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THE LANDSCAPE OF STARTUP CORPORATE GOVERNANCE IN THE FOUNDER-FRIENDLY ERA

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In corporate governance scholarship, there is an important debate about the nature and roles of the members of the board of directors in venture capital-backed private companies. The impact of a newly emerged, founder-centric model has been underappreciated, while the role of the independent director as tiebreaker or swing vote is vastly overstated. The reality is that corporate governance in these companies is a norm-driven, consensus-building process that rarely spills out into open conflict.

This is the first empirical study of startup corporate governance post-Great Recession and during the pandemic. Using survey and interview methodologies, this Article makes four primary contributions to the existing literature on corporate governance in venture capital-backed companies. First, during the last period of economic growth after the Great Recession, a founder-centric model of corporate governance emerged. This has had significant implications for venture capitalists on boards, how they choose to monitor the companies they invest in, and how boards are structured. Second, independent directors are typically not tiebreakers or swing votes as current scholarship assumes; in fact, they play a secondary role to founders and investors who serve on the board of directors. Although conflicts inevitably occur, the underlying modus operandi is geared toward consensus building, and it is

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rare for the board to have a non-unanimous vote. Third, although fiduciary duties and contractual mechanisms still loom large in corporate governance, most of the work is done informally with best practices and the growth-at-all-costs model framing much of what is done regarding corporate governance. Corporate governance measures are primarily prioritized during times of economic downturns and immediately prior to initial public offerings and acquisitions. Lastly, even with the increased focus on diversity, equity, and inclusion efforts in the larger national conversation about public companies, these discussions are still in their nascent stages in venture capital-backed private companies; it is in this area where corporate governance efforts need to be reimagined.

INTRODUCTION

Other than the certificate of incorporation of a venture capital ("VC")-backed private company (also referred to as a startup),[1] there is very little primary source documentation that scholars can access to determine how such companies structure their boards and the role and nature of the different board members. However, there is a group of individuals who have a front row seat to what transpires in board meetings and significant legal knowledge and understanding of corporate governance in the private company setting: the lawyers who represent VC-backed private companies. They have the inside knowledge on what transpires behind closed doors (or via Zoom, as the case may be during our new remote reality). To better understand the corporate governance dynamics at play within high technology ("high-tech") startups, the author conducted a survey of and interviewed lawyers with deep experience in the startup world. Collectively, these lawyers have sat in on thousands of board meetings. Their observations helped to shed light on corporate governance practices within startups. Although the lawyers did not agree on everything, there were a few areas in which the lawyers coalesced that have implications for the study of corporate governance.

The findings from the survey and interviews provide novel empirical evidence that startup corporate governance is animated by a founder-centric model that emerged after the Great Recession and is largely driven by a consensus-building process.[2] This model and process have implications for board dynamics and the amount of influence wielded by the three different types of directors: the founder-management director,

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1. *See* Jens Frankenreiter et al., *Cleaning Corporate Governance*, 170 U. PA. L. REV. 1 (2021). The author also notes the high cost of certificates of incorporation. *Id.*

2. Other empirical studies on VC financings took place pre-Great Recession and were primarily focused on VC contracting. *See, e.g.*, Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281 (2003) (describing contracts between VCs and investors); D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 324–27 (2005) (examining corporate charters of VC-backed firms). Several empirical studies utilize interviews in the startup realm. *See* Abraham J.B. Cable, *Does* Trados *Matter?*, 45 J. CORP. L. 311 (2020); Abraham J.B. Cable, *When Does Big Law Work?*, 102 MARQ. L. REV. 875 (2019).

