorse the rule that preferred stock rights be "clearly expressed and will not be presumed"[259]—an approach that, as seen in *Benchmark*, can operate as strict construction in everything but name.

Analysis of the policy reasons for the development of this interpretive principle of preferred stock rights only further weakens its doctrinal validity. *Penington*, like *Gaskill*, involved a dispute between common and preferred stockholders over the distribution of a liquidated company's assets. Understanding this historical context is critical, for this type of dispute was a common one in the early years of preferred stock and significantly colored courts' analyses of preferred stock rights. *Gaskill*, for instance, relied heavily on a line of cases from New Jersey and England involving similar disputes between common and preferred stockholders over the distribution of a liquidated company's assets. These cases held that "with respect to capital all outstanding stock, whatever its source, is entitled, in the absence of statute or of a contract provision to the contrary, to a ratable participation in the distribution of the capital to which all have contributed."[260]

In essence, these cases articulated a default rule of equal sharing for preferred and common stock in liquidation scenarios. It is against this backdrop that one must interpret subsequent statements by Delaware courts that "all stock enjoys equal rights and privileges, and that claims for special preferences must be clearly provided by the charter contract. Such was in effect the holding of *Gaskill v. Gladys Belle Oil Co*."[261] To the extent courts use this language to support a general rule of narrow construction of preferred stock rights, they give *Gaskill* a life entirely separate from its original policy rationale of specifying how preferred stockholders could opt out of an equal-sharing default rule on corporate liquidations.

Nor does the one policy consideration advanced by contemporary Delaware courts create a satisfactory rationale for a narrow construction of preferred stock rights. As the Delaware Supreme Court stated in *Elliot Associates*,

256. Holland v. Nat'l Auto. Fibres, Inc., 194 A. 124, 126 (Del. Ch. 1937).
257. Goldman v. Postal Tel., 52 F. Supp. 763, 767 (D. Del. 1943).
258. Elliot Assocs., L.P. v. Avatex Corp., 715 A.2d 843, 853 n.46 (Del. 1998).
259. *Id.* at 853 n.46 (quoting Rothschild Int'l Corp. v. Ciggett Group, 474 A.2d 133, 136 (Del. 1984)).
260. *Gaskill*, 146 A. at 338.
261. Penington v. Commonwealth Hotel Constr. Corp., 155 A. 514, 520 (Del. 1931).

L.P. v. Avatex Corp.,[262] the interpretive principle of requiring preferred stock rights to be clearly expressed "continues a coherent and rational approach to corporate finance."[263] Simply stated, the approach is one where preferred stock investors have enormous incentive to draft clear preferred stock rights, with the Delaware judiciary occasionally lending a helping hand by providing examples of sufficiently clear language. Indeed, Benchmark's case was undoubtedly made more difficult by the fact that the Delaware Supreme Court in *Avatex* had specifically approved language providing for a preferred stock veto right over adverse changes effected by merger.[264] Consequently, the *Avatex* court concluded that "the path for future drafters to follow in articulating class vote provisions is clear."[265] Given the availability of this language, Judge Noble was therefore reluctant "to create uncertainty in a complex area where *Avatex* has set down a framework for consistency."[266] Yet *Avatex* provided clarity in only one narrowly defined context: how to protect against adverse changes to preferred stock rights by means of a merger. It said nothing about how preferred stockholders can draft with sufficient clarity the multitude of other rights they might seek. Under the logic of *Avatex*, preferred stockholders must remain uncertain of the legal effect of these untested rights until a court has approved a particular expression as sufficiently clear. In this regard, it can hardly be surprising that commentary within the VC industry following *Benchmark* expressed concern regarding the enforceability of other customary preferred stock terms.[267] Indeed, the fact that the Delaware Supreme Court felt compelled to provide a "path for future drafters" at all is itself a testament to the systemic uncertainties created by the prevailing preferred stock interpretive principles.

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262. 715 A.2d 843.

263. *Id.* at 854.

264. *See id.* at 844 ("[W]e hold that certain preferred stockholders have the right to a class vote in a merger where: (1) the certificate of incorporation expressly provides such a right in the event of any 'amendment, alteration or repeal, whether by merger, consolidation or otherwise' of any of the provisions of the certificate of incorporation; (2) the certificate of incorporation that provides protections for the preferred stock is nullified and thereby repealed by the merger; and (3) the result of the transaction would materially and adversely affect the rights, preferences, privileges or voting power of those preferred stockholders. In so holding, we distinguish prior Delaware precedent narrowly because of the inclusion by the drafters of the phrase, 'whether by merger, consolidation or otherwise.'").

265. *Id.* at 855.

266. Benchmark Capital Partners IV, L.P. v. Vague, No. Civ. A. 19719, 2002 WL 1732423, at *10 (Del. Ch. July 15, 2002), *aff'd sub nom.* Benchmark Capital Partners IV, L.P. v. Juniper Tin Corp., 822 A.2d 396 (Del. 2003).

267. *See, e.g.*, Michael Kendall & John LeClaire, *The* Benchmark *Case and the Limits of Preferred Stock Protections*, VENTURE CAPITAL J., Nov. 2002, at 38, 39 (warning that the *Benchmark* "decision could represent the tip of an iceberg with respect to certain 'standard' preferred stock terms that, in light of the Delaware cases, may be found to be ambiguous or imprecise").

Thus, there are neither doctrinal nor policy reasons for treating the complex contractual arrangement negotiated by CIBC, Juniper, and Benchmark as something other than contractual. Using both preferred stock and standard contract provisions, CIBC and Benchmark did exactly what financial economists predict rational investors do when making an investment in a private corporation: They sought to protect themselves through contract against potential agency risks—both those arising from conflicts with managers and those arising from conflicts with one another. To the extent investors use preferred stock to express these rights, the Delaware principle of narrow construction burdens these contractual rights in an unexpected and potentially costly way for investors. Likewise for entrepreneurs, the enhanced investment risk faced by VC investors must inevitably lead to a higher cost of capital for firms seeking VC financing.[268]

Admittedly, resorting to ordinary contract principles to interpret preferred stock rights will hardly eliminate the risk that contractual provisions may fail to have their intended effect. Contracts are inherently incomplete and no contract can protect against all potential agency risks.[269] By forsaking the narrow-construction doctrine, however, Delaware courts can ensure that the same gap-filling measures apply to all investor contract provisions regardless of the type of document that contains them. In the context of VC finance, this result would permit VC investors to continue to use preferred stock as their security of choice without the attendant risks associated with the prevailing preferred stock interpretive principles.

B. *Benchmark*, Corporate Scholarship, and the Theory of the Firm

Whatever its shortcomings with respect to doctrinal analysis, *Benchmark* nevertheless provides a useful illustration of the central thesis of this Article. The agency risks faced by Benchmark were multiple and complex. As with most VC investors, Benchmark sought to contain investor-manager agency risk with Juniper's management through a variety of investment techniques, including staging its investments and syndicating its investments to other VC investors such as CIBC. In so doing, however, Benchmark ultimately created

268. *See* BARNEA ET AL., *supra* note 17, at 2 (noting correlation of nonsystematic investment risk with a firm's cost of capital).

269. Indeed, the impossibility of drafting "complete" contracts is a primary reason why contracting parties can engage in opportunistic behavior toward one another. *See* Benjamin Klein, *The Hold-Up Problem*, *in* 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 241 (Peter Newman ed., 1998); Alan Schwartz, *Incomplete Contracts*, *in* 2 *id.* at 277; Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641, 1642 (2003).

a new dimension of interinvestor agency risk when CIBC itself sought to protect against potential agency problems with Juniper's management. Only by appreciating the dynamic formation of these agency risks is it possible to understand why Benchmark sought to preserve a separate veto right and why it ultimately sought to exercise it over the Series D financing. Moreover, as this part shows, the analytical framework used in this Article provides insight not only into VC investment but also into the general character of agency problems in a firm. In this regard, the story of VC finance highlights the need to move beyond traditional theories of the firm in at least two respects.

First, the presence of both investor-manager and interinvestor agency problems in VC investment suggests the need to reassess traditional analytical frameworks that emphasize a unitary perspective of agency risk within a firm. As discussed previously, a significant amount of contemporary corporate scholarship concerns itself with examining the agency problems created by the separation between management and risk-bearing equity in public corporations.[270] One need look no further than the significant debate concerning the proper internal governance institutions of firms to see the pervasiveness of this unitary, one-dimensional framework. In their important work on team production and corporate governance, Blair and Stout note that a primary obstacle for their team production theory is the widespread acceptance among corporate scholars of what they call the "grand design principal agent model."[271] As they note, this paradigm has given rise to two recurring themes in legal scholarship. "First, that the central economic problem addressed by corporation law is reducing 'agency costs' by keeping directors and managers faithful to shareholders' interests; and second, that the primary goal of the public corporation is—or ought to be—maximizing shareholders' wealth."[272]

Blair and Stout's team production model provides a paradigm of the firm that takes a first step beyond this unitary, one-dimensional framework. In their view, a corporation consists of the collaborative efforts of multiple participants with potentially conflicting interests. These participants—including shareholders, employees, and other stakeholders such as creditors—make firm-specific contributions to the corporation that are difficult to recover once committed.[273] Because these contributions are also likely to be nonseparable from one another, a number of problems can arise as participants squabble over how to divide any economic surpluses generated by the team production.[274] In

270. *See supra* text accompanying notes 39–43.
271. Blair & Stout, *supra* note 14, at 287.
272. *Id.* at 248–49.
273. *See id.* at 249.
274. *See id.*

general terms, the team members have created a series of agency relationships in which each participant is a principal and must rely on the team as its agent.[275] To address the problem of mutual opportunism this creates, team members voluntarily cede control over the firm and their sunk-cost, firm-specific investments to an outside party that lacks any direct incentive to take advantage of team members. Blair and Stout argue that this role is filled in most public corporations by the board of directors, which acts as a "mediating hierarch" of the firm to resolve team members' conflicting interests.[276]

Yet even as Blair and Stout assail the traditional grand-design paradigm, they continue to rely on a fundamentally unitary perspective of agency risk—or in their terms, "'team production' problem."[277] Team members are presented as discrete constituents of the corporation with separate, well-defined interests. For instance, Blair and Stout justify shareholder voting rights on the basis that shareholders have a "homogeneous interest" in maximizing share price which is often in harmony with other stakeholders' interests.[278] Likewise, in their paradigm, the board mediates between the conflicting interests of distinct corporate constituencies such as bondholders, employees, and shareholders.[279] This unitary approach toward each corporate constituency is certainly at odds with the experience of the VC industry, where interconstituency conflict is a way of life.

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275. *See* Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403, 418–19 (2001). Blair and Stout utilize the phrase "team production" to describe their theory, but as the text illustrates, it can easily be recharacterized as a theory about agency problems. Indeed, Blair and Stout take the "team production" concept from Armen Alchian and Harold Demsetz, whose work was built largely on principal-agent economics. *See* Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 794 (1972) (describing the "essence of the classical firm" as one involving team production coordinated by a "central agent . . . called the firm's owner and the employer"). Jensen and Meckling likewise note the close relationship between "agency cost problems" and "team production problems":

> [A]gency costs arise in any situation involving cooperative efforts (such as the co-authoring of this paper) by two or more people even though there is no clear cut principal-agent relationship. Viewed in this light it is clear that our definition of agency costs and their importance to the theory of the firm bears a close relationship to the problem of shirking and monitoring of team production which Alchian and Demsetz (1972) raise in their paper on the theory of the firm.

Jensen & Meckling, *supra* note 8, at 309.

276. Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 686 (2003).

277. Blair & Stout, *supra* note 275, at 419.

278. Blair & Stout, *supra* note 14, at 313; *see also id.* at 302 n.135 ("[T]he passive investors who own stock in public corporations tend to share homogeneous interests—in particular, an interest in maximizing the market price of their shares.").

279. *Id.* at 306.

Moreover, *Benchmark* demonstrated that VC investors will often seek to resolve these conflicts independently of the board through stockholder voting rights. Blair and Stout concern themselves primarily with public corporations, but even in that context, the interests of corporate constituencies will often be heterogeneous and will require mediation outside the realm of the board. This is particularly true for shareholders, who may have private interests that conflict with the goal of maximizing shareholder value generally or with the particular interests of certain shareholders.[280] Just as in *Benchmark*, these private interests may induce influential shareholders to engage in rent-seeking behavior that is beyond the domain of the board of directors' authority to mediate.[281] These intershareholder agency problems remain unexplained by the team production model, yet they may fundamentally affect the risk profile of corporate investment.[282]

In contrast, corporate scholarship concerning close corporations has generally been better at grappling with intershareholder conflicts. As noted above, it is widely agreed that "shareholders in closely held corporations face a high risk of loss from their fellow shareholders' opportunism."[283] Moreover, there is a general consensus that the primary constraints on shareholder opportunism—contractual agreements, reputational constraints, and fiduciary duties running from shareholder to shareholder—are not entirely effective in eliminating this risk.[284] The result is that the risk of intershareholder conflict increases the cost of capital for closely held firms.[285]

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280. *See generally* Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power* 53 UCLA L. REV. 561 (2006); Stephen M. Bainbridge, *Shareholder Activism and Institutional Investors* (UCLA Sch. of Law, Law-Econ. Research Paper No. 05-20, 2005), *available at* http://ssrn.com/abstract=796227; *see also* Edward Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 466–68 (1991) (discussing potential conflict between large and small investors in public companies).

281. *See infra* text accompanying notes 288–297.

282. *See* Carney, *supra* note 5, at 20 ("In efficient capital markets with rational expectations, investors will demand compensation, in the form of increased yields, for expected [interinvestor conflicts] that cannot be costlessly diversified away."). For an analysis of why it may not be possible to diversify away these interinvestor conflicts even within public equity investing, see *id.* at 11.

283. *See supra* text accompanying notes 4–5; *see also* Paul G. Mahoney, *Trust and Opportunism in Close Corporations*, *in* CONCENTRATED CORPORATE OWNERSHIP (Randall K. Morck ed., 2000); Lawrence E. Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. PA. L. REV. 1675 (1990); Douglas K. Moll, *Shareholder Oppression in Close Corporations: The Unanswered Question of Perspective*, 53 VAND. L. REV. 749 (2000); Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 J. CORP. L. 913 (1999).

284. *See, e.g.*, Easterbrook & Fischel, *supra* note 5, at 279 (recognizing that although contractual mechanisms have evolved to protect minority shareholders, "[t]he more power minority shareholders have, the more likely is deadlock").

285. *See* EASTERBROOK & FISCHEL, *supra* note 31, at 243.

Yet here too the analytical framework underlying most studies of close corporations fails to account for the multiple dimensions of agency risk faced by investors in a private company. In particular, investor-manager agency problems are commonly assumed to be nonexistent or significantly reduced in closely held firms.[286] The primary exception is, of course, in the context of VC investment where scholars have focused exclusively on these agency problems to the exclusion of agency problems among investors. While this Article has shown the shortcomings of the traditional VC model, the model nevertheless illustrates that investor-manager agency problems may play a critical role in closely held corporations. By not accounting for them, the standard analytical framework for close corporations potentially obscures the risks of private company investment.

Second, in addition to emphasizing the need to consider multidimensional agency problems in firms, VC finance also highlights the dynamic manner in which these problems can develop. Recall again that it was Benchmark's attempt to control investor-manager agency risk with Juniper's management through staged financing and syndication that created the potential for interinvestor agency risk with CIBC. Closely related to the development of this interinvestor agency risk was the fact that these investors were VC funds subject to the capital-time investment constraint and significant investment return incentives. Also related to the size of this agency risk was the existence of the preferred stock contract provisions that were negotiated between Benchmark and CIBC—most importantly, the veto rights retained by Benchmark. An accurate ex ante assessment of Benchmark's potential agency risks in investing in Juniper would have required consideration of the interplay of all of these factors.

The dynamic character of agency problems has important—and understudied—implications for corporate scholarship. Traditionally, agency cost theory has been utilized to determine how agency problems might increase a firm's cost of capital. All other things being equal, investors will demand a higher rate of return as compensation for higher agency costs.[287] The dynamic character of agency problems provides a further twist to the preceding analysis: Not only must an investor account for the multiple dimensions of agency

286. *See supra* text accompanying note 5; *see also* EASTERBROOK & FISCHEL, *supra* note 31, at 233 ("Because closely held corporations do not separate management from risk bearing, monitoring is less costly.").

287. *See, e.g.*, Jensen & Meckling, *supra* note 8, at 313 ("Prospective minority shareholders will realize that the owner-manager's interests will diverge somewhat from theirs, hence the price which they will pay for shares will reflect the monitoring costs and the effect of the divergence between the manager's interests and theirs.").

problems in a firm, but she must also account for any agency problems that will arise when she seeks to address them (for example, through bonding or monitoring efforts). Thus, in pricing a start-up company investment, a rational VC investor must consider not only agency risks with management, but the agency risks that might develop with other VC investors once she tries to reduce these investor-manager agency risks. The extent of these interinvestor agency risks, in turn, may be affected by characteristics of the investors themselves (for example, are the VC funds nearing the expiration of their investment terms?) and mechanisms the VC investor might utilize to reduce these risks (for example, reciprocal veto rights). After *Benchmark*, the enforceability of these mechanisms must also be considered.

Nor are the dynamic characteristics of agency problems limited to VC investment. Attempts to rein in investor-manager agency problems borne by public company shareholders might likewise create additional dimensions of agency conflict for shareholders. Take, for instance, the argument for increasing institutional investor activism in corporate governance. In theory, institutional investors should help minimize investor-manager agency problems in public corporations by taking an active role in corporate governance.[288] Institutions typically hold larger blocks of shares than individuals and have the resources and incentives to develop expertise in making and monitoring public company investments. Moreover, their considerable share holdings should enable them to obtain directors' attention and to make changes in a board's composition when firm performance lags. Indeed, the desire to reunite ownership and control by deferring to institutional investors has led to several initiatives to empower institutional investors to fulfill this role, such as the Securities and Exchange Commission's recent proposal to permit shareholders to nominate directors directly and have their nominees listed in the company's proxy statement.[289]

By granting institutional investors more power, the agency costs of investing in public equities are altered but not necessarily reduced. As Stephen Bainbridge has noted, institutional investor activism in practice has fallen far short of its theoretical potential.[290] The high costs of activism have encouraged institutional investors to remain "rationally apathetic" when it comes to exercising shareholder rights or engaging in active firm monitoring.[291] The

288. For an articulation of this argument, see generally MARK J. ROE, STRONG MANAGERS, WEAK OWNERS (1994); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990).

289. *See* Security Holder Director Nominations, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274).

290. *See* Bainbridge, *supra* note 280, at 10–11.

291. *Id.* at 12–14.

exceptions are those shareholders who seek to use increased shareholder rights to self-deal or to take private benefits from the corporation that are not shared by other investors. Unions and pension plans, for instance, have been particularly active shareholders even though their activism often redounds to their private benefit.[292] A corporate investor, too, might seek to use its leverage as a large-block shareholder to skew a firm's business decision to obtain a larger share of the firm's business—regardless of whether it enhances firm value.[293] Lastly, hedge funds—investment funds that, like VC funds, have capital-time investment constraints and significant investment return incentives—might utilize enhanced shareholder rights to engage in rent-seeking behavior. For instance, a hedge fund might seek to use its shareholder leverage to engage in 1980s-style greenmail tactics to extract side payments from company management.[294] Alternatively, as recently demonstrated in *High River Limited Partnership v. Mylan Laboratories, Inc.*,[295] a fund might utilize derivative transactions to acquire voting rights in a firm without any concomitant economic interest. It can then exercise these voting rights in a manner that advances the fund's long position in another firm.[296]

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292. *See id.* at 15–16 (describing instances where union pension funds have used shareholder proposals to obtain employee benefits they could not obtain through collective bargaining).

293. This technique was vividly illustrated by duPont Company's investment in General Motors (GM) in the early twentieth century. In 1917, duPont substantially increased its equity position in GM as a means "to obtain for du Pont the bulk of GM's artificial leather, polyimide, paint, and varnish businesses." Anabtawi, *supra* note 280, at 576.

294. *See id.* at 596 (noting that shareholders "can use private negotiations with management to obtain greenmail-type payments in exchange for agreeing to support managerial interests"); *see also* Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 TULANE L. REV. 409, 456 (1998) (noting activist stockholders may pursue agendas not shared with stockholders as whole and seek to "extract[ ] side payments, akin to greenmail, from management interested in eliminating the threat of a stockholder by-law initiative"). In objecting to the SEC's director nomination proposal, the Business Roundtable expressed special concern regarding the potential for hedge funds to abuse shareholder nominations as a means to extract greenmail. *See* Sara Hansard, *SEC Proxy Proposal May Give Hedge Fund Too Much Power*, INVESTMENT NEWS, Nov. 24, 2003, at 12 ("What I'm really worried about are the hedge funds and the vulture funds and the other people who will see this as a great opportunity to force companies into transactions that may be good for the hedge fund or good for the vulture fund but may not be good for other security holders.") (quoting Martin Lipton, founding partner, Wachtell, Lipton, Rosen & Katz); Letter from John J. Castellani, Bus. Roundtable, to Jonathan G. Katz, Sec'y, Sec. & Exch. Comm'n (Dec. 22, 2003), *available at* http://www.sec.gov/rules/proposed/s71903/jjcbrt122203.htm.

295. 353 F. Supp. 2d 487 (M.D. Pa. 2005).

296. *High River* concerned a proposed acquisition of King Pharmaceuticals, Inc. (King) by Mylan Laboratories, Inc. (Mylan)—a transaction that the market regarded as placing too high a value on King. *See* Anabtawi, *supra* note 280, at 591. Perry Corp. (Perry), a hedge fund, acquired a fully hedged position in Mylan such that it controlled a large portion of Mylan's voting power but had no economic stake in its Mylan shares. Because Perry held a long position in King, it used its Mylan voting power to advance the King acquisition. High River Limited Partnership (High River), a hedge fund controlled by Carl Icahn, held a large long-position in Mylan and a short-position

Shareholders might seek to combat these types of intershareholder agency problems, but as demonstrated in the VC context, such efforts will entail agency costs of their own.[297]

Ultimately, analysis of the full scope of agency problems in VC investment returns us to the "generality of the agency problem" emphasized by Jensen and Meckling almost thirty years ago.[298] The agency problems confronting investors are multiple and, as shown in the context of VC investment, often interrelated. By focusing exclusively on one dimension of agency risk—be it the agency risks with management in a public corporation or the agency risk among shareholders in a private company—we risk obscuring the full dimension of agency problems facing corporate investment.

CONCLUSION

This Article has used VC finance to introduce into corporate scholarship an appreciation for the dynamic formation of agency problems among—and within—a firm's various stakeholder groups. VC scholarship—like corporate scholarship in general—has long overlooked how investors can face multiple dimensions of agency risk. As this Article has shown, the techniques that VC investors use to minimize investor-manager conflicts often create the potential for conflict among investors themselves. For many companies such as FormFactor, success in developing a company's technology and business, combined with healthy market conditions, permit these conflicts to remain primarily potential conflicts hidden from exposure. Even in these situations, however, the possibility of interinvestor conflict fundamentally affects investment risk and defines the structure of VC contracts in critical ways. And where an investment fails to conform to these idealized conditions, *Benchmark* shows us how easily these potential conflicts can turn into actual ones.

More generally, analysis of the dynamic relationship between investor-manager and interinvestor agency risk in VC finance has broader implications for corporate scholarship. This result can hardly be surprising. The traditional model of the start-up company is a common starting point for numerous

in King in the expectation that the overvalued transaction would collapse. High River initiated the suit to enjoin Perry from voting its Mylan shares to approve the merger. *Id.* at 591–93.

297. *Cf. id.* at 577 (describing shareholder efforts to oppose rent seeking as potentially creating "squabbling costs" that are born by shareholders but "consume[ ] resources that have a positive opportunity cost somewhere else in the economy simply in attempting to shuffle wealth among shareholders").

298. Jensen & Meckling, *supra* note 8, at 309.

paradigms of the firm and their associated theories of corporate law.[299] By revealing the flaws of the traditional model of VC investment, one might naturally expect paradigms of the firm that have been constructed with it to appear all the more fragile. This conclusion seems particularly appropriate for the grand-design principal-agent paradigm that, like the traditional model of VC investment, concerns itself primarily with the agency problems that exist between shareholders and managers. The experience of the VC industry suggests that to appreciate fully the scope of agency problems within a firm, one must contend with the multiple dimensions in which these problems can exist and the dynamic manner in which they interact. Analysis of the VC market suggests that rational investors are well aware of these problems and the investment risks they create. Corporate scholarship should be as well.

299. *See, e.g.*, Blair & Stout, *supra* note 14, at 275–76 (using hypothetical start-up company to demonstrate team production model); G. Mitu Gulati, William A. Klein & Eric M. Zolt, *Connected Contracts*, 47 UCLA L. REV. 887, 896 (2000) (using venture-backed start-up company to set forth a "connected contracts" model of collaborative economic activity).