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Dynamic Views of Startup Governance and Failure

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1. Introduction

The venture capital industry has profoundly expanded over the past several decades as it has become a key driver of economic growth and innovation in the United States, where the industry has its roots. During this time, a great volume of research across disciplines has focused on the role of venture capitalists and the features of venture capital contracting.

In particular, legal scholars and financial economists have explored how venture capitalists (VCs) act as specialized intermediaries uniquely tailored to financing innovative startups. Theoretical and empirical work examines the particular set of contracting and governance mechanisms that venture capitalists have developed to address information asymmetry, agency costs, uncertainty, and incomplete contracting. Investing in syndicated, staged rounds of convertible preferred stock, venture capitalists famously deploy capital from a fund into a portfolio of startups and bargain for a complex set of contracts and governance arrangements that separate cash flow and control rights.

This chapter brings together scholarship and case law that builds on this foundational work and sheds light on how startup governance evolves dynamically across the life cycle of the startup toward a successful exit or failure. In so doing, the chapter highlights two key points that have become important themes in understanding the governance of venture-backed startups.

First, while foundational scholarly literature focused on a vertical conception of venture-backed startup relationships between a stylized venture capitalist as principal and entrepreneur as agent, more recent work has added the horizontal dimension of relationships between startup participants and an understanding of change across the life cycle. These additions help to provide a fuller picture of the

complexity in startup governance and the potential for competing or misaligned interests between various startup participants that are navigated through time.

Second, scholars have increasingly explored the governance implications of the "power law" business model of venture capitalists, in which a small number of big winners in a portfolio can drive the success of a fund. In contrast to the focus on venture capital contracting at the individual startup level in foundational scholarly literature, more recent work has explored how the power law drives venture capitalists' incentives and governance-related activity across the startups in their portfolio and the broader startup ecosystem.

Thus, in sum, understanding venture-backed startup governance and failure involves taking account of the distinctive form of contracting and governance mechanisms deployed in venture capital financings, appreciating the pattern of dynamic governance change across the life cycle of a startup for its varied participants, and including a broader portfolio or ecosystem view that incorporates the business model of venture capital. This chapter proceeds by examining each in turn and concluding with areas for future research.

2. Foundational Understandings of Venture-backed Startup Governance

Historically, entrepreneurial finance has existed from various sources, but it was not until the mid-twentieth century that the modern venture capital industry arose, and subsequently took off in the United States in the 1980s with a combination of business and legal transformation.[1] Pioneering venture capital firms raised private capital in limited partnerships, deployed these funds into innovative startups, and developed practices to stage financings, guide founders, encourage incentive compensation, and more (Nicholas 2019, pp. 225-227, 206-214).

[1] Nicholas (2019) provides a comprehensive history of the venture capital industry. Mallaby (2022, pp. 17-39) discusses the pioneers of venture capital. Pollman (2024) explores the business and legal transformations that catalyzed the venture capital industry.

By the 1990s and early 2000s, legal scholars and financial economists created an impressive body of literature that captures important aspects of venture-backed startup governance. Early models focused on the "VC-entrepreneur" relationship (Klausner and Litvak 2001, p. 55). Specifically, many scholars framed analysis as occurring between an archetypal VC and entrepreneur (Hart 2001, p. 1088; Smith 2005, p. 316),[2] examining the contracting and governance mechanisms that VCs use to address the problems of information asymmetry, agency costs, uncertainty, and incomplete contracting.

As a starting point, scholars theorized the role of VCs as informed intermediaries solving the "lemons" problem or adverse selection that could otherwise result under conditions of information asymmetry between informed entrepreneurs and uninformed investors (Chan 1983). In this view, VCs bridge the gap between entrepreneurs and the ultimate investors that come into the VC fund as limited partners, by the VCs offering industry and technical expertise that helps to identify talent and high-quality ideas (Sahlman 1990).

In turn, once a VC decides to invest in a startup, the VC-entrepreneur relationship can be envisioned as one of principal and agent, giving rise to agency costs from the potentially conflicting interests.[3] After having taken the VC's investment, the entrepreneur could engage in self-dealing, fail to exert optimal effort, take on too much or too little risk, and so on. In response to such agency costs, and the problem of information asymmetry noted above, as well as the high levels of uncertainty in innovative startups, VCs monitor their portfolio firms and negotiate for contractual and governance arrangements that separate cash and control rights.