the investor director, and the independent director, each of which is described in more detail below. Furthermore, the survey and interviews challenge certain assumptions about foundational principles in the field of corporate governance related to VC-backed private companies, particularly regarding the importance and role of the independent directors. In addition, the survey and interviews make clear that the norm setting that gives startups the flexibility to create their own timeline for when to implement corporate governance measures is essential to the development of startups as they mature. The fluidity of the corporate framework and governance challenges that Elizabeth Pollman describes in her recent work[3] is the key to why a norm-based corporate governance structure rather than a prescribed set of rules that are implemented at certain stages of a company's lifecycle is preferable. These measures are prioritized by startups not only during initial public offerings ("IPOs") and acquisitions,[4] but also economic downturns, as evidenced by what occurred during COVID-19.[5] If individual companies are doing poorly during an economic boon, investors no longer put in the time and energy into them that they otherwise might if they are doing well. As a result, corporate governance measures are not prioritized for a company that does not have a chance of survival. The pandemic provided a unique opportunity to understand how corporate governance changes during an economic downturn. Finally, when the author interviewed lawyers about whether diversity, equity, and inclusion ("DEI") issues were discussed or prioritized during a time when Black Lives Matter protests were occurring across the United States, it became clear that important issues in the social landscape, such as diversifying boards, did not necessarily translate into a priority for most startups. Instead, the focus was either on the growth of the economy during good times or survival of the startup during an economic downturn.

This Article closely examines corporate governance practices in VC-backed private companies, how they evolve over the life cycle of these companies, and when such practices are pri-

3. Elizabeth Pollman, *Startup Governance*, 168 U. PA. L. REV. 155, 199 (2019).

4. *Id.* at 209–16.

5. *See infra* Section III.B.3.c.

oritized. Part I gives a brief overview of corporate governance and how it applies in the startup context. In particular, it discusses the normative/narrative framework[6] and how best practices play a large role in determining corporate governance behavior. Part II explains the different roles that founders (who become the "founder-management directors"), VC investors (who become the "investor directors"), and independent directors play on the board and, more specifically, in the corporate governance practices of VC-backed private companies. In addition, it illustrates the impact of startups staying private longer and the growth-at-all-costs model on corporate governance in startups. Using survey and interview methodologies, Part III highlights four key findings. First, a founder-centric model of governance emerged after the Great Recession. Second, independent directors do not play the role of tiebreaker or swing vote as assumed in corporate law scholarship; in fact, the board is driven by a consensus building process. Third, although corporate governance is generally framed using best practices, corporate governance is valued, implemented, and sustained differently in good versus bad economic times. During good economic times, corporate governance practices are influenced by a growth-at-all-cost mindset. In contrast, during economic downturns, corporate governance becomes increasingly important. Fourth, DEI initiatives under the corporate governance umbrella are in their nascent stages and generally not prioritized. Instead, the focus is on the startup's growth or survival. Finally, Part IV provides a playbook on how to improve the corporate governance framework in light of the founder-friendly reality.

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6. In describing how corporate law works, Professor Edward Rock described a normative/narrative model of the Delaware Court of Chancery in the context of management buyouts. Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work*, 44 UCLA L. REV. 1009 (1997). The author uses Professor Rock's framework in the private company context to illustrate why the use of norms or "best practices" over bright-line rules gives startups flexibility in the corporate governance context. "[S]tandards work very differently than rules, . . . standards are typically generated and articulated through a distinctively narrative process, leading to a set of stories that is typically not reducible to a rule." *Id.* at 1013–16.

I.
CORPORATE GOVERNANCE

This Part begins by giving an overview of corporate governance. It then briefly discusses how corporate governance matters differ in the VC context and how the normative/narrative framework (defined below) can be helpful in contextualizing the evolution of corporate governance in the private company context.

A. *Corporate Governance Generally*

Many scholars point to Adolf A. Berle and Gardiner Means' 1932 publication of *The Modern Corporation and Private Property* as the seminal work in understanding corporate law.[7] It "delineated the separation of ownership and control in the modern corporation and the problems that separation caused."[8] The separation of ownership and control they describe, as well as the related agency costs associated with it, remain critical to the understanding of corporate governance today. The term "corporate governance" was popularized in the 1980s.[9]

> 'Corporate governance' is a broad concept that the legal literature has given a narrow definition. Scholars discuss it most often in the context of specific regulatory reforms or in terms of charter provisions and other easily observable structural characteristics on which regressions can be run. But corporate governance may refer more broadly to any aspect of the system of incentives and constraints operating within a firm.[10]

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7. ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION & PRIVATE PROPERTY (1932); Harwell Wells, *The Birth of Corporate Governance*, 33 SEATTLE U. L. REV. 1247, 1247 (2010) ("*The Modern Corporation* is said to be the 'ur-text [or original text] of modern corporate governance' . . . .").

8. Wells, *supra* note 7.

9. *Id.* at 1252 n.16. The term corporate governance was also synonymous with the movement to reform corporate rules and norms with the aim of providing stockholders greater legal protections. *See, e.g.*, Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1259–60 (1982).

10. Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors' and Officers' Liability Insurance Market*, 74 U. CHI. L. REV. 487, 516 (2007).

Often, the term is used in the public company context and "is a response to the agency problems created by the separation of ownership and control, namely the powerless shareholders and the autonomous management."[11] Hillary Sale describes good corporate governance as "allow[ing] for a balance between what officers and directors do and what shareholders desire. The term implies that managers have the proper incentives to work on behalf of shareholders and that shareholders are properly informed about the activities of managers."[12] Leaders in the business world have described corporate governance as something that "exists to serve corporate purposes by providing a structure within which stockholders, directors and management can pursue most effectively the objectives of the corporation."[13] The understanding of corporate governance this Article relies on is derived from the Delaware Supreme Court case *M.M. Cos., Inc. v. Liquid Audio, Inc.*, which states that "[t]he most fundamental principles of corporate governance are a function of the allocation of power within a corporation between its stockholders and its board."[14]

B. *Corporate Governance in the Venture Capital Context*

Corporate governance in the VC context differs from what has been described above. In the VC-backed private company context, the stockholders are not powerless, and the lines between ownership and control are blurred because majority common stockholders are often times part of management and majority series preferred stockholders typically have a designated seat on the board pursuant to a contract.[15] The founders of the company not only own a significant share of the company, but they also are in control, holding multiple roles

11. *See* Wells, *supra* note 7, at 1252.

12. Hillary Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 460 (2004). As Stephen Bainbridge said, "the central problem of corporate governance" is the separation of ownership and control. STEPHEN BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 6 (2008).

13. BUS. ROUNDTABLE, STATEMENT ON CORPORATE GOVERNANCE 2–3 (1997).

14. M.M. Cos., Inc. v. Liquid Audio, Inc., 813 A.2d 1118, 1126 (Del. 2003).

15. *See Model Legal Documents*, NAT'L VENTURE CAP. ASS'N, https://nvca.org/model-legal-documents/ (last visited Nov. 27, 2021) (follow "Voting Agreement" hyperlink).

such as CEO and director. As Elizabeth Pollman observed, "[l]ongstanding theories of corporate ownership and governance do not capture the special features of startups."[16]

As private companies stay private longer and employ thousands—instead of hundreds—of people, this lack of separation becomes more problematic if one person (the founder and major stockholder) has an outsized vote in decisions that impact the company. Also, independent directors do not play the moderating influence that the conventional wisdom in corporate governance scholarship assumes. As this Article will discuss in Part III below, founders may have a myopic view that could lead to the demise of the company if other viewpoints of non-founder-management directors are not considered. This is not the case of the powerless stockholder and autonomous management, but rather the opposite: a powerful stockholder often serves as the CEO and can control the narrative of the company.

C. *The Normative/Narrative Framework*

The normative/narrative theory of corporate law was initially applied in the context of management buyouts of public companies.[17] This Article argues that this theory provides a helpful construct from which to view the evolution of the standards of conduct relating to corporate governance in VC-backed private companies, many of which are high tech companies.

VC-backed private company corporate governance has three layers: the fiduciary duties of care and loyalty as explained in Delaware case law;[18] the contractual agreements to

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16. Pollman, *supra* note 3, at 155 (illustrating that vertical and horizontal tensions arise because of the overlapping governance roles among founders, investors, executives, and employees).

17. *See* Rock, *supra* note 6, at 1017. Professor Rock notes, "Delaware opinions can be understood as providing a set of parables—instructive tales—of good managers and bad managers, of good lawyers and bad lawyers, that, in combination, fill out the normative job description of these critical players." *Id.* at 1016.

18. *See, e.g.*, Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1989) ("[D]irectors owe fiduciary duties of care and loyalty to the corporation and its shareholders."); *In re* Trados Inc. S'holder Litig., 73 A.3d 17 (Del. Ch. 2013).

which the parties agree to in VC financings;[19] and a best practices framework which is not governed by rules but by standards.[20] The duties of care and loyalty serve as guiding principles for directors and become increasingly important as the company matures. The court cases that discuss these duties become part of a lawyer's toolkit that she can use going forward in advising clients about choices regarding corporate governance. The contractual mechanisms are bargained-for arrangements between sophisticated parties that help determine the composition of the board, block rights for certain stockholders (typically, holders of preferred stock), and valuation, among other things.[21] Finally, it is the best practices framework that informs a great deal of corporate governance practices in startups as discussed in Part III below. As this Article shows, it is the narrative constructed from the best practices framework that form the norms under which corporate governance in VC-backed private companies operate.

II.
Board Roles, the Impact of Startups Staying Private Longer, and the Growth-At-All-Costs Mindset on Corporate Governance

The board is responsible for hiring and firing the CEO, guiding the business's long-term strategic direction, approving certain corporate actions (e.g., major acquisitions, financings, etc.), maintaining compliance and good corporate governance, serving as a coach to the CEO, and helping the company network.[22] However, "the role of the board is not to run the company or dictate the strategy."[23] The dynamic of the board and how corporate governance is implemented is influenced by the players on the board: the founder or management directors ("founder-management directors"), the investor direc-

19. *See generally* Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 Stan. L. Rev. 1067, 1069 (2003); Jennifer S. Fan, *Catching Disruption: Regulating Corporate Venture Capital*, 2018 Colum. Bus. L. Rev. 341 (2018).

20. Fan, *supra* note 19.

21. *Cf.* Gilson, *supra* note 19, at 1069.

22. Scott Kupor, Secrets of Sand Hill Road 202–09 (2019).

23. *Id.* at 207.

tors, and the independent directors.[24] In order to provide the appropriate context for the findings from the survey and interviews that are discussed in Part III, this Part of the Article will discuss the characteristics of each of the individuals that typically comprise the board of directors. This Part will also explain how startups staying private longer and the growth-at-all-costs mindset impact corporate governance.

A. *The Board of Directors*

1. *Founders and Management*

The first directors of a startup come from the founding team. The founders are the heart and soul of a startup. Although VCs have a great deal of power, the startup would not be what it is without the vision of the founders. Zohar Goshen and Assaf Hamdani characterize the subjective value an entrepreneur attaches to her concept as the entrepreneur's idiosyncratic vision.[25] These scholars argue "that controlling shareholders hold a control block to increase the pie's size (pursue idiosyncratic vision) rather than to dictate the pie's distribution (consume private benefits). . . . [W]hen the entrepreneur's idiosyncratic vision is ultimately realized, the benefits will be distributed pro rata to all investors."[26] Under this framework, control matters for both entrepreneurs and investors in the public company setting, as illustrated by the tension between idiosyncratic vision and asymmetric information, differences of opinion, and agency costs.[27] "The controlling owner values permanent and uncontestable control because it allows her the freedom of action that is often necessary to realize her idiosyncratic vision. At the same time, the controller-

24. Other scholars have analyzed the role of directors on startup boards. *See* Brian J. Broughman, *The Role of Independent Directors in Startup Firms*, 2010 UTAH L. REV. 461, 464 (discussing the role of the independent director as tiebreaker); Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 972 (2006) (finding that the boards of VC-backed corporations are typically controlled by preferred shareholders, not common shareholders).

25. Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 560 (2016).

26. *Id.*

27. *Id.* at 583.

entrepreneur's large equity stake limits investors' exposure to management agency costs."[28]

Therefore, in an environment where funds are plentiful and valuations are high because multiple VC firms and non-traditional investors[29] are interested in investing (and have a fear of missing out), the founders are able to negotiate for founder-friendly terms. It is in these situations that the vertical and horizontal tensions become even more pronounced.[30] The increasingly complex financial and governance structures in late-stage startups[31] also exacerbate the issue.

When founders raise money, the essential elements to a pitch to the VCs are market sizing, team, product, go-to-market strategy, and a plan for the next fundraising round.[32] When selecting which startup to invest in, however, VCs view the team as the most important factor.[33] Research on the decision-making processes of VCs confirm the team's importance.[34] Business-related factors rank a distant second in the minds of VCs when it comes to evaluating the success or fail-

28. *Id.* at 569.

29. Non-traditional investors include corporate venture capital ("CVC"), mutual funds, private equity, sovereign wealth funds, among others. The author analyzes these investors and their impact on the VC ecosystem in a future article. Note that the term "tourist VCs" is also commonly used to describe non-traditional investors. *See, e.g.*, Gary Rivlin, *So You Want to Be a Venture Capitalist*, N.Y. TIMES (May 22, 2005), https://www.nytimes.com/2005/05/22/business/yourmoney/so-you-want-to-be-a-venture-capitalist.html. *See also* PITCHBOOK, PITCHBOOK 2019 VENTURE CAPITAL OUTLOOK 5 (2018).

30. Robert P. Bartlett, III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 42, 61 (2006).

31. Pollman, *supra* note 3, at 209–10.

32. KUPOR, *supra* note 22, at 127–39.

33. Ninety-six percent of respondents said the team was the most important factor for the success of the startup; it was ninety-two percent for failures. Paul Gompers et al., *How Do Venture Capitalists Make Decisions?* 7 (Eur. Corp. Governance Inst., Working Paper No. 477, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2801385. Surprisingly, VCs don't mention themselves as a factor in the success or failure of the company. *Id.*

34. "In selecting investments, VCs place the greatest importance on the management/founding team. The management team was mentioned most frequently both as an important factor (by 95% of VC firms) and as the more important factor (by 47% of VC firms)." *Id.* at 6.

ure of a startup.[35] Logically, the focus on the founders makes sense. "When the 'business' is nothing more than a very small collection of individuals—in some cases only one or two founders—with an idea, much of the VCs' evaluation will focus on the team."[36] Put differently, what VCs look for is the founder-market fit which "speaks to the unique characteristics of this founding team to pursue the instant opportunity."[37] In addition to the founder(s), the VCs also look at the product.[38] Lastly, they look at market size—the bigger the better.[39] In emphasizing the importance of the team to this degree, the VCs also cede some degree of control to the founder-management director. They are more likely to defer to a management director who is also the founder of the company.[40] This is especially true of the rock star founder—a larger than life entrepreneur—described in Part III below.

2. *Venture Capital Investors*

The second group of directors in a startup are drawn from the VCs who invest in such companies. Venture capital is often thought of as "a high-touch form of financing used primarily by young, innovative, and risky companies."[41] The general partners of VC firms, who make the decisions about which of these startups to invest in, raise money for their various funds from limited partners. The limited partners who make such investments are university endowments, foundations, cor-

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35. Although business-related factors were noted as important "with business model at 83%, product at 74%[,] market at 68%, and industry at 31%," they "were rated as most important by only 37% of firms." *Id.*

36. KUPOR, *supra* note 22, at 43.

37. *Id.* at 45.

38. *Id.* at 48–49. The author notes that early-stage VCs ask, "Will this product solve a fundamental need in the market (whether or not that need is known currently to customers) such that customers will pay real money to purchase it?" Furthