

MANAGING RISK ON A \$25 MILLION BET: VENTURE CAPITAL,
AGENCY COSTS AND THE FALSE DICHOTOMY OF THE CORPORATION

Robert P. Bartlett, III*

Abstract:

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 inter-shareholder 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 finance, this Article demonstrates for the first time how this dichotomy obscures how all firms—public and private—often face the same agency problems. Companies receiving venture capital (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 inter-investor 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 implication for corporate investors—a new model of the firm is required that applies to all firms, public and private. This Article outlines this model and articulates its implications for corporate investors, corporate scholars and corporate law in general.

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I. INTRODUCTION

In 1999, two venture capital firms invested \$25 million in a newly-formed Internet search firm called Google. Four years later, after its initial public offering, their investment was worth over \$4 billion.¹ Yet not every company is a Google. Consider, for example, another \$25 million investment made by prominent venture capital firm Benchmark Capital. Its investment in Juniper Financial Corp., originally made during the “dot-com bubble” in 2000, ultimately 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 a Google or a Juniper Financial.

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

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

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 about the potential for inter-shareholder 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

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. Using venture capital finance, this Article demonstrates for the first time how this dichotomy obscures how all firms—public and private—frequently face the same structural investment risks. Indeed, only by constructing a model of the firm that ignores this false dichotomy can we recognize the full scope of investment risks that affect firms of any mold.

Start-up companies⁷ receiving venture capital (VC) investment are uniquely situated to examine this dichotomy, as they exist at a cross-roads

³ See, e.g., Stephen J. Choi, *Law, Finance, and Path Dependence: Developing Strong Securities Markets*, 80 TEX. L. REV. 1657, 1659 (2002) (“A well-known agency problem exists between managers and dispersed shareholders of public corporations.”); see also *infra* TAN 23-33 & 245-247.

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, 1745 (2001) (“[I]t is widely recognized that participants in closely held corporations face a high risk of loss from their fellow participants’ opportunism...”); see also *infra* TAN 256-258.

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 relates to these differing dimensions of structural investment risk. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 277-83 (1986) (describing as the “fundamental difference” the investor-manager conflicts created by the separation of risk bearing and management in publicly-held firms and the inter-shareholder conflicts created by its unification in closely-held firms); Blair & Stout, *supra* note 4, at 1735 (2001) (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.”); Lucian Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U. L. REV. 489, 495-96 (2002) (describing the “agency problem associated with the inherent conflict of interests between managers and shareholders of public corporations” which represents a “different problem[] than those posed by close corporations”).

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 states provide special close corporation statutes, they are systematically underutilized by close corporations. See generally Tara Wortman, *Unlocking Lock-In: Limited Liability Companies and the Key to Underutilization of Close Corporation Statutes*, 70 N.Y.U. L. REV. 1362, 1381-86 (1995).

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

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 initial public offering (“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, they represent a logical starting point for examining how a firm can experience both the inter-shareholder conflicts typically associated with private companies as well as the investor-manger 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 that has focused exclusively on the conflicts of interest that exist between VC investors and company managers. Informed in large part by the agency costs theory of the firm introduced in 1976 by Michael Jensen and William Meckling,⁸ the model focuses on the significant information asymmetries and 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 shareholder-shareholder conflicts that have historically plagued closely-held firms. Of particular

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).

⁹ This model of VC investment can be found in virtually any academic discussion of VC finance. See, e.g., William 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.”); 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.”); 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.”); Steven Kaplan and 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.]”); PAUL A. 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). 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: LINKING GOVERNANCE WITH REGULATORY POLICY at 55-69 (Michael Whincop ed., 2001).

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 homogenized 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 inter-investor conflicts.

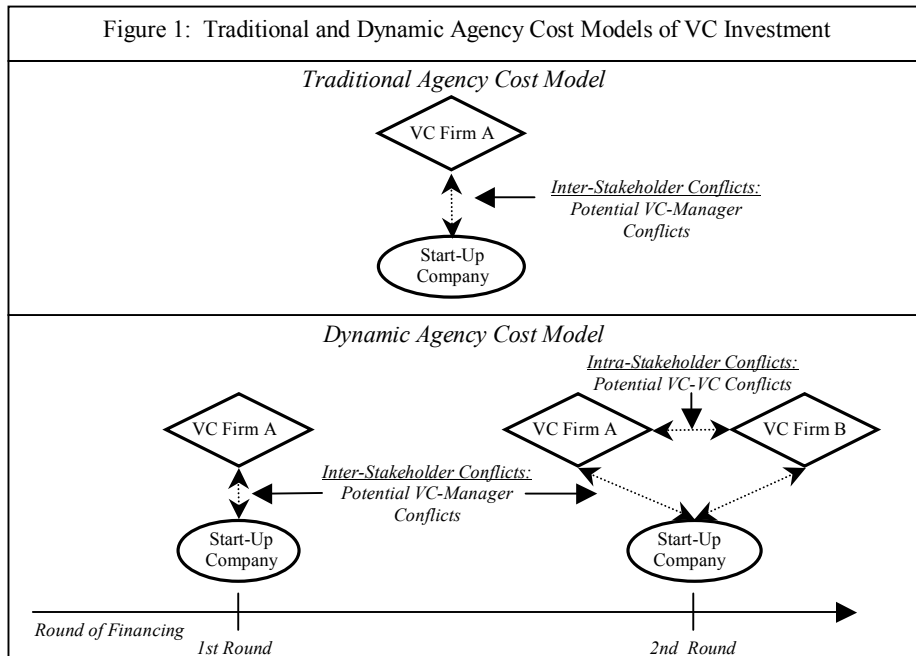
To minimize manager agency risk, VC investors undertake a number of strategies in making company investments, including the acquisition of control and monitoring rights, the staging of investments through “rounds” of financing and the syndication of investments with other VC investors.¹¹ Although much has been written about these strategies, 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 different prices. This simple fact of VC investment, 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 is 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 inter-investor 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. To be sure, this insight echoes those such as Margaret Blair and Lynn Stout who have likewise noted the inadequacies of the traditional principal-agent paradigm of the public corporation. Blair and

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 Kaplan and Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV ECON. STUD. 281, 283 (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.”).

¹¹ *See infra* Part II(A).

Stout’s “team production” model rightfully expands the analytical framework by considering the full range of inter-stakeholder conflicts that exist within a firm (e.g., shareholder vs. managers, shareholder vs. bondholder, etc.).¹² 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. Moreover, their team production model continues to view agency problems as essentially stable and concrete.¹³ Yet as VC investment demonstrates, these problems are commonly dynamic and evolving; it is the very attempt by investors to manage investor-manager agency risk that creates a second dimension of agency risk among investors themselves. 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 inter-stakeholder and intra-stakeholder conflicts and applies to all firms, public and private. Figure 1 sets forth this “dynamic agency cost model” as it applies to 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 non-systematic risks of corporate investment.

¹² For a general description of Blair and 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).

¹³ See *infra* TAN 252-253.

Financial contracting theory tells us that when faced with non-systematic risk such as agency risk, rational investors should respond by contracting against it or discounting the value of the investment.¹⁴ 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 in VC investment.¹⁵ Yet given the reality of both investor-manager *and* inter-investor 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 for analyzing how to plan successful VC investments and, more generally, how we can 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.¹⁶

For similar reasons, the 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 worked to obscure the scope of agency risks within a firm, they have likewise worked to limit academic 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

¹⁴ See AMIR BARNEA, AGENCY PROBLEMS AND FINANCIAL CONTRACTING 2 (1985).

¹⁵ See, e.g., Francesca Cornelli & Oved Yosha, *Stage Financing and the Role of Convertible Securities*, 24 REV. ECON. STUD. 126 (2003) (financial model demonstrating optimal use of convertible securities to minimize management "window dressing" of corporate performance); Klaus Schmidt, *Convertible Securities and Venture Capital Finance*, 58 J. FIN. 1139 (2003) (financial model demonstrating optimal use of convertible securities to induce efficient investment by entrepreneurs and VC investors); Thomas Hellman, *The Allocation of Control Rights in Venture Capital Contracts*, 29 RAND J. ECON. 57 (1998) (financial model demonstrating optimal use of VC control rights to protect against entrepreneur hold-ups); Dirk Bergemann & Ulrich Hege, *Venture Capital Financing, Moral Hazard, and Learning*, 22 J. BANK. FIN. 703 (1998) (financial model demonstrating optimal mixture of debt and equity to address moral hazard risks posed by entrepreneurs); Anat Admati & Paul Pfleiderer, *Robust Financial Contracting and the Role of Venture Capitalists*, 49 J. FIN. 371 (1994) (financial model demonstrating optimal use of "fixed fraction contracts" to resolve agency problems between VC investors and entrepreneurs); Erik Berglöf, *A Control Theory of Venture Capital Finance*, 10 J.L. ECON. & ORG. 247 (1994) (financial model demonstrating optimal contract design to mitigate investor-manager conflicts of interest).

¹⁶ 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 Baird & Robert Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 777-788 (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 venture capital markets overseas have likewise focused on the need to replicate American-style VC contracts to develop efficient VC economies. See, e.g., Gilson, *supra* note 9; Haksoo Ko, *Venture Capital in Korea? Special Law to Promote Venture Capital Companies*, 15 AM. U. INT'L L. REV. 457, 459-462 (2000).

contracts to protect themselves against investor-manager agency risk.¹⁷ 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 inter-investor conflicts. This perspective allows us to analyze for the first time characteristics of VC contracting that have previously been ignored in VC scholarship. By focusing on investor-manager conflicts, the traditional agency costs model lacks the capacity to explain—indeed, even recognize—these prominent features of VC contracting that arise due to the potential for agency problems among investors. Likewise, the dynamic model permits a fresh look at the reasons for and the effect of many common provisions of VC contracts that are distinct from traditional agency cost explanations.

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?¹⁸ To date, the large literature on this subject has generally focused on preferred stock's advantageous tax characteristics and its capacity for aligning the interests of managers and VC investors.¹⁹ Using the dynamic agency cost model, this Article presents another important but overlooked advantage: preferred stock makes it easier for VC investors to manage contractually inter-investor 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. This doctrine significantly impairs VC investors' ability to use preferred stock to minimize inter-investor 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 inter-stakeholder and intra-stakeholder conflicts places renewed emphasis on the need for governance

¹⁷ See *infra* TAN 38-41.