[2] Hart explains: "Although venture capitalists often represent several large rich individuals or institutions, they correspond quite well to the single investor of the Aghion-Bolton model. Similarly, the founder or founders of a start-up company can be represented without too much of a stretch by a single entrepreneur." Smith notes: "The focus of this Article is the venture capital relationship, stylized here as a relationship between an entrepreneur and a venture capitalist."

[3] Klausner and Litvak (2001, p. 56). Jensen and Meckling (1976, pp. 305) theorize the principal-agent relationship and agency costs in the ownership structure of the firm.

This "monitoring" model, focused on a vertical conception of the VC-entrepreneur relationship as principal-agent, rested on both theoretical and empirical foundations. Using a survey of VCs, Gorman and Sahlman (1989) found that VCs devote considerable time to overseeing the startups in their portfolio by sitting on boards, making informal visits, and assisting in key management decisions. Lerner (1995) explored how VC board representation is greater as the need for oversight increases and found that the geographic proximity of VCs is closely related to the likelihood of sitting on a portfolio startup's board.

Beyond screening and monitoring, VCs further respond to information asymmetry as well as agency costs and uncertainty through the contractual and governance arrangements negotiated when they make an investment. One of the most "potent" of these practices is staged financing.[4] Instead of allocating upfront, at the seed stage, all of the capital that a startup would likely require to reach a successful exit, VCs invest in incremental rounds. After observing a startup's progress after such a round of financing, VCs can add capital in subsequent rounds or decide to discontinue further financing. Staged financing thus provides incentives to entrepreneurs to hit periodic milestones and allows VCs to threaten abandonment if the company underperforms or is plagued by agency costs. Using a random sample of several hundred venture-backed startups, Gompers (1995) tested predictions from agency and monitoring cost theory and confirmed that VCs concentrate in early-stage technology industries where monitoring is valuable, and if they learn negative information, they withhold new financing.

VC investment in staged rounds of financing typically takes the form of convertible preferred stock with related shareholder agreements, which allow for separating cash flow and control rights.[5] This practice, which enables making cash flow and control rights contingent on future outcomes,

[4] Gompers (1995, p. 1461) discusses findings of field research documented in Sahlman (1990). On the syndication of staged rounds of financing, see Lerner (1994) and Sorenson and Stuart (2001).
[5] Kaplan and Strömberg (2003); Gilson (2003, pp. 1072-73).

supports theories of incomplete contracting and shifts of control to investors in different states.[6] Further, cash flow rights in venture-backed startups reflect classical principal-agent and information asymmetry problems. For example, Kaplan and Strömberg (2003, p. 299) found that VCs increase pay performance sensitivity in response to uncertainty about the quality of the founder and startup venture by using an equity-based compensation structure that subjects founders to additional time vesting, fewer liquidation cash flow rights, and more explicit performance compensation. Contractual preferences that VC investors receive with their equity, such as liquidation preferences, further allocate cash flow rights so as to mitigate risk on the downside, and the convertible nature of the equity generally provides for the termination of these features on the upside event of an initial public offering (IPO) of sufficient size.[7] Moreover, the allocation of control rights is of particular focus in venture-backed startups and can be done through board size and composition, shareholder voting arrangements, and protective provisions or veto rights (Kaplan and Strömberg 2003, pp. 287-90). Given staged financing, the typical pattern is for a startup to raise sequential rounds of convertible preferred stock, each time re-negotiating the bargain among existing participants and new investors regarding the allocation of control and contractual rights.

Finally, another important aspect of venture-backed startup governance illuminated by the foundational literature of the 1990s and early 2000s concerns the role of VC reputation. As explored above, the key organizational and contractual techniques used in the venture capital financing context "have at their core the transfer of discretion from the entrepreneur to the venture capital fund" (Gilson 2003, p. 1085). The question accordingly arises of what prevents VCs from acting

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[6] Aghion and Bolton (1992); Grossman and Hart (1986); Hart and Moore (1988) and (1990); Dewatripont and Tirole (1994).

[7] Bratton (2002, pp. 914-16, 939-44) discusses why venture capitalists use preferred stock and how they contract for protections from downside failure. Gilson (2003, pp. 1084-85) discusses the exit and the conversion of preferred stock into common stock upon IPO and termination of various preferences and control rights. For a tax efficiency argument for the use of convertible preferred stock, see Gilson and Schizer (2003).

opportunistically against the interests of entrepreneurs. Most notably, Ronald Gilson argued that "[t]he conservation of discretion principle counsels that the discretion be vested in the party whose behavior is more easily policed" and that "the presence of an effective reputation market" for VCs supports the transfer of discretion to VC funds. Gilson (2003, p. 1086) identified three attributes for a reputation market to operate: anticipated repeat future transactions, shared expectations of what constitutes appropriate behavior by the party to whom discretion is transferred, and observable satisfaction of expectations by those who will deal with the advantaged party in the future.

Given the concentrated and geographically localized community of venture capital funds in Silicon Valley in the late twentieth century, as well as VCs' need to raise successive funds, Gilson concluded that the VC reputation market allowed entrepreneurs to rely on implicit contracting to protect against opportunistic conduct.[8] Additional research, from fields spanning sociology to finance, bolstered this understanding of VC reputation as a critical feature for venture capital contracting in startups from seed stage to exit.[9]

3. Venture-Backed Startups Governance Across the Life Cycle

By the early twenty-first century, empirical and theoretical analyses of venture capital contracting and governance practices had established the contours of the VC-entrepreneur relationship and the monitoring model as highlighted in the above discussion. Although this literature explains much of the world of venture-backed startup governance, a number of developments highlighted areas for further exploration.

Vertical and Horizontal Relationships Among Startup Participants

Even before the dot-com bust of 2001, it was becoming increasingly apparent that VCs were not immune from opportunistic conduct—they were not only powerful principals in an envisioned

[8] Gilson (pp. 1086, 1092) observes that the braiding of the VC fund-portfolio company contract with the investor-VC fund contract supports a VC reputation market because of the need of VCs to raise successive funds.
[9] Megginson and Weiss (1991); Saxenian (1994); Suchman (1994).

principal-agent relationship with entrepreneurs, but also subject to the sharp elbows and interests of other startup participants. To start, the "once-prevailing story" that entrepreneurs routinely ceded control to VCs through a majority of the stock and board seats, was at best "incomplete."[10] Kaplan and Strömberg's research (2003, Table 2) had already highlighted that real-world board arrangements were diverse. Board control is sometimes held by the VCs, but in many instances it is shared with or held by founders.[11] In a well-known case, *Equity-Linked Investors, L.P. v. Adams*, the VC investors found themselves unable to force a company on the "lip of insolvency" to liquidate where it would have likely recouped substantially less than the $30 million in liquidation preference of the preferred stock.[12] Lacking board control or contractual rights to force liquidation, the VCs could not stop the company from completing a last-minute financing transaction to buy more time, while potentially jeopardizing the remaining assets.[13] Although the court recognized the board had imposed undesired economic risks on the preferred shareholders, it held that there was no breach of duty. Any "special protections" for the preferred shareholders are "contractual in nature."[14]

Moreover, preferred shareholders are not only vulnerable when they lack control vis-à-vis the common shareholders, but also when conflicts arise among the preferred shareholders. Put more broadly, relationships within the venture-backed startup can be envisioned as both vertical, such as between investors and entrepreneurs, and horizontal, between various equity holders (Bartlett 2006). As explained by Bartlett (2006, p. 63), when VCs attempt to minimize agency costs with entrepreneurs by financing startups through staged, syndicated rounds and seeking control rights, they create the circumstances for divergent interests among investors—a "potential horizontal agency problem."

[10] Bratton (2002, pp. 897-98) discusses Black and Gilson (1998).
[11] Kaplan and Strömberg (2003); Bratton (2002, pp. 898-901) discusses Kaplan and Strömberg's findings about board control. For discussions of venture-backed startup boards and independent directors, see Feld, Blumberg, and Ramsinghani (2022), Broughman (2010), and Ewens and Malenko (2020).
[12] 705 A.2d 1040, 1041 (Del. Ch. 1997).
[13] *Equity-Linked Investors*, 705 A.2d at 1041; Bratton (2002, pp. 927-29) discusses *Equity-Linked Investors*.
[14] 705 A.2d 1040.

Different economic interests between VCs can stem from the timing or performance of their own fund as well as the participation levels and terms upon which they invested in a portfolio startup. For example, the closer a VC gets to the end of the term of its fund, it may face increasing pressure to seek liquidity events for its portfolio companies. Similarly, when raising a successive fund, VCs might push to accelerate positive returns or delay losses in a particular portfolio company. An early successful exit could boost the internal rate of return (IRR) of a portfolio as measured at that time, which could be critical for a VC seeking to attract limited partners (LPs) to their next fund. And, conversely, because VCs generally carry an investment at cost until an exit or subsequent financing, a VC might favor delaying an exit for a struggling startup in order to present a better picture of its overall portfolio to current and prospective LPs. Further, for a VC that invested early in a startup at a low valuation, an exit opportunity may be attractive even if it would not represent a gain for later investors that came in at a higher valuation. In all, as Bartlett observed, "because of staged investment and investment syndication, a venture capitalist who invests in a start-up company faces a discernable risk that it may disagree at some point with the company's other VC investors" about significant decisions such as subsequent financings and exit (Bartlett 2006, p. 74).

VCs' attempts to protect their preferences concerning the timing and amount of a subsequent financing or exit cannot perfectly mitigate or eliminate the horizontal agency problem (Bartlett 2006). To the extent the investors do not participate at the same level and terms, and maintain such pro rata participation at every stage, with similar timing of their funds, the potential for misalignment exists. Their attempts to address this concern through contractual provisions might even increase the risk for inter-investor conflict in some instances. For example, pay-to-play provisions can align investors' incentives to continue to fund a company, but they can also raise the stakes of the debate by punishing nonparticipating investors. Likewise, anti-dilution provisions can protect investors from downside

risk, but they can generate investor conflicts by diluting those that do not get an adjustment and affect the value of earlier investments (Bartlett 2006, p. 81).

By the dot-com bust and its aftermath, these inter-investor disputes began to find their way to Delaware courts, which underscored the vulnerability of preferred shareholders by narrowly construing their contractual rights. In *Benchmark Capital Partners IV, L.P. v. Vague*, the Delaware Court of Chancery rejected a preferred shareholder's attempt to enjoin a merger and preferred stock issuance that would harm its interests.[15] The preferred shareholder, Benchmark Capital, had invested in Juniper Financial's Series A and B rounds of financing. The Series C round was entirely financed by another investor, the Canadian Imperial Bank of Commerce (CIBC), which obtained majority voting power subject to the Series A and B shareholder veto rights. It also obtained the right to waive these veto rights, provided the waiver did not "diminish or alter the liquidation preference or other financial or economic rights" of the Series A or B preferred stock.[16] Although the Series A and B investors, including Benchmark Capital, had not anticipated another round of financing, it was soon needed and efforts at fundraising were unsuccessful besides from CIBC in a down-round financing that significantly diluted the other investors. CIBC and Juniper structured the financing as a subsidiary merger, which was not specifically covered by Benchmark's veto rights. The Court of Chancery rejected Benchmark's challenge, noting that the drafters of the veto rights could have expressly addressed material adverse changes accomplished through a subsidiary merger, but had not done so.[17] As Bratton and Wachter (2013, p. 1874) observed, preferred shareholders that take minority stock positions in reliance on special contract rights can thus find themselves unable to enforce the rights

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[15] 2002 WL 1732423, No. Civ.A 19719 (Del. Ch. July 15, 2002).
[16] *Benchmark*, 2002 WL 1732423 at *3.
[17] *Benchmark*, 2002 WL 1732423 at *9. For another example of Delaware's approach to construing contractual protections of preferred stockholders in venture-backed startups, see *SV Investment Partners, LLC v. ThoughtWorks, Inc.*, 7 A.3d 973 (Del. Ch. 2010), aff'd 37 A.3d 205 (Del. 2011). Bratton and Wachter (2013, p. 1821) observe that Delaware courts are "the dominant arbiters of preferred stock disputes."

"because the contract is embedded in a stock issue" subject to judicial interpretation in the corporate law paradigm.

Although a "preferred stockholder in control doesn't have these problems," a new issue arises: "Does fiduciary law come to bear to protect a common stock minority when a preferred stockholder in control exercise its contract rights to impair the common's interest?" (Bratton and Wachter 2013, p. 1875). The Delaware Court of Chancery "opted emphatically" (p. 1876) in the common shareholders' favor in the venture-backed startup case, *In re Trados Inc. Shareholder Litigation*.[18] As in *Equity-Linked Investors*, the case presented a dispute arising from conflicting interests of the common and preferred shareholders regarding an exit leading to liquidation, but in the instance of *Trados* the preferred shareholders had obtained a significant number of board seats and pushed for a sale of the company.[19] The merger transaction yielded $60 million in cash and stock consideration — executives received $7.8 million pursuant to a management incentive plan, the preferred shareholders received the remaining $52.2 million pursuant to their liquidation preference, which was not fully satisfied, and the common shareholders received nothing.[20] Common shareholders sued the directors for breach of fiduciary duty, claiming that the board should not have agreed to the merger and had a duty to continue operating the company on a stand-alone basis for the benefit of the common shareholders.[21]

In a post-trial opinion, the court explained "the standard of conduct for directors requires that they strive in good faith and on an informed basis to maximize the value of the corporation for the benefit of its residual claimants," by pursuing "the best interests of the corporation and its common stockholders, if that can be done faithfully with the contractual promises owed to the preferred."[22] Due to the lack of a majority of independent, disinterested directors, the court deployed the entire

[18] 73 A.3d 17 (Del. Ch. 2013).
[19] *Trados*, 73 A.3d at pp. 20, 45-54.
[20] *Trados*, 73 A.3d at p. 20.
[21] *Trados*, 73 A.3d at p. 42.
[22] *Trados*, 73 A.3d at p. 41 (internal quotation mark and citation omitted).

fairness test, ultimately concluding that although the process suffered significant flaws, the fair value of the common stock was zero and the decision to approve the merger was entirely fair.[23] The VC-appointed directors narrowly escaped loss, but a message rang out in Silicon Valley and beyond: the VCs took "a pretty good tongue-lashing" for much of the court's opinion and were lucky to be "[s]aved by the bell" on the fair price analysis, delivering a "Pyrrhic victory" to the defendants given the enormous amount of time and money spent on litigation (Kupor 2019).[24]

A vibrant debate among scholars and jurists has flourished concerning the wisdom of the law's approach to these varied shareholder conflicts in venture-backed startups.[25] While consensus in this debate is elusive, awareness has grown that VC investors may monitor the entrepreneurs, as in the imagined vertical agency relationship, but they are also conceptually in a horizontal relationship with the common shareholders and other preferred shareholders.

Dynamic Startup Governance Change Over Time

From these scholarly insights and cases involving venture-backed startups, a larger pattern also emerges: "startups involve heterogeneous shareholders in overlapping governance roles that give rise to vertical and horizontal tensions between founders, investors, executives, and employees" (Pollman 2019, p. 159). The potential conflicts or misalignment of interests is not simply between VCs and founders or preferred vs. common or other preferred, but also between the common shareholders as they can likewise be differently situated from each other in the startup (pp. 178-96).[26]

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[23] *Trados*, 73 A.3d at pp. 55, 60, 79. A shareholder's exercise of control through contractual rights can also give rise to fiduciary duties. For example, *Basho Techs. Holdco B, LLC v. Georgetown Basho Inv'rs, LLC*, C.A. No. 11802, 2018 WL 3326693 (Del. Ch. July 6, 2018), *aff'd* 221 A.3d 100 (Del. 2019) found that a preferred shareholder's exercise of a blocking right breached its fiduciary duties owed to the corporation and other shareholders.

[24] Cable (2019, p. 102) notes that *Trados* "reverberated loudly in Silicon Valley" with its "sharp critique of the board for failing to more vigilantly serve common shareholders."

[25] For example, Bratton and Wachter (2013, pp. 1885-87, 1904-06) critique Delaware's approach to preferred shareholders and common stock maximization. Strine (2013) responds to Bratton and Wachter with a defense of Delaware's approach to preferred shareholders. Bartlett (2014, p. 295) critiques *Trados* as "undermining the utility of the corporate form as a vehicle for maximizing firm value."

[26] Founders, executives, and employees are often common shareholders or optionholders in startups and their equity arrangements and incentives may vary widely. Divergence in their interests "can arise when the company has an acquisition offer or is being sold, in secondary sales in which some shareholders have an opportunity to sell their shares, and even in

Furthermore, as I have explored in earlier work, these potential tensions tend to multiply across the life cycle of the startup as it adds participants with varied interests and claims (Pollman 2019). At the founding stage, governance is not an issue if ownership and control are fully aligned in the founder. Some startups, however, involve two or more cofounders, which already creates the potential for governance conflict. Furthermore, early-stage startups usually hire employees and grant them incentive-based equity such as restricted stock or stock options that will have an exercise price and vest over time.[27] Seed financing often adds angel investors, accelerators, or other outside investors.[28] The addition of employees and outside investors "creates governance challenges that can be understood as horizontal between equity holders (or debt and equity), and simultaneously vertical with the founder acting as a managerial agent" (Pollman 2019 p. 197).

Notably, when startups take venture capital financing they again increase potential governance issues. As we have seen, because VCs typically invest through convertible preferred stock, the first round of VC financing adds another layer of horizontal governance issues between the common and preferred shareholders. And, unless the subsequent financing round is exactly pro rata with the same investors, the potential for conflicts between the preferred shareholder arises, and a greater diversity of interests is often represented on the board. With each financing round, the pattern continues. Other capital sources such as corporate venture capital or debt may add to the governance complexity. Further, as a startup hires additional executives and employees with varied types of incentive-based

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everyday corporate decisionmaking such as regarding whether to extend the exercise period for certain optionholders" (Pollman 2019, pp. at 194-95).

[27] For discussion of startup employee compensation issues, see, for example, Aran (2018, p. 1269) and Cable (2017).

[28] Seed financing can take a wide variety of forms. For example, Bernthal (2016) examines startup accelerators and their equity stakes, Ibrahim (2008) explores angel investors, and Coyle and Green (2014, pp. 165-73) describe convertible securities, simple agreements for future equity, and preferred seed stock. While venture capital contracting has increasingly standardized with the rise of the National Venture Capital Association model documents, the capital structures of companies at the time of Series A financing has "become substantially more complex" from prior seed stage financing (Bartlett 2023).

equity and associated terms, the potential divergences between the interests of common shareholders also grows over time (Pollman 2019 p. 198).

Accordingly, "startup governance typically evolves from relatively simple to very complex sets of tensions between and among participants—it is not static and yet on the whole it changes in predictable ways" (Pollman 2019, p. 198). Venture-backed startups "face interrelated horizontal and vertical governance issues and involve heterogeneous shareholders, overlapping governance roles, and dynamic change" (pp. 198-99).

4. Portfolio Views of Venture-Backed Startup Governance (How the Power Law Drives Governance)

As this chapter has explored thus far, the governance of venture-backed startups can be understood at the individual firm level through in-depth examinations of venture capital contracting practices and the monitoring model as well as frameworks setting out the potential tensions or misaligned interests among all startup participants and how they change over time, typically growing more complex. Yet fully understanding venture-backed startup governance (and failure) also requires taking into account how the power law drives VC incentives and activity across firms.

The crux of the matter is that returns from investing in high-risk, high-growth innovative ventures often do not follow a normal distribution. Instead, the lion's share of returns are typically earned from a small number of investments in the portfolio. Some, or even many, of a fund's investments may go to zero or not be fully recouped. For example, one limited partner shared aggregate data on its returns from 7,000 investments made by VC funds from 1985 to 2014 and 6% of deals had generated 60% of the total returns.[29] This is known as the "power law" of venture capital, which is not truly a law at all, but rather a description of outcomes or business model. As Sebastian Mallaby (2022, p. 14) has explained, the economics of startup investing, in which VCs "look for radical departures from the

[29] Dixon (2015) discusses data shared by Horsley Bridge; Evans (2016).

past" with successful "[t]ail events" being the target, is an important part of "why venture is so different from other types of finance."

Given the power law, VCs typically seek to invest only in companies that have the potential to be outliers in terms of massive returns that can drive the success of a fund (Thiel 2014, pp. 86-87). Baseball references abound in venture capital such as thinking in terms of "home runs" or "grand slams" per "at bat" or the "Babe Ruth effect" (pp. 86-87).[30] The famous baseball slugger's philosophy encapsulated the strategy of many VCs: "I swing big, with everything I've got. I hit bit or I miss big" (Dixon 2015, quoting Babe Ruth). And generally the bigger the better for reaching the highest echelons of successful VC funds. Venture capital firm Andreessen Horowitz has noted that "home runs for good funds are 20x, but the home runs for great funds are almost 70x" (Dixon 2015).[31]

The power law drives VC incentives and governance-related activity across startups and the startup ecosystem. It impacts VC conduct in both downside and upside scenarios. On the whole, VCs often care less about individual firm losses and more about not missing out on grand slams and making sure that the successful startups in their funds reach outsized exits. Scholars have examined these dynamics in depth and how they affect startup governance, while a number of important questions still remain for future research.

First, on the downside, the vast majority of startups do not achieve an IPO or M&A deal that provides returns to all equity holders, and yet few startups use the formal bankruptcy system (Pollman 2023, pp. 352). The typical capital structure of startups does not involve significant commercial liabilities that need to be satisfied; indeed, as we have seen, VCs generally provide the bulk of the funding and they invest through convertible preferred stock with contractual provisions such as

[30] "Given the portfolio approach and the deal structure VCs use, . . . only 10% to 20% of the companies funded need to be real winners to achieve the targeted return rate" (Zider 1998, pp. 131, 136). Mallaby (2022, pp. 6-9) explains the power law of venture capital.

[31] "The best VC funds don't just have more failures and more big wins – they have bigger big wins" (Evans 2016).

liquidation preferences to protect on the downside (p. 335).[32] As discussed above, when a startup does not seem likely to reach a big exit, VCs have incentives to push toward a liquidation, as in the scenario that occurred in *Trados*. But the goal is not simply to recoup whatever amounts might be gained from liquidation preferences, it also serves to reduce opportunity costs by freeing VCs to put their time and governance efforts into other companies that might have more lucrative exits.[33] Cognizant of the power law, VCs tend to concentrate their attention and resources on a select few startups that they perceive to have the greatest potential for success. Conversely, this selective focus means that startups deemed less promising may receive comparatively less attention and support, potentially impacting their trajectory and survival.

In the vibrant U.S. venture ecosystem, law and culture have shaped a system for dealing with the large number of venture-backed startups that do not reach successful exits. Soft-landing acquisitions, acqui-hires, and state insolvency procedures known as assignments for the benefit of creditors (ABCs) allow startup participants to "fail with honor" and redeploy their talent and capital (Pollman 2023, p. 327). Tensions and disputes might arise between startup participants in these end-of-life arrangements, but in the big picture VCs are aided by having pathways for dealing with these situations so they can cut their losses and entrepreneurs similarly benefit from knowing that failing will not foreclose their ability to get other jobs or try to raise money for a new venture (pp. 354, 368).

More specifically, M&A sales, even when not large exits, include "carrots" (Broughman and Fried 2013) for founders and employees, employment at the acquiring company, or the ability to craft a narrative for future career success (Pollman 2023, p. 353). Some companies cannot find a buyer for a traditional M&A deal but have a valuable team and might be able to do an "acqui-hire" that gets some

[32] Bratton (2002, p. 893) analyzes how VCs contract for preferred stock "to solve or avoid downside failure".

[33] Cable (2015, pp. 53-54) describes the opportunity cost conflict that arises where "active investors must allocate their efforts among competing projects." Broughman, Smith, and Pollman (2020) observe that fiduciary protections may not address concerns arising from horizontal conflicts between beneficiaries.

capital back to investors and gives the optics of an exit which may hold reputational value plus employment for founders and some of the employees (Coyle and Polsky 2013). In an ABC, the company assigns by contract its assets to an assignee, often a firm that specializes in such work, and the assignee acts as a trustee for the liquidation under state insolvency procedures. Although it is not the ending that startup participants dream of at founding, an ABC can be faster, cheaper, less public, and less work for corporate fiduciaries than a bankruptcy proceeding (Pollman 2023, pp. 359-60). These various pathways can help to efficiently and gracefully manage the end of the startup's life and preserve relationships and reputations that are important in the startup ecosystem of repeat players. On the whole, the dense network of professional ties and startup culture that normalizes failure and encourages redeploying capital and talent helps to lower risk and motivate founders and employees to engage in entrepreneurship (p. 369).

Second, on the upside, or in the hopes for such an outcome, the power law dynamic can lead to a heightened emphasis on rapid growth and scalability in portfolio companies, as they are key factors in achieving the outsized returns that VCs seek. Consequently, governance strategies may prioritize aggressive expansion strategies, sometimes at the expense of long-term sustainability or other considerations. A series of high-profile startup scandals, and even cases of fraud, have raised concerns and brought into question whether the monitoring model fully captures board oversight and governance practices in startups.[34]

Additionally, the power law of venture capital shapes the exit strategies pursued by venture capitalists, further influencing governance practices within startups. Given the disproportionate

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[34] Jones (2017, pp. 166-69) discusses startup scandals and "governance problems presented by persistent Unicorns." Pollman (2019, pp. 200-08) discusses monitoring failures in startups and how startup directors have "incentives to prioritize growth and profits" and are in overlapping roles as "both the monitor and the subject" which "may engender conflicts of interest and weaken oversight." Pollman (2020, pp. 379-80) also observes that "the venture-backed governance model tends to encourage risk-taking and aiming for potentially unattainable goals" and discusses how this pressure can contribute to an environment in which fraud occurs. Broughman and Wansley (2023, p. 1303) discusses how "VCs' retreat from active governance is hard to explain under the monitor model" and offers a "risk-seeking model" of VC behavior.

returns generated by a small fraction of successful startups, venture capitalists may prioritize exits that maximize their potential returns. For example, VCs might anticipate and try to prevent "beach money exits" that provide founders a relatively small but personally meaningful exit when a larger exit might be possible down the road by continuing to build the company and take on risk (Wansley 2019, pp. 153-55). VCs typically want grand slams, not moderately successful returns. Therefore, VCs often screen prospective founders for high levels of ambition, they seek contractual blocking rights to veto certain exits, and they monitor founders to ensure their expectations about exit are aligned and founders are focused on growing the business rather than courting prospective acquirers (pp. 154-55).

Bringing these insights together, Broughman and Wansley (2023) have set forth a "risk-seeking model" that complements the earlier "monitoring" model, taking account of how the power law shapes governance in individual startups and across the startup ecosystem. As we have seen, while VCs seek exponential growth from a small number of outlier companies, founders bear firm-specific risk that cannot be diversified. Under Broughman and Wansley's novel theory, "VCs use their role in corporate governance to persuade risk-averse founders to pursue high-risk strategies" (p. 1299). In exchange for pursuing high-risk strategies, VCs offer founders an implicit bargain to provide them with private benefits such as early liquidity from secondary stock sales, job security in the form of founder-friendly governance, and soft landings if the startup fails (p. 1300). This model fits with trends in which large numbers of startups have reached "unicorn" status with reported post-money valuations above $1 billion and VCs have been willing to give founders more control and even dual-class structures with disproportionate voting power (p. 1303).[35] Under this analysis, VCs with founder-

[35] Strebulaev and Gornall (2020) discuss the rise of unicorns and develop a valuation model taking into account contractual cash flow terms from convertible preferred stock financings, finding that post-money valuations overstate company values. Blank (2017) traces the shift from the 1980s and 1990s era of VCs as strong monitors to the emergence of "founder friendly" VCs in the twenty-first century and dual-class share structures even in pre-IPO companies. Aggarwal, Eldar, Hochberg, and Litov (2022, p. 143) observe a significant increase in the percentage of venture-backed IPOs with dual-class share structures from the 1990s.

friendly reputations gain a competitive advantage in access to deal flow and ex ante pricing, but run a greater risk of poor performance due to suboptimal monitoring (Broughman and Wansley 2023).

A number of additional complexities and questions remain, while new issues of startup governance arise. The range of investors into venture-backed startups has expanded dramatically, for example, from a more diverse set of seed stage financiers to mutual funds, private equity investors, and sovereign wealth funds entering companies in their later stage. Further, while some VCs have adopted founder-friendly practices, a variety of firms and strategies populate the industry. The impacts of these assorted investors on startup governance as well as variation by region and around the world adds to the broader picture. The ups and downs of the market, and the financial and social environment for startup and tech investing, also contributes to continued change. The impacts on stakeholders from risk-seeking governance additionally garners attention and with waves of innovation such as in artificial intelligence, new issues come to the fore about designing structures that can facilitate rapid growth while tempering the potential dangers of technology on society. In all, these observations underscore the dynamic nature of startup governance and failure, which continue to evolve in the twenty-first century.

5. Conclusion

This chapter has explored three aspects or perspectives for understanding venture-backed startup governance and failure. First, as explored through foundational research and scholarly literature, VC contracting can be understood at the individual firm level as a response to addressing the issues of information asymmetry, agency costs, uncertainty, and incomplete contracting that arise when investing in high-risk, innovative startups. VCs navigate the challenges they face by monitoring their portfolio firms and negotiating for contractual and governance arrangements that separate cash and control rights. Second, startup governance can be understood not only through the "vertical" lens of a principal-agent relationship between investors and entrepreneurs, but also through the "horizontal"

set of relationships and potential misalignments between shareholders. Dynamic governance change across the life cycle of a startup occurs as potential tensions tend to multiply over time as the startup adds participants with varied interests and claims. Third, the power law of venture capital significantly impacts how venture capitalists govern startups, for example influencing their allocation of resources, emphasis on rapid growth, power dynamics with founders, risk tolerance, and exit strategies. By understanding and navigating the dynamics of the power law, venture capitalists seek to maximize the potential for outsized returns within their portfolio while managing numerous failures and the inherent risks associated with startup investments. However, this approach also raises governance challenges, highlighting the need for additional research and consideration of the broader societal implications of venture capital practices. Bringing together these perspectives on venture-backed startup governance and failure contributes to a richer understanding and sheds light on areas of continual evolution.

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