¹⁸ See Ronald J. Gilson and David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock* 116 HARV. L. REV. 874, 875-76 (2003).

¹⁹ See *e.g.*, *id.* at 875 (providing tax explanation for preferred stock usage); Thomas Hellman, *IPOs, Acquisitions and the Use of Convertible Securities in Venture Capital* (Graduate Sch. Of Bus., Stanford Univ., Research Paper No. 1702, 2000), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=257608 (explaining how convertible securities provide an optimal trade-off between the need to allocate cash flows to VC investors and the desire to make efficient exit decisions); Berglöf, *supra* note 15, at 247 (providing control theory for preferred stock usage); William Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891 (2002) (same); Cornelli & Yosha, *supra* note 15 (finding convertible securities prevent signal manipulation by entrepreneurs); Sahlman, *supra* note 9 (noting that “[f]lexible conversion terms alter the risk-and-return-sharing scheme” and encourage entrepreneurs to build value); see also *infra* TAN 56-59.

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 distinct from their original intent and potentially increase the risk of 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 II provides a brief overview of the traditional agency costs model of VC investment, highlighting how it provides an incomplete explanation for many prominent features of VC finance. Part III sets forth a dynamic agency cost model of VC investment. Specifically, it shows how the investment techniques described in Part II create potential inter-investor conflicts of interest to which VC investors respond by negotiating contract provisions that further increase the potential for investor conflict. Part IV examines how the economy following the “dot-com” bubble turned these potential conflicts into actual ones and laid the foundation for a series of inter-investor lawsuits after 2000. These include the landmark case of *Benchmark Capital Partners v. Vague*²⁰—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 inter-investor dispute underlying *Benchmark*, Part V 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 inter-investor conflict in *Benchmark* signifies the need to reassess the theory of the firm in corporate legal scholarship. Part VI concludes.

II. 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 1990,²¹ venture capital 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

²⁰ 2002 WL 31057462 (Del. Ch., July 15, 2002), *aff'd*, 822 A.2d 396 (Del. 2003).

²¹ See Sahlman, *supra* note 9.

investment?²² 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 (i.e., equity investment) is separated from its control (i.e., management)? Appreciation of this challenge, famously articulated by Adolf Berle and Gardiner Means in 1932²³ and subsequently formalized by Jensen and Meckling in 1976, defines the primary analytical framework used in contemporary corporate scholarship.²⁴

Alternatively dubbed the “agency cost theory of the firm” and the “nexus-of-contracts” conception of the corporation,²⁵ this analytical framework models organizations as webs of express, implied, and metaphorical contracts among individuals with conflicting interests.²⁶ 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.”²⁷ A critical insight of this approach has been to demonstrate the importance of principal-agent economics for the study of firms.²⁸ Agency relationships are created among contracting parties because one party (the agent) will ordinarily hold discretionary and unobservable decision-making power to affect the wealth of another (the principal). Recognizing that an agent may not always act in its best interests, a principal may discount the value of the relationship or it might expend resources to monitor the agent. Conversely, to avoid these costs an agent might choose to offer “bonds” to a principal as a guarantee of good faith. Monitoring and bonding are not costless,

²² See Gilson, *supra* note 9, at 1069.

²³ See ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 127-52 (1932).

²⁴ See, e.g., Blair & Stout, *supra* note 12, at 248 (“The literature employing the principal-agent approach [to corporate governance] is too voluminous to cite in its entirety.”); Robert Sitkoff, *An Agency Cost Theory of Trust Law*, 89 CORN. L. REV. 621, 621 (2004) (“Agency cost theories of the firm dominate the modern literature of corporate law and economics.”).

²⁵ 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 inter-changeably within both academic camps. Jensen and Meckling utilized each concept in setting forth the general theory, see Jensen & Meckling, *supra* note 8, at 308-10, and all credit them with first developing the framework. See Sharon Hannes, *Images of Organizations and Interfirm Externalities: A Comment on Prof. Rubin*, 6 THEOR. INQ. IN LAW 391, 393 n 3 (2005). This Article uses the term “agency cost theory” because (a) 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 (b) 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.

²⁶ See *id.* at 310-11. For a definitive exposition of this theory in corporate legal scholarship, see FRANK H. EASTERBROOK AND DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 1-39 (1991).

²⁷ Jensen & Meckling, *supra* note 8, at 310.

²⁸ As Jensen and Meckling describe it, “[m]any 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).

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. Some residual welfare loss is inevitable in every agency relationship that will likewise require the principal to discount the value of the relationship. This residual loss, together with monitoring expenditures by a principal and bonding expenditures by the agent, constitute the total agency costs in an agency relationship.²⁹

As applied to organizations, agency 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 vs. bondholders, labor vs. management, etc.—corporate scholarship has focused primarily on the agency relationship between shareholders and managers in modern public corporations.³⁰ For instance, shareholder-manager agency conflicts dominate Frank Easterbrook and Daniel Fischel's classic analysis, *The Economic Structure of Corporate Law*. 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.³¹ Other scholars, holding a less sanguine view of market efficiency, have used the theory to argue for reform efforts that reduce agency costs born by public company shareholders.³² 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.³³

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 required to transfer a

²⁹ See Jensen & Meckling, *supra* note 8, at 308.

³⁰ Jensen and Meckling themselves discuss only two agency relationships in setting forth their agency cost theory: "the contract characterizing the relationship between the manager (i.e., agent) of the firm and the outside equity and debt holders (i.e., principals)." Jensen & Meckling, *supra* note 8, at 310.

³¹ See EASTERBROOK & FISCHEL, *supra* note 26, at 8-22.

³² See, e.g., Reza Dabadj, *Reconceiving the Firm*, 26 CARD. L. REV. 1459, 1473-77 (2005) (summarizing literature).

³³ See, e.g., John Core, et. al., *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 how to run the company, and managers can use this discretion in ways that do not maximize shareholder value."); see also Blair and Stout, *supra* note 12, 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.").

portion of the profits generated from the venture back to the investor.³⁴ The managers will therefore have a tendency to shirk or otherwise fail to exert an optimal level of effort.³⁵ The managers may also have incentives to use firm resources to create private benefits, to adopt strategies that entail inappropriate levels of risk relative to the expected return and/or to threaten to leave the firm at a time when replacement of a manager is costly.³⁶ Additionally, managers know more about the company and their abilities than investors do. This asymmetry of information makes it difficult for VC investors to distinguish between competent and incompetent managers.³⁷

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,³⁸ to theoretical models of optimal contract design,³⁹ to testing these models against empirical analyses of VC contracts.⁴⁰ 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.⁴¹ Under this agency cost model of VC investment, venture capitalists accomplish this by designing contracts that provide for: (1) staged investment, (2) the use of equity-based compensation, (3) control and monitoring rights, (4) the sale of convertible preferred stock and (5) the ability to syndicate investments.

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.⁴² Staging its investment allows a VC investor to minimize the risk of investing 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.

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. Low-quality managers may be deterred all

³⁴ See Steven Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, at 3 (SSRN Elec. Paper Coll. No. 218175, 2000), available at <http://papers.ssrn.com/abstract=218175>.

³⁵ See Klausner & Litvak, *supra* note 9, at 56.

³⁶ *See id.*

³⁷ See GOMPERS & LERNER, *supra* note 9, at 158.

³⁸ See, e.g., Sahlman, *supra* note 9; GOMPERS & LERNER, *supra* note 9, at 157-273; Bernard Black & Ronald Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 253 (1998).

³⁹ *See supra* note 15.

⁴⁰ See, e.g., Kaplan and Strömberg, *supra* note 10, at 281 (comparing actual VC contracts to "the assumed and predicted ones in different financial contracting theories."); Kaplan & Strömberg, *supra* note 9, at 2177-81 (same); GOMPERS & LERNER, *supra* note 9, at 171-200, 242-271.

⁴¹ See Klausner & Litvak, *supra* note 9, at 59.

⁴² *See id.* at 60; Black & Gilson, *supra* note 38, at 253.

together from seeking VC financing.⁴³ Once an investment is made, staged investment thereafter provides a powerful incentive for managers to meet the designated milestones in order to receive future financing.⁴⁴ 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.⁴⁵ 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.⁴⁶

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 "founders" stock that vest over time.⁴⁷ By tying management's compensation to the company's overall performance, equity-based compensation is intended to minimize the risk that managers will shirk from their duties or pursue private benefits that do not accrue to the company's stockholders generally. Likewise, the vesting provisions provide an incentive for management to retain their employment, thereby minimizing the risk of management departure.⁴⁸

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. For instance, 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% of the financing transactions and controlled the board in 25%.⁴⁹ Additionally, a VC investor typically obtains special stockholder voting rights (or "protective provisions") allowing the investor to veto important corporate actions.⁵⁰ The scope of these protective provisions differs from company to company, but a VC investor will commonly have veto rights over important corporate transactions such as the issuance of securities, asset sales, mergers or other changes in control.⁵¹ Lastly, the practical effect of staged financing

⁴³ See Klausner & Litvak, *supra* note 9, at 60.

⁴⁴ *See id.*

⁴⁵ *See id.*; but see *infra* TAN 98-103 (noting existing investors may stop funding a company without necessarily harming its fundraising ability).

⁴⁶ *See id.*

⁴⁷ *See id.* at 62.

⁴⁸ *See id.*

⁴⁹ See Kaplan and Strömberg, *supra* note 10, at 287-89.

⁵⁰ 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).

⁵¹ See, e.g., NVCA, Model Certificate of Incorporation at 10 n18, available at http://www.nvca.org/model_documents/model_docs.html [hereinafter, NVCA Model Charter] (providing investor veto rights over the following actions: liquidation, dissolution, change-in-control,

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.⁵²

4. *Use of Convertible Preferred Stock.* In making an investment, a VC investor generally acquires shares of a company's convertible preferred stock.⁵³ 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,⁵⁴ preferential dividend rights, redemption rights, and antidilution protection.⁵⁵ 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.

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.⁵⁶ 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.⁵⁷ 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.⁵⁸ The use of preferred stock also enhances the incentive effect of common stock options. 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.⁵⁹

5. *Syndication of Investments.* Lastly, VC investors reduce agency risk by partnering with one or more other VC investors when investing in a start-up company.⁶⁰ Moreover, as a start-up company requires additional financing, the company and its VC investors will often solicit a new investor to "lead" each round of financing. Existing investors will then co-invest alongside it.⁶¹ For instance, in one study an average of 2.2 VC firms

charter/bylaw modifications, creation/issuance of securities, purchase/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 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*, 11 BUS. LAW TODAY (June 2002).

⁵² See Gilson, *supra* note 9, at 1069.

⁵³ See Kaplan & Strömberg, *supra* note 10, at 286 (reporting that convertible preferred stock was used in 95% of their sample financing transactions).

⁵⁴ For a discussion of liquidation preferences, see *infra* TAN 91-93.

⁵⁵ For a discussion of antidilution protection, see *infra* TAN 138.

⁵⁶ For a summary of this literature, see *supra* TAN 19.

⁵⁷ See Klausner & Litvak, *supra* note 9, at 64.

⁵⁸ See *id.* at 65-66.

⁵⁹ See Gilson & Schizer, *supra* note 18, at 889-909.

⁶⁰ See Klausner & Litvak, *supra* note 9, at 66-67.

⁶¹ See Josh Lerner, *The Syndication of Venture Capital*, 23 FIN. MGMT. 16, 18 (1994).

invested together at a company's first stage of financing; at the second stage, an average of 3.3 invested together; and in later stages the average increased to 4.2.⁶²

While syndication provides VC firms a means to diversify their investment portfolios, it also plays an important role in addressing the agency costs and information asymmetries inherent in VC investment. Empirical studies of syndication patterns indicate that older and larger VC firms tend to syndicate with one another,⁶³ suggesting that VC investors syndicate to obtain each other's judgment with respect to particular investment opportunities.⁶⁴ 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. At the same time, this aspect of syndication 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.⁶⁵

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.⁶⁶ To date, however, no one has sought to depart from the standard account of VC investment to examine whether these unexplained complexities stem from a common investment problem unrelated to investor-manager conflicts. In particular, the fact that multiple VC investors jointly invest in the same start-up company might suggest the potential for inter-investor conflicts in the same way that shareholder-shareholder conflicts routinely bedevil other closely-held corporations. Yet 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.⁶⁷ By relaxing this assumption, however, it becomes possible to identify a number of unexplained features

⁶² See GOMPERS & LERNER, *supra* note 9, at 261.

⁶³ See *id.* at 261-66.

⁶⁴ See Klausner & Litvak, *supra* note 9, at 66.

⁶⁵ 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 towards management. See PAUL GOMPERS AND JOSH LERNER, *THE MONEY OF INVENTION: HOW VENTURE CAPITAL CRATES NEW WEALTH* 12 (2001). The intuition is that a VC investor who acts opportunistically towards 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 31-32; but see *infra* TAN 205-207 (noting the significant growth and fluidity of the VC community).

⁶⁶ Kaplan and Strömberg, *supra* note 10, at 307-308.

⁶⁷ See *supra* TAN 10.

of VC contracting that might very well exist because of the potential for inter-investor conflicts.

One need not look far to find these common, unexplained features. For instance, the VC practitioner literature is replete with articles discussing a contracting provision called a “pay-to-play.”⁶⁸ A pay-to-play penalizes a company’s existing VC investors who fail to participate at a pre-specified 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 non-participating investor’s preferred stock into common stock, thereby stripping the investor of all preferential rights.⁶⁹

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 costs model if managers demanded the provision to protect themselves against potential opportunism by VC investors.⁷⁰ 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 of one prominent VC firm explains 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.⁷¹

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 its different stages of financing. Indeed, adherents of the traditional model commonly ignore the fact that start-up companies frequently grant different preferential rights to its investors at each stage of financing.⁷² Those

⁶⁸ See, e.g., John LeClaire, *WatchMark Ruling Clarifies Pay-To-Play*, VENTURE CAP. J., April 1, 2005 (noting that “[r]ecent times have seen a surge in the use of ‘pay-to-play’ techniques in private company financing rounds”); Colin Blaydon & Michael Horvath, *Bury the Ratchet*, VENTURE CAP. J., January 1, 2002 (discussing pay-to-play).

⁶⁹ For an example of a pay-to-play provision, see the NVCA Model Charter, *supra* note 51, at 32-34.

⁷⁰ Cf. note 65.

⁷¹ Brad Feld, *Term Sheet: Pay-To-Play*, Feld Thoughts (March 22, 2005), http://www.feld.com/blog/archives/2005/03/term_sheet_payt.html (last visited January 21, 2006).

⁷² 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

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, Paul Gompers and Josh 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.⁷³ Conversely, Steven Kaplan and Per Strömberg have argued that VC investors increase their cash flow and control rights over financing rounds because VC investors demand from managers “more equity and control as compensation for providing additional funding.”⁷⁴ Each study analyzed a company’s VC investors as a homogenous whole; therefore, none studied the way in which these stage-specific rights might affect relations among a company’s VC investors.

Yet even a cursory look at several recent VC investments reveals that much of the complexity of VC contracting stems from the allocation of preferential rights among a company’s VC investors. Between January 1, 2001 and December 31, 2004, 142 U.S. start-up companies completed an IPO after having completed more than one round of VC financing.⁷⁵ Analysis of these companies’ capitalization history reveals a typical capital structure that is considerably more complex than that ordinarily depicted in the traditional agency cost model. As predicted by the model, 132 (93%) of the companies in the sample issued preferred stock to their VC investors. What is universally ignored in the model, however, is the fact for 116 (88%) of these companies, the preferred stock was issued in more than one series (e.g., Series A, Series B, etc.).

Examination of these different series of preferred stock reveals real economic differences in their terms. An example appears with FormFactor,

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 II(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 18, 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 V, the issuance of multiple series of preferred stock over time can result in truly worthless common stock.

⁷³ See GOMPERS & LERNER, *supra* note 9, at 183-192.

⁷⁴ Kaplan and Strömberg, *supra* note 10, at 313.

⁷⁵ This sample was obtained through a database of VC financings maintained by Securities Data Corporation (SDC). Information concerning each company’s capitalization history was obtained by examining the company’s registration statement filed with the Securities and Exchange Commission (SEC). 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-US securities regulations and tax laws often prevent these issuers from issuing preferred stock. Also excluded are companies for which no registration statement was available.

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.⁷⁶ 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 in the following order:⁷⁷

Payment Priority	Recipient:
First \$76,000,000 of proceeds	Holder of Series D – Series G Preferred Stock
Next \$13,000,000 of proceeds	Holder of Series B and Series C Preferred Stock
Next \$270,898 of proceeds	Holder of Series A Preferred Stock
Any remaining proceeds	Holder 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? 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.⁷⁸ The negotiated arrangement of board representation is in marked contrast to the description of VC investors’ board rights found in VC scholarship where VC investors are analyzed collectively to determine the extent to which they “control” the board of directors.⁷⁹ 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

⁷⁶ 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 (filed with SEC June 11, 2003)[hereinafter FormFactor Registration Statement].

⁷⁷ See *id.* at F-17–F-18.

⁷⁸ 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% 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, Form S-1, Exh. 3.01, at 6. [hereinafter FormFactor Certificate].

⁷⁹ See *supra* TAN 49.

VC investors received special preferential rights, older preferred series did not necessarily receive the benefit of these new rights. For instance, only the holders of FormFactor's Series D through and Series G Preferred Stock were entitled to antidilution protection. To the extent different VC investors hold different amounts of the company's seven series of preferred stock, what types of inter-investor conflicts are created by the distribution of these preferential rights?

Lastly, the traditional agency costs 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.⁸⁰ Most 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.⁸¹ In many of the cases, however, the plaintiffs have been VC investors seeking redress against their co-investors in a start-up company. Given the potential for VC investor opportunism created by investors' contract rights described in Part II(A),⁸² the traditional agency costs 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. To better understand the structure of VC finance and its concomitant challenges for VC investors, a more nuanced model of VC investment is required.

III. 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 several unexplained features of VC finance. Under this modified 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 inter-investor conflict.

Before proceeding further, it is useful to clarify how an inter-investor conflict can exist among a company's investors. In general, an inter-investor 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. For example, where a start-up company

⁸⁰ In a 2002 survey of court filings, the *Venture Capital Journal* identified fourteen "recent or active lawsuits involving VCs." Charles Fellers, *VCs Mired in Litigation of Their Own Making*, *VENTURE CAP. J.*, November 1, 2002.

⁸¹ For instance, of the lawsuits identified by the *Venture Capital Journal*, most were suits by company founders against VC investors; five involved inter-investor lawsuits concerning a VC financing. *See id.*

⁸² *See* note 65.

receives equity financing from investors with differing investment objectives, the interests of the investors with respect to certain company actions may differ. A venture capital division of a public corporation, for instance, may co-invest with traditional VC investors in a company with which the public corporation has a strategic relationship.⁸³ 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.⁸⁴

Although these direct inter-investor conflicts exist in certain contexts, the focus of this Article is on a more subtle and pervasive form of inter-investor 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")⁸⁵ 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*). Venture capital funds are limited in duration (funds ordinarily have a ten-year life) and have a limited amount of capital with which to make investments.⁸⁶ 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.⁸⁷

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 compensation (or "carried interest") creates a powerful

⁸³ During 2003, corporate VC investors accounted for direct investments of \$1.1 billion, or 6.3% of all VC investments. See NATIONAL VENTURE CAPITAL ASSOCIATION YEARBOOK 2004 at 38 [hereinafter, NVCA Yearbook].

⁸⁴ To prevent a corporate investor from blocking such a transaction, venture capitalists 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., NVCA, Model Voting Agreement at 4 available at http://www.nvca.org/model_documents/model_docs.html (providing for drag-along right).

⁸⁵ 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.

⁸⁶ See Sahlman, *supra* note 9, at 489-91.

⁸⁷ 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 87, at 396. For a summary of this scholarship, see *id.* at 394-98.

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%) of a fund's realized profits.⁸⁸ 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 inter-investor conflicts in the following manner. First, the capital/time investment constraint ensures that VC investors will hold different amounts of a company's preferred securities that are issued at each stage of financing owing to investment syndication and the staging of investments. 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 it should sell these securities through a company "exit event" 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.

That VC investors appreciate these potential conflicts becomes readily apparent in examining VC contracts. This is especially true with regard to contract provisions concerning exit events and future financings where the potential for conflict is at its greatest. Yet as shown below, these carefully negotiated provisions are at best imperfect solutions to resolving inter-investor conflict and may even accentuate inter-investor conflict in certain circumstances. Indeed, it is this underlying imperfection in VC contracting that laid the foundation for the inter-investor 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 understand 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.⁸⁹ The valuation will determine the amount of the company

⁸⁸ See GOMPERS & LERNER, *supra* note 9, at 57-70.

⁸⁹ See Brad Feld, *Venture Capital Deal Algebra*, Feld Thoughts (July 7, 2004), http://www.feld.com/blog/archives/2004/07/venture_capital.html (last visited January 21, 2006).

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% of NewCo’s ownership (i.e., \$5,000,000 investment / (\$10,000,000 valuation + \$5,000,000 investment)).⁹⁰ The ownership interest of NewCo’s existing stockholders will correspondingly be reduced from 100% to 66.6%.

EarlyFund and NewCo will use the 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.⁹¹ Assuming there are 10,000,000 shares of common stock outstanding, a \$10,000,000 valuation yields a price per share of \$1.00 (i.e., \$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 \$1.00.⁹² 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.⁹³

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

⁹⁰ In contrast, if EarlyFund values NewCo at \$15,000,000, it would purchase equity representing only 25% of NewCo’s ownership (i.e., \$5,000,000 investment / (\$15,000,000 valuation + \$5,000,000 investment)).

⁹¹ For this purpose, the number 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.

⁹² 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 Supp. 2004) [hereinafter *Hi-Tech Charter*].

⁹³ For a description of antidilution protection, see *infra* TAN 138.

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.⁹⁴

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% of the \$10,000,000 offering.⁹⁵ As discussed above, this commitment 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 \$2.00.⁹⁶ 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.

⁹⁴ See Hi-Tech Charter, *supra* note 92, at 8-13.

⁹⁵ Several studies have examined the tendency of VC investors to purchase their "pro-rata share" of a later-stage offering. See Lerner, *supra* note 61, at 23-24 (examining tendency of VC investors to purchase their pro-rata share in follow-on financings); Admati & Pfleiderer, *supra* note 15, at 373-74 (1994) (offering formal model for why VC investors tend to purchase their pro rata share in follow-on rounds of financing). For purposes of this example, EarlyFund's pro-rata share is defined to mean the 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 company's investors. See Seth Levine, *What Does Pro-Rata Mean?*, Feld Thoughts (Sept. 3, 2004).

⁹⁶ 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 *infra* note 91. 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.

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:

Stockholder:	Series A Preferred Stock:		Series B Preferred Stock:		Common Stock:		Total:	
	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%

As shown in this example, the combination of staged investing and 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.⁹⁷ 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.⁹⁸ Moreover, as the example

⁹⁷ Prominent venture capitalists Alan Salzman (of VantagePoint Venture Partners) and John Doerr (of Kleiner, Perkins, Cauffield & Byers) note, "[i]f a company is successful accomplishing and moving through its development cycle, it should be able to raise capital less expensively (i.e., achieve a higher company valuation) as time and success progress and the company is able to accomplish the removal or significant reduction of major business risks." Alan Salzman and John Doerr, *The Venture Financing Process*, in *START-UP & EMERGING COMPANIES* at §7.03 (Richard D. Harroch ed., 1998).

⁹⁸ 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 Hachigian and Brooks Stough, *Venture Capital: Key Issues in Follow-On Financing Rounds* in *35TH ANNUAL INSTITUTE ON SECURITIES REGULATION* 193, 221-22 (Practicing Law Inst. Course Handbook Series No. 1396, 2003). 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.

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% of any new issuance (but 100% of the Series A Preferred Stock) while LaterFund will hold 16.7% of any new issuance (but 66.6% 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 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, thereby requiring the issuance of additional shares of common stock or common stock options.⁹⁹ 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.¹⁰⁰

In addition, a VC fund will ordinarily have a number of structural limitations in 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,¹⁰¹ commonly resulting in a reduction in the size of each follow-on investment. More importantly, if a fund under-allocates the amount of capital it needs for follow-on investments, the fund may run out of capital to support further investments in its portfolio.¹⁰² A VC fund may also have limitations in its partnership agreement regarding the extent it may participate in future

⁹⁹ See *supra* Part II(A)(2).

¹⁰⁰ 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% (6,666,667 / 30,000,000), and LaterFund's pro rata share would decrease to 11.1% (3,333,333 / 30,000,000).

¹⁰¹ 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 being 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 CAP. J., August 1, 2001. 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 WEEK, January 14, 2002 (noting that FTV, a later stage investor, reserved "significantly less than 50% of the capital ... for follow-on financings").

¹⁰² Under-allocation 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 towards 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 101, at 3.

financings. For instance, VC fund partnership agreements commonly have investment limitations that restrict the amount of capital a fund is permitted to invest in any one company.¹⁰³

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. Venture capital firms routinely market themselves to companies and LPs as focusing on either "early stage" or "late stage" investments.¹⁰⁴ For LPs, the distinction is of significant importance in understanding a VC firm's risk profile, and a VC investor may be weary 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 1996 when Mohr Davidow Ventures ("MDV"), an "early stage venture capital firm,"¹⁰⁵ purchased 3,390,822 shares of Series B Preferred Stock at a price of \$0.87, for a total investment of nearly \$3,000,000.¹⁰⁶ 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% for approximately \$2,000,000. A new "expansion stage" VC investor,¹⁰⁷ Institutional Venture Partners ("IVP"), led this round of financing and purchased 55% of the shares sold for \$3,000,000.¹⁰⁸ Between 1997 and 1998, the company sold 5,552,973 shares of Series D Preferred Stock at \$3.45 for gross proceeds of almost \$20,000,000. Of this amount, MDV and IVP each purchased only 434,783 shares (7.5% of the offering) in exchange for investments of \$1,500,000 each. New investors Intel Corporation and later-stage VC investor Morgan Stanley Venture Partners ("MSVP")¹⁰⁹ 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

¹⁰³ See Klausner & Litvak, *supra* note 9, at 70.

¹⁰⁴ See, e.g., *infra* notes 105, 109.

¹⁰⁵ MDV website at www.mdv.com.

¹⁰⁶ General information concerning FormFactor's financing history was obtained from the financial statements included as part of FormFactor's S-1 Registration Statement. See *supra* note 76. 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, Exh. 4.02 (Apr. 22, 2002). 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.*

¹⁰⁷ IVP website, at <http://www.ivp.com/>.

¹⁰⁸ See FormFactor Registration Statement, at F-17-F-18.

¹⁰⁹ See MSVP website, at www.morganstanley.com/institutional/venturepartners/faq.html?page=faq.

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% of the offering).¹¹⁰ 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.

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 inter-investor conflict.

B. Inter-Investor 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 venture capital 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 inter-investor conflicts might arise in a variety of contexts,¹¹¹ the two that appear to play the largest role in VC contracts are those relating to the company's ultimate exit strategy and the company's future financing.

1. Conflicts over Exit Events. In general, VC investors ordinarily seek to "exit" company investments through one of two principal methods: the sale of shares into the public markets after a company's IPO or an acquisition of a company for cash or publicly-traded securities.¹¹² 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, "the 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."¹¹³

¹¹⁰ MDV invested \$349,000; IVP and MSVP each invested \$250,000. See FormFactor Registration Statement, at F-17-F-18.

¹¹¹ See *supra* TAN 83-81.

¹¹² See LEVIN, *supra* note 7, at 9-3.

¹¹³ *Id.* 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 may

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 per share would view less favorably a proposed IPO in 2003 at \$10 per share than 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%, or an annual internal rate of return ("IRR") of approximately 40%.¹¹⁴ In contrast, a stockholder who only participated in the Series G financing would realize a total loss of -33%, or an annual IRR of approximately -18%. 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 prevents investment cost from ever becoming "sunk" 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 30-50%.¹¹⁵ Moreover, because many of these investments will ultimately be written off, each individual investment should promise a 40-50% projected IRR after accounting for the venture capitalist's fees and compensation.¹¹⁶

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

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 CAP. J., Sept. 1, 2004.

¹¹⁴ In general, an 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 in-flows associated with an investment with the sum of the present value of the cash outflows accruing from it and its present unrealized value.

¹¹⁵ See Salzman and Doerr, *supra* note 97, at §7.02[2].

¹¹⁶ *See id.*

investor in the process of raising another fund, these early “home runs” may be critical to attracting LPs.¹¹⁷ Moreover, under the prevailing industry valuation standards, VC investors generally carry a company investment at cost until an exit event or a subsequent financing.¹¹⁸ 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: an investment valued at cost simply looks better to LPs than an investment loss.

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%) of the profits realized on a fund’s start-up company investments.¹¹⁹ 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 winding-up 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.¹²⁰ 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 difference between receiving an incentive payment from the VC fund and having to recontribute capital to its LPs.¹²¹

Thus, because of staged investment and 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

¹¹⁷ See, e.g., Lawrence Aragon, *Harvard Revs Up Ignition’s Third Fund*, VENTURE CAP. J., December 1, 2004 (reporting that successful fundraising “isn’t about who know that counts; it’s whether you can show a return on investment”); see also GOMPERS & LERNER, *supra* note 9, at 241 (noting propensity among venture capitalists to “grandstand”—taking a start-up company public as quickly as possible—to facilitate fund-raising among LPs).

¹¹⁸ 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 and Fred Wainwright, *The Stage Is Set*, PRIVATE EQUITY INT’L., May 2004.

¹¹⁹ See *infra* TAN 88.

¹²⁰ See Steven Franklin and Stig Colberg, *Evaluating and Managing a Potential Clawback Liability*, VENTURE CAP. J., Sept. 1, 2002.

¹²¹ Assume, for instance, a fund makes two investments of \$100 each and provides for a 20% carry. If the first investment is sold for \$1,000, the fund must first return \$100 to LPs as return of capital. Thereafter, it may distribute the \$900 of profits 80% to LPs (\$720) and 20% 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 (i.e., \$1000 - \$200), requiring the venture capitalist to recontribute \$20 to the LPs to ensure its carried interest does not exceed 20% of fund profits. If the fund had sold the second investment at cost (i.e., \$100), the net profit of the fund would have been \$900 (i.e., \$1,100 - \$200), thereby avoiding any look-back liability. See *id.*

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 forgo 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.¹²²

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. In the words of one leading VC lawyer, “contracts 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 portfolio company at the back end when the exit strategy is executed.”¹²³

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.¹²⁴ 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.¹²⁵ 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.¹²⁶ As a result of these two provisions, a VC investor can block the conversion of its preferred stock on an IPO 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

¹²² 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 CAP. J., December 2, 2004.

¹²³ LEVIN, *supra* note 7, at 1-11.

¹²⁴ See Maha Ibrahim, et al., *Illustrative Venture Investment Term Sheet*, in 35TH ANNUAL INSTITUTE ON SECURITIES REGULATION 193, 221-22 (Practicing Law Inst. Course Handbook Series No. 1396, 2003).

¹²⁵ See, e.g., Kaplan & Strömberg, *supra* note 10, at 289 (finding automatic conversion provisions in 95% of the financing rounds examined).

¹²⁶ See Hi-Tech Charter, *supra* note 92, at 8-36-8-37.

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 (i.e., \$7.50, \$11.00 and \$15.00, respectively).¹²⁷ 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.¹²⁸

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.¹²⁹ 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,

The general rule with respect to priorities among multiple rounds of preferred stock investments is that of LIFO—"last in, first out." New investors in a later-stage company will want to ensure that in the event of a redemption or liquidation, their money comes out first.... Later stage investors are particularly concerned about liquidation preferences.¹³⁰

Unfortunately, understanding 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, a straightforward analysis of

¹²⁷ See FormFactor Certificate, at 5-6.

¹²⁸ See *id.*

¹²⁹ See *supra* TAN 91-93.

¹³⁰ Daniel Case & Standish O'Grady, *An Overview of Venture Capital*, in *START-UP COMPANIES: PLANNING, FINANCING AND OPERATING THE SUCCESSFUL BUSINESS* 6.13 (Richard D. Harroch ed., 1996).

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.¹³¹ 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.¹³²

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 VC 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 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 (i.e., \$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.* Additionally, upon investing in a start-up company, a VC investor must address the potentially different 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

¹³¹ See FormFactor Certificate at 14-15.

¹³² 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.

funding allocation to the company or its fund may simply lack the capital to make additional investments.¹³³

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. Ordinarily, a VC investor will expect its ownership percentage in a start-up company to be diluted when the company issues stock to new investors at a higher price than the VC investor paid for its own shares. Although its percentage ownership of the company will diminish, the value of the stockholder'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.¹³⁴

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.¹³⁵ 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 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.

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.¹³⁶ By forcibly stripping the preferred rights of a non-participating investor, a pay-to-play provides a significant deterrent against failing to participate in a financing that triggers the provision.

With regard to the risk that the company will complete a low-priced financing, a VC investor will ordinarily request upon making an investment a combination of stockholder veto rights and price-based antidilution

¹³³ See *supra* TAN 101-102.

¹³⁴ 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 pre-financing ownership percentage, VC investors must purchase their pro-rata share of the financing. See *supra* TAN 95.

¹³⁵ See *supra* note 118.

¹³⁶ See *supra* TAN 68-69.

protection. As before, FormFactor provides a concrete illustration of both 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.¹³⁷ 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 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 issuance of the lower-priced stock, the ratio at which each share of the VC investor's 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.¹³⁸ 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, in contrast to most accounts of VC investment, the specific provisions that appear in VC contracts are not just about controlling agency

¹³⁷ See FormFactor Certificate at 14-15.

¹³⁸ 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. More mild, "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 Bartlett, *supra* note 134, at 24-26.

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 these 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.

In describing the manner in which a company's VC investors contain potential inter-investor 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 inter-investor 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.¹³⁹

Moreover, the provisions described above might actually increase the risk for inter-investor conflict. Even with a pay-to-play, investors may continue to develop divergent opinions regarding the desirability of financing a company. The provision, however, increases the stakes of these debates by actively punishing non-participating investors. Likewise, the use of antidilution protection can turn 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 inter-investor conflicts that laid the foundation for the unprecedented inter-investor disputes that erupted following the collapse of the Internet economy.

IV. PATHOLOGICAL VENTURE CAPITAL INVESTMENT: 2001-2003

In the months following the collapse of the Internet economy, a relatively new investment risk began to concern many venture capitalists:

¹³⁹ Cf. Hachigian and Stough, *supra* note 98 at 221-22 (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.").

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 against a co-investor in a start-up company was an entirely novel phenomenon. The source of this new risk arose from the flawed nature in which VC investors had traditionally resolved potential inter-investor conflicts of interest. In particular, the economic climate encouraged a type of company financing in which VC investors leading the financing demanded greater preferential rights to protect their economic interests at the same time that many of the company's existing VC investors were significantly constrained in their ability to participate in the financing. These preferential rights drove a wedge between the interests of those VC investors who participated and those who did not.

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 64, which fell further to 24 in 2002.¹⁴⁰ Likewise, the number of opportunities for start-up companies to "exit" by means of a meaningful acquisition also plummeted. Although the annual number of acquisitions of venture-backed companies was relatively constant from 2001 through 2002, the aggregate value of these transactions fell from \$68.4 billion in 2000 to \$16.8 billion in 2001 to \$7.9 billion in 2002.¹⁴¹ (Figure 2)

Year	Mergers & Acquisitions				IPOs	
	Total Deals	Deals with Disclosed Values	Total Disclosed Value (\$M)	Average Deal Size (\$M)	Number of IPOs	Total Offer Amount (\$M)
2000	316	202	\$68,353.1	\$338.4	264	\$25,499.4
2001	353	165	\$16,798.9	\$101.8	41	\$3,489.9
2002	316	151	\$7,874.4	\$52.1	24	\$2,473.5

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 "pre-bubble" investment trends. In contrast to the 7,832 VC investments made in 2000 (representing a total of \$104 billion invested), VC investors made only 4,451 investments in 2001 (representing a total of \$40 billion invested) and 3,042 investments

¹⁴⁰ See NVCA, *Q3 2005 Exit Poll*, (October 3, 2005), available at <http://www.nvca.org/pdf/2005Q3IPOreleasefinal.pdf>.

¹⁴¹ See Sanjay Subhedar, *Relief Is Finally Coming with a Rise in M&A*, VENTURE CAP. J., July 1, 2003.

in 2002 (representing a total of \$21.5 billion).¹⁴² 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.¹⁴³ 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.¹⁴⁴ For start-up companies seeking financing, finding a new VC investor to lead a financing became increasingly difficult, requiring many companies to turn to 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.¹⁴⁵ 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.¹⁴⁶ As a result, the financings ordinarily triggered VC investors’ antidilution protection.

The resulting dilution of a prospective “down-round” financing often brought out the divergent interests of a company’s managers and its multiple VC investors. 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% to 37.5%, while EarlyFund and LaterFund would

¹⁴² See NVCA, *Industry Statistics*, available at <http://www.nvca.org/ffax.html>.

¹⁴³ See NVCA, *Venture Capital Investments in Q2 2002 Continue To Slide Back Toward Pre-Bubble 1998 Levels*, available at www.nvca.com/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”).

¹⁴⁴ See, e.g., *Entrepreneurs Sound Off On Perils of Fund-Raising*, VENTURE CAP. J., Jan. 1, 2002 (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 CAP. J., Feb. 1, 2001 (“[V]enture financing for start-ups has become increasingly scarce as venture capitalists focus on shepherding their existing portfolio companies through this difficult financing market.”).

¹⁴⁵ See Alistair Christopher, *University of Washington*, VENTURE CAP. J., May 1, 2001.

¹⁴⁶ 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 that were completed at a valuation lower than a company’s prior financing were as follows for each quarter of 2002: 57%, 52%, 67% and 68%. See Fenwick & West, LLP, *Trends in Legal Terms in Venture Financings In the San Francisco Bay Area (Fourth Quarter 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 Charles R. Fellers, *A Rocky Venture Environment Shapes The Legal Landscape*, VENTURE CAP. J., Mar. 1, 2002.

see their stakes remain the same at 33.3% and 16.7%, respectively.¹⁴⁷ 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%, while the equity stakes of EarlyFund and LaterFund would *increase* to 34.3% and 18.2%, respectively.¹⁴⁸ 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 the lower-cost Series A Preferred Stock.¹⁴⁹ As a result, following the antidilution adjustments, the percentage increase in LaterFund's equity stake would be 6% more than the increase in EarlyFund's equity stake.¹⁵⁰

"Down-round" financings also included a number of preferential terms that accentuated the potential conflict between participating VC investors, non-participating VC investors and management. As Figure 3 shows,¹⁵¹ 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."¹⁵² First, VC investors increasingly demanded preferred stock having a multiple, senior liquidation preference, often with multiples of up to three or four times the original investment cost.¹⁵³ VC investors also purchased more "participating" convertible preferred stock in lieu of traditional convertible preferred stock. As noted above, traditional preferred stock entitles a holder to a preferential payment upon a liquidation or acquisition

¹⁴⁷ In general, the pre-existing ownership interest of every stockholder would be reduced by 25% (i.e., \$5,000,000 investment / (\$15,000,000 pre-money valuation + \$5,000,000 investment)).

¹⁴⁸ 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* TAN 95-96. The antidilution analyses are available upon request.

¹⁴⁹ In general, each series of preferred stock will receive an antidilution adjustment based on the difference between the original issue price of the series and the price of newly issued stock. As a result, the Series B Preferred Stock (having an issue price of \$2.00 per share) will 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 134, at 33.

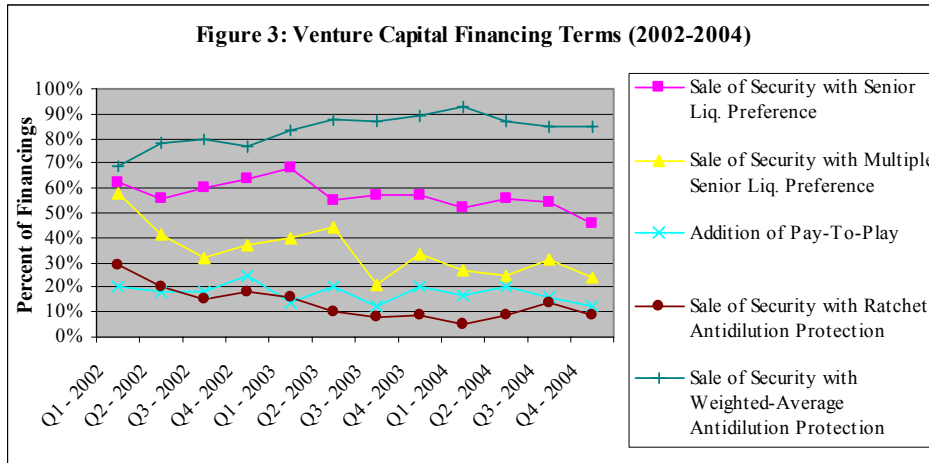
¹⁵⁰ The divergent effect of the financing on EarlyFund and LaterFund is especially clear where the price of the down-round financing results in an antidilution adjustment to the Series B Preferred Stock but not to the Series A Preferred Stock. For instance, had the pre-money valuation of NewCo been \$25,000,000, EarlyFund's equity stake (even with full pro rata participation) would decrease from 33.3% to 33.28%, while LaterFund's equity stake would *increase* from 16.67% to 17.38%.

¹⁵¹ Figure 3 is derived from the F&W Survey.

¹⁵² Stephen Davis & Kenneth Drake, *United States: Protecting the Private Equity Investment Without Killing the Golden Goose*, INT'L FIN. L. REV., Jan. 1, 2003.

¹⁵³ See Hi-Tech Charter, *supra* note 92, at 8-12 – 8-13. For instance, if a VC investor purchased for \$1 a share of preferred stock having a "3X" senior liquidation preference, it would be entitled to \$3—rather than \$1—upon an acquisition of the company prior to any proceeds being paid on other shares of company capital stock.

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, 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 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.¹⁵⁴



VC investors also demanded stronger forms of antidilution protection. In particular, VC investors increasingly purchased securities with “full-ratchet” antidilution protection rather than the historic industry-standard “weighted-average” antidilution protection.¹⁵⁵ Full-ratchet antidilution protection effectively “re-prices” the protected preferred stock to the price of any future, lower-priced issuance.¹⁵⁶ Indeed, under most formulations, the issuance of even a single share of lower-priced stock requires re-pricing all protected preferred stock to the lower price. The result is in stark

¹⁵⁴ 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 founders and 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 Mason, *Are we Covered?*, VENTURE CAP. J., Mar. 1, 2005.

¹⁵⁵ See *supra* Figure 3; see also Carolina Brauschweig, *No More Easy Street: VCs Tighten the Purse Strings*, VENTURE CAP. J., May 1, 2001.

¹⁵⁶ 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.

contrast to “weighted-average” formulas which re-price protected preferred stock based on the price *and quantity* of the 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 more mild forms of antidilution protection. Imagine, for example, that LaterFund had received full-ratchet antidilution protection in the Series B financing of NewCo. 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 by both LaterFund and EarlyFund. Specifically, LaterFund’s equity stake would have increased from 16.7% to 37.5%, while EarlyFund’s equity stake would have increased from 33.3% to only 35.7%.

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 ratchet antidilution protection.¹⁵⁷ 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.¹⁵⁸ 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.¹⁵⁹ 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 through an acquisition. But given the depressed acquisition valuations of start-up companies, investors’ aggregate liquidation preferences threatened to absorb most, if not all, of the probable acquisition proceeds.¹⁶⁰ 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

¹⁵⁷ Timothy Harris, *The Antidilution Death Spiral*, 5 J. PRIVATE EQUITY, 34 (2002).

¹⁵⁸ For an analysis for how these adjustments could result in such situations, see generally Bartlett, *supra* note 134, at 31-34.

¹⁵⁹ *See id.*

¹⁶⁰ See Ravi Chiruvolu, *It May Be Time To Hit the Reset Button On Liquidation Preferences*, VENTURE CAP. J., July 1, 2002.

preferred stock into common stock.¹⁶¹ In many cases, existing VC investors consented to these adverse changes in hopes of recouping 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.¹⁶²

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.¹⁶³ In other cases, VC investors simply appear to have been reluctant to “throw good money after bad.” As one venture capitalist remarked in 2002, “[o]ur 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.”¹⁶⁴

Not surprisingly, the rise of down-round financings quickly exposed the latent inter-investor conflicts arising from the combination of staged financing and investment syndication. Negotiations between a company’s participating and non-participating investors over “how to split the equity”¹⁶⁵ 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 “new 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....”¹⁶⁶ In some cases, the prevalence of reciprocal veto rights 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.¹⁶⁷

¹⁶¹ Curtis Mo, *Recent Trends in Venture Capital Financing Terms*, in 35TH ANNUAL INSTITUTE ON SECURITIES REGULATION 193, 221-22 (Practicing Law Inst. Course Handbook Series No. 1396, 2003).

¹⁶² See Joan Lesser & Carrie Johnson, *Financing Troubled Companies: Highly Dilutive (Down Round) Financings*, COMP. INT. LAW. (January 2003).

¹⁶³ See *supra* notes 101-103.

¹⁶⁴ John Ince, *Where Is the Money*, UPSIDE, May 20, 2002 (quoting general partner of SI Ventures).

¹⁶⁵ Fellers, *supra* note 80.

¹⁶⁶ Brauschweig, *supra* note 155.

¹⁶⁷ Bartlett, *supra* note 134, at 34.

That participating and non-participating investors alike often had representatives on a company's board of directors further complicated matters. 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. Directors representing VC investors who would be participating in the financing had a "financial interest" in the transaction,¹⁶⁸ requiring careful procedural precautions in order to discharge the director's duty of loyalty.¹⁶⁹ 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 the board's compliance with its fiduciary duties.¹⁷⁰ 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 notes, in the event of a sale, directors will need 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."¹⁷¹

In sum, the down-round financings of 2001-2003 exposed not only the prevalence of inter-investor 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."¹⁷²

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

In the summer of 2002, the potential intensity of inter-investor conflict became vividly public in *Benchmark Capital Partners IV, L.P. v. Vague*.¹⁷³ As noted earlier, the case arose from an attempt by Benchmark Capital to

¹⁶⁸ DEL. CODE ANN. tit. 8, § 144(a) (1998).

¹⁶⁹ See, e.g., Lesser & Johnson, *supra* note 162 ("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 Mallenbaum & Sheila Saegh, *Pay-to-Play Structure Increases Investors' Leverage in Business*, N.Y.L.J. (Dec. 3, 2001).

¹⁷⁰ See Kurt Berney, *Dilutive Venture Capital Financings*, in PRIVATE EQUITY & VENTURE CAPITAL INVESTING: LEGAL, FINANCIAL & STRATEGIC TECHNIQUES FOR SUCCESSFUL INVESTING 163, 193-194 (Practicing Law Inst. Course Handbook Series No. 1276, 2001).

¹⁷¹ Matthew Quilter & Austin Choi, *Duties of Directors: Venture Capitalist Board Representatives and Conflicts of Interest*, in VENTURE CAPITAL: GETTING FINANCING IN A CHANGING ENVIRONMENT 889, 905 (Practicing Law Inst. Course Handbook Series No. 1267, 2001).

¹⁷² Egan & Selinger, *supra* note 144.

¹⁷³ 2002 WL 31057462 (Del. Ch., July 15, 2002), *aff'd*, 822 A.2d 396 (Del. 2003).

enjoin one of its start-up companies, Juniper Financial Corp., 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,¹⁷⁴ 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 II in an economic environment that accentuated the potential inter-investor conflict these 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 II(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 on-line bank.¹⁷⁵ Typical of VC investment, Benchmark acquired shares of Series A Preferred Stock and received a number of control and monitoring rights, most notably representation on the company’s board of directors as well as several stockholder veto rights.¹⁷⁶ 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.¹⁷⁷

Like Benchmark, CIBC also engaged in the VC investment strategies outlined in Part II(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, no doubt aware of the potential inter-investor conflicts that might arise with CIBC, had approved the Series C financing on the condition of retaining these reciprocal veto rights. Although CIBC appeared to accept this arrangement, it did demand an important concession from the existing stockholders. Specifically, it obtained the right to waive these veto rights, provided the waiver did not

¹⁷⁴ 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.

¹⁷⁵ See 2002 WL 31057462 at *2.

¹⁷⁶ See *id.* at *2-3.

¹⁷⁷ See *id.* at *2.

“diminish or alter the liquidation preference or other financial or economic rights” of the Series A Preferred Stock or Series B Preferred Stock.¹⁷⁸ 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 protection.¹⁷⁹ As described in Part IV(A), these preferential rights might harm the interests of Benchmark and Seligman, but they 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.¹⁸⁰

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.¹⁸¹ The significant capital needs of Juniper stemmed largely from federal banking regulations that required the company to maintain a “well-capitalized” status. 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.¹⁸² 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 ratchet antidilution protection.¹⁸³ As a result, CIBC would hold more than 90% 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% to 7%.¹⁸⁴ 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 dividend rights. 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

¹⁷⁸ *Id.* at *3.

¹⁷⁹ The Series A and Series B Preferred Stock were entitled to more mild “weighted-average” antidilution protection. *See* Juniper Amended and Restated Certificate of Incorporation, at 24.

¹⁸⁰ *See* 2002 WL 31057462 at *3.

¹⁸¹ *See id.* at *4.

¹⁸² *See id.*

¹⁸³ *See id.*

¹⁸⁴ *See id.*

reduce the aggregate liquidation preference on these shares from \$115 million to \$15 million.¹⁸⁵

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.¹⁸⁶ 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...."¹⁸⁷

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,¹⁸⁸ 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 "materially adversely change[d] the rights, preferences and privileges" of the Series A and Series B Preferred Stock.¹⁸⁹ Second, 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.¹⁹⁰ 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

¹⁸⁵ See *id.* at *5 n. 20.

¹⁸⁶ *Id.* at *1.

¹⁸⁷ *Id.* at *3.

¹⁸⁸ See DEL. CODE ANN. tit. 8, 251(b) (2002).

¹⁸⁹ *Id.* at *7.

¹⁹⁰ See *id.* at *9.

Series A or Series B Preferred Stock.¹⁹¹ 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."¹⁹² Had Benchmark intended the veto rights to cover material adverse changes accomplished through a merger, Benchmark should have added this restriction. As a consequence, the court concluded, "to 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."¹⁹³ 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 charter amendment and indirect modifications effected through 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 "general language" concerning preferred stock voting rights to require a class vote on a merger and its "integral and accompanying modifications to the corporate charter and the corporation's capital structure" where none was intended.¹⁹⁴ 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."¹⁹⁵

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

¹⁹¹ *Id.* at *13.

¹⁹² *Id.* at *7.

¹⁹³ *Id.* at *9.

¹⁹⁴ *Id.* at *10.

¹⁹⁵ *Id.*

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."¹⁹⁶ CIBC and Juniper could therefore complete the proposed Series D financing notwithstanding its adverse economic effect on Benchmark and Seligman.

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

By demonstrating the potential intensity of inter-investor 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 ... appearing in the once-clubby world of venture capital as investors fight to wring value from troubled investments made during the Internet bubble."¹⁹⁷ For VC investors and their lawyers, the case represented an important cautionary tale of a VC firm that failed to protect itself against the risk of inter-investor conflict. For them, the lesson to be learned from *Benchmark* was clear: VC investors should draft better protective provisions.¹⁹⁸

Outside the context of VC investment, 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 inter-investor 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 inter-investor 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 multi-dimensional agency problems within a firm.

¹⁹⁶ *Id.* at *14.

¹⁹⁷ Bransten, *supra* note 2.

¹⁹⁸ *See infra* TAN 208.

A. *The Contractual Nature of Preferred Stock Rights*

Although journalistic accounts of *Benchmark* focused on the rise of inter-investor “tensions” following the dot-com meltdown, the existence of inter-investor conflict was hardly a new development. As discussed in Part III, the potential for inter-investor 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 non-controlling shareholder. The American history of the private corporation is replete with stories of minority shareholder “oppression.”¹⁹⁹

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 inter-investor tensions were especially pronounced. Yet public disputes—let alone lawsuits—among VC investors have remained exceedingly rare. Although several inter-investor lawsuits have arisen since 2002, the number of lawsuits is surprisingly small relative to the number of down-round financings.²⁰⁰ Moreover, the small number of lawsuits is in marked contrast to the dire warnings during the 2001-2003 economic downturn concerning the potential legal liability for VC investors participating in down-round financings.²⁰¹ What explains the dearth of inter-investor 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 non-controlling investors. 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 towards management.²⁰² It might therefore be supposed that a similar dynamic constrains one VC investor from acting opportunistically towards another investor.²⁰³ Under this

¹⁹⁹ See Robert Thompson, *The Shareholder’s Cause of Action for Oppression*, 48 BUS. LAW. 699, 702-03 (2000); see also *infra* TAN 256-258.

²⁰⁰ See *supra* notes 80-81.

²⁰¹ See *supra* TAN 172.

²⁰² See *supra* note 65.

²⁰³ 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, 1739-44 (2001) (examining role of reputational sanctions within the cotton industry); David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 373, 408-26 (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 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 function as “private devices which provide incentives that assure contract performance in the absence of any third-party enforcer”).

theory, a VC investor who acts “aggressively” towards another investor may develop a tarnished reputation among fellow investors as 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 financial performance. Thus, a VC investor’s desire for “deal flow” may create an incentive for developing a reputation for fair-dealing and non-litigiousness within the VC community.

While there is evidence that reputational concerns do encourage cooperative behavior among VC investors,²⁰⁴ 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 displace legal sanctions.²⁰⁵ 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.²⁰⁶ With greater amounts of capital at stake in each start-up company, the incentive to protect these investments in the face of the significant inter-investor conflicts outlined in Parts III and IV undoubtedly strained any reputational incentives promoting cooperation.²⁰⁷ This appears to have been precisely the case in *Benchmark*—not only did CIBC negotiate provisions that accentuated the conflict with Benchmark, but each of CIBC and Benchmark invested considerable sums in Juniper.

In these situations, an investor—no longer able to rely on reputational incentives to constrain rent-seeking behavior—must instead rely on

²⁰⁴ 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 CAP. J., October 1, 2003.

²⁰⁵ In general, social norms appear to work best as a non-legal sanction within a close-knit community, defined as a network in which power is broadly distributed and information pertinent to informal control circulates easily among network members. See ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES 177 (1991). The VC industry, in contrast, has undergone considerable expansion in recent years. The membership of the NVCA alone has grown from 87 firms in 1980 to over 900 firms in 2003 with over 9,000 investment principals. See NVCA YEARBOOK at 18-19. Indeed, veteran venture capitalists occasionally lament the changing world of venture capital “[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 CAP. J., December 1, 2002.

²⁰⁶ For instance, in each 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 83, at 40.

²⁰⁷ Industry insiders often explain the handful of inter-investor 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., March 5, 2003 (quoting Joseph Bartlett).

negotiated contract provisions to minimize the risks posed by inter-investor conflicts. Of particular importance in this regard are the veto rights—or quasi-veto rights (such as liquidation preferences and anti-dilution rights)—described in Part III. These rights protect a VC investor against corporate actions adverse to its particular economic interests. 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.²⁰⁸

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 non-binding term sheet—often lumps the allocation of investor veto rights under a general heading entitled “Protective Provisions.”²⁰⁹ 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, although many may also appear in other, more explicitly “contractual” documents, such as the Investor's Rights Agreement or the Voting Agreement.²¹⁰ 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.²¹¹

In virtually all cases, investors' veto-rights are allocated not to individually named VC investors but to particular series of preferred stock.²¹² The use of reciprocal veto rights to control inter-investor conflict would pose an especially acute risk of investor hold-ups were each VC investor to receive separate veto-rights. Allocating rights based on preferred stock ownership diminishes this risk. As discussed in Part III, inter-investor conflicts arise from the fact that a company's VC investors

²⁰⁸ See, e.g., *Orrick Publications: Benchmark Capital Partners IV, L.P. v. Vague*, available at www.Orrick.com; LeClaire, *supra* note 68.

²⁰⁹ See, e.g., NVCA, Model Term Sheet, at 6, available at http://www.nvca.org/model_documents/model_docs.html.

²¹⁰ See Thomas Klaus Gump, *Down Round Financings in 1 VENTURE CAPITAL AND PUBLIC OFFERING NEGOTIATION 10A-1, 10A-11* (Michael J. Halloran et al. eds, 3d ed. Supp. 2003) (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”).

²¹¹ 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 NVCA, Model Investors' Rights Agreement, at 29-30, available at http://www.nvca.org/model_documents/model_docs.html. 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.*

²¹² See NVCA Model Charter, at 17-18 (providing for “Series A Preferred Stock Protective Provisions”); Hi-Tech Charter, at 8-55–8-57 (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).

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. 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 opportunistically exercising a veto right.²¹³

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 inter-investor conflict. Considered in this light, 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,

[c]ertificates 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.²¹⁴

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.²¹⁵

²¹³ 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 inter-investor disputes. See Robert P. Bartlett, III, *Conflict and Cooperation in Venture Capital Contracting* (manuscript on file with the author); cf. Oliver Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. REV. 519, 540 (1983) (discussing incentives for cooperative dispute resolution in ventures where a “mutual hostage” situation exists).

²¹⁴ 2002 WL 31057462 at *6.

²¹⁵ *Id.* (quoting *Elliot Associates, L.P. v. Avatex Corp.*, 715 A.2d 843, 852-53 (Del. 1998)).

Although these “precedential parameters” would seem to apply only to the “rights, preferences and limitations of preferred stock that distinguish that 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.”²¹⁶

Armed with this principle, Judge Noble thus disposed of Benchmark’s workmanlike attempt to interpret its preferred stock 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.²¹⁷ Although this straight-forward analysis might satisfy a Delaware court interpreting an ordinary contract,²¹⁸ 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 Indus., Inc.*,²¹⁹ 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.

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, however, refused to read this veto right generally based on established Delaware precedent that protective rights “must ... be clearly expressed and will not be presumed.”²²⁰ With regard to Benchmark’s attempt to veto the issuance of the Series D Preferred Stock, Judge Noble 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. Judge Noble conceded that an ambiguity existed in the meaning of this language and that it could “easily be given the

²¹⁶ *Id.*

²¹⁷ See *supra* TAN 189-191.

²¹⁸ In general, Delaware courts interpret ordinary contracts using the “plain meaning rule.” See *Watkins v. Beatrice Companies, Inc.*, 50 A.2d 1016, 1021 (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.” *Northwestern National Insurance Co. v. Esmark, Inc.*, 672 A.2d 41, 43 (1996). To discern the parties’ intent, courts look first to the express language of the contract: “[w]here the contract language is clear and unambiguous, the parties’ intent is ascertained by giving the language its ordinary and usual meaning.” *Id.* Delaware courts look to extrinsic evidence to discern contractual intent only “if there is an ambiguity in the contract.” *Id.*

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

²²⁰ 2002 WL 31057462 at *10.

broad interpretation suggested by *Benchmark*.²²¹ He ultimately concluded, however, that “[t]o adopt [*Benchmark*’s] position would amount to presuming a preferential voting right. In the present case, however, where (at least) an ambiguity exists, our law requires that it be resolved *against* creating the preference.”²²²

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, *Pennington v. Commonwealth Hotel Construction Co.*²²³ In *Pennington*, the receiver of a liquidated corporation requested 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.”²²⁴ At issue was whether the liquidated corporation could pay preferred stockholders their unpaid accrued dividends that were 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 stockholders and common 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.”²²⁵ 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 dividends that would have been payable out of net profits or surplus while the company was a going concern but went unpaid for some reason.²²⁶

Not content with this 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.²²⁷

In support of this proposition, the court cited a 1929 chancery court opinion, *Gaskill v. Gladys Belle Oil Co.*²²⁸ Only the loosest read of *Gaskill*,

²²¹ *Id.* at *13.

²²² *Id.*

²²³ 151 A. 228 (Del. Ch. 1928).

²²⁴ *Id.* at 230.

²²⁵ *Id.* at 232.

²²⁶ *Id.* at 234.

²²⁷ *Id.*

²²⁸ 146 A. 337 (Del. Ch. 1929).

however, could support this broad pronouncement. *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 power, or restrictions or qualifications thereof, as shall be stated and expressed in the Certificate of Incorporation."²²⁹ Given this language, the *Gaskill* court concluded that the preferred stock rights should have been set forth in the charter and not the bylaws.²³⁰

Nothing in *Gaskill* suggests that, had these rights been expressed in the charter, it would have applied anything other than ordinary contract principles in interpreting them.²³¹ Nonetheless, *Pennington* 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 the charter, but "clearly" expressed,²³² and by 1943, *Gaskill* and its progeny required that preferred stock rights "must be strictly construed."²³³ This doctrine of "strict construction" continued until 1998 when the Delaware Supreme Court disapproved the continued use of the phrase.²³⁴ The court nonetheless continued to endorse the rule that preferred stock rights be "clearly expressed and will not be presumed"²³⁵—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 only further weakens its doctrinal validity. *Pennington*, 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' analysis of preferred stock rights. *Gaskill*, for instance, relied heavily on a line of New Jersey and English cases 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 [paid in] 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."²³⁶

²²⁹ *Id.* at 338.

²³⁰ *See id.* at 340-41.

²³¹ *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.").

²³² *Holland v. National Automotive Fibres, Inc.*, 194 A. 124 (Del. Ch. 1937).

²³³ *Goldman v. Postal Telegraph*, 52 F. Supp. 763 (1943).

²³⁴ *Elliot Associates, L.P. v. Avatex Corp.*, 715 A.2d 843, 852 (Del. 1998).

²³⁵ *Id.* at 852 n 46.

²³⁶ *Gaskill*, 146 A. at 338.

In essence, these cases articulated a default rule of equal sharing for preferred stock 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.*”²³⁷ 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, L.P. v. Avatex Corp.*,²³⁸ the interpretive principle of requiring preferred stock rights to be clearly expressed “continues a coherent and rational approach to corporate finance.”²³⁹ Corporate drafters seeking to create preferred stock veto rights need look only to the language used in *Avatex* for an example of a sufficiently “clear” veto right covering adverse changes effected through a merger.²⁴⁰ Judge Noble likewise expressed reluctance “to create uncertainty in a complex area where *Avatex* has set down a framework for consistency.”²⁴¹ Yet *Avatex* provides clarity in only one narrowly-defined context. It says 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.²⁴² 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.

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

²³⁷ *Penington v. Commonwealth Hotel Construction Corp.*, 155 A. 514 (Del. 1931).

²³⁸ 715 A.2d 843 (Del. 1998).

²³⁹ *Id.* at 854.

²⁴⁰ *Id.*

²⁴¹ 2002 WL 31057462 at *10.

²⁴² See, e.g., LeClaire, *supra* note 68 (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.”).

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.²⁴³

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.²⁴⁴ 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 venture capital, 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 it to other VC investors such as CIBC. In so doing, however, Benchmark ultimately created a new dimension of inter-investor 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 section 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 and toward a theory that is robust to the dynamic character of multidimensional agency problems.

First, this Article's emphasis on the presence of both investor-manager and inter-investor agency problems in VC investment suggests the need to

²⁴³ See BARNEA, *supra* note 14, at 2 (noting correlation of non-systemic investment risk with a firm's cost of capital).

²⁴⁴ Indeed, the impossibility of drafting "complete" contracts is a primary reason why contracting parties can engage in opportunistic behavior towards one another. See Benjamin Klein, *The Hold-Up Problem*, in 2 NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 241 (Peter Newman ed. 1998); Robert E. Scott, *A Theory Of Self-Enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641, 1642 (2003).

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.²⁴⁵ 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, Margaret Blair and Lynn 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 paradigm.”²⁴⁶ 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.²⁴⁷

At first blush, Blair and Stout’s alternative team-production model appears to provide a paradigm of the firm that moves 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.²⁴⁸ 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.²⁴⁹ In 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.²⁵⁰

²⁴⁵ See *supra* TAN 30-33.

²⁴⁶ Blair & Stout, *supra* note 12, at 287.

²⁴⁷ *Id.* at 248-49.

²⁴⁸ See *id.* at 249.

²⁴⁹ See *id.*

²⁵⁰ See Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403, 418-17 (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 Alchian and Demsetz, whose work was built largely on principal/agent economics. See Armen 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

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. In most public corporations, Blair and Stout argue that this role is filled by the board of directors which acts as a “mediating hierarch” of the firm to resolve team members’ conflicting interests.²⁵¹

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 problems.” 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 “homogenous interest” in maximizing share price which is often in harmony with other stakeholders’ interests.²⁵² Likewise, in their paradigm, the board mediates between the conflicting interests of distinct corporate constituencies such as “bondholders,” “employees” and “shareholders.”²⁵³ This unitary approach towards each corporate constituency is certainly at odds with the experience of the VC industry where inter-shareholder conflict is a way of life. 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 this context, the interests of corporate constituencies will often be heterogeneous. 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.²⁵⁴ 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 director’s authority to mediate.²⁵⁵ These inter-shareholder agency-problems remain unexplained by the team-production model, yet they may fundamentally affect the risk profile of corporate investment.

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.

²⁵¹ 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).

²⁵² Blair & Stout, *supra* note 12, at 313; *see also id.* at 302 n135 (“[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.”).

²⁵³ *Id.* at 306.

²⁵⁴ *See generally* Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, UCLA School of Law, Law-Econ Research Paper No. 05-16, available at <http://ssrn.com/abstract=783044>; Stephen Bainbridge, *Shareholder Activism and Institutional Investors*, UCLA School of Law, Law-Econ Research Paper No. 05-20, available at <http://ssrn.com/abstract=796227>; *see also* Edward Rock, *The Logic and Uncertain Significance of Institutional Investor Activism*, 79 Geo. L.J. 445, 466-68 (1991) (discussing potential conflict between large and small investors in public companies).

²⁵⁵ *See infra* TAN 261-270.

In contrast, corporate scholarship concerning close corporations has generally been better at grappling with the intra-stakeholder conflicts that can arise among shareholders. As noted above, it is widely agreed that shareholders in closely held corporations face a high risk of loss from their fellow shareholders' opportunism.²⁵⁶ Moreover, there is general consensus that the primary constraints on shareholder opportunism—contractual agreements, reputational constraints, fiduciary duties running from shareholder to shareholder—are not entirely effective in eliminating this risk.²⁵⁷ The result is that the risk of inter-shareholder conflict increases the cost of capital for closely-held firms.²⁵⁸

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 non-existent or significantly reduced in closely-held corporations.²⁵⁹ 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 short-comings 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.

In addition, by emphasizing the relationship between investor-manager agency costs and inter-investor agency costs in VC finance, this Article highlights the dynamic character of agency problems in a firm. 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 inter-investor agency risk with CIBC. Closely related to the development of this inter-investor 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*

²⁵⁶ See *supra* TAN 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).

²⁵⁷ 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...").

²⁵⁸ See EASTERBROOK & FISCHEL, *supra* note 26, at 243.

²⁵⁹ See *supra* TAN 5; see also EASTERBROOK & FISCHEL, *supra* note 26, at 228-252 ("Because closely held corporations do not separate management from risk bearing, monitoring is less costly").

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 costs 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.²⁶⁰ 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 problems in a firm; she must also account for any agency problems that will arise when she seeks to address them (e.g., through bonding or monitoring efforts). Thus, in pricing a start-up company investment, a rationale 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 inter-investor agency risks, in turn, may be affected by characteristics of the investors themselves (e.g., are the VC funds nearing the expiration of their investment terms?) and mechanisms the VC investor might utilize to reduce these risks (e.g., reciprocal veto rights). After *Benchmark*, the enforceability of these mechanisms must also be considered.

Nor are the dynamic characteristics of agency costs limited to VC investment. Attempts to reign in investor-manager agency problems born 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.²⁶¹ 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 SEC's recent proposal to permit shareholders to nominate directors directly and have their nominees listed in the company's proxy statement.²⁶²

²⁶⁰ 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.")

²⁶¹ For an articulation of this argument, see generally MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* (1994); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990).

²⁶² See Security Holder Director Nominations, Exchange Act Release No. 48,626 (October 14, 2003).

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.²⁶³ 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.²⁶⁴ The 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 pensions plans, for instance, have been particularly active shareholders, even though their activism often redounds to their private benefit.²⁶⁵ 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.²⁶⁶ 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.²⁶⁷ Alternatively, as recently demonstrated in *High River Limited Partnership v. Mylan Laboratories, Inc.*,²⁶⁸ 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.²⁶⁹

²⁶³ See Bainbridge, *supra* note 254, at 10-11.

²⁶⁴ *Id.* at 12-14.

²⁶⁵ See *id.* at 15-16 (describing instances where union pension funds have used shareholder proposals to obtain employee benefits they could not obtain through bargaining).

²⁶⁶ This technique was vividly illustrated by du Pont Company’s investment in General Motors (GM) in the early twentieth century. In 1917, Du Pont substantially increased its equity position in GM as a means to secure for du Pont the bulk of GM’s artificial leather, polyimide, paint and varnish businesses. See Anabtawi, *supra* note 254, at 18.

²⁶⁷ See *id.* at 41 (noting that shareholders can use private negotiations with management to obtain greenmail-type payments in exchange for agreeing to support managerial interests); see also Hamermesh, *supra* note 254, at 456 (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 direct 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 Letter from John Castellani, Business Roundtable, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (December 22, 2003) (Comments of Martin Lipton) (“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.”).

²⁶⁸ *High River Limited Partnership v. Mylan Laboratories, Inc.* No. 1:04-cv-02677-SHR (M.D. Pa. 2005, case filed Dec. 13, 2004) (case voluntarily dismissed).

²⁶⁹ *Mylan* 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 254, at 35. 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.

Shareholders might seek to combat these types of inter-shareholder agency problems, but as demonstrated in the VC context, such efforts will entail agency costs of their own.²⁷⁰

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.²⁷¹ The agency problems confronting investors are multiple and, as shown in the context of VC investment, often inter-related. 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.

VI. 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 inter-investor 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 inter-investor 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 paradigms of the firm and their associated theories of corporate law.²⁷² By revealing the flaws of the traditional model of VC

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 in King in the expectation that the over-valued transaction would collapse. High River initiated the suit to enjoin Perry from voting its Mylan shares to approve the merger. *See id.* at 35-36.

²⁷⁰ *Cf. id.* at 18-19 (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”).

²⁷¹ Jensen & Meckling, *supra* note 8, at 309.

²⁷² *See, e.g.,* Blair & Stout, *supra* note 12, at 275-76 (using hypothetical start-up company to demonstrate team production model); G. Mitu Gulati, et. al., *Connected Contracts*, 47 UCLA L. REV. 887, 896

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.

(2000) (using venture-backed start-up company to set forth a “connected contracts” model of collaborative economic activity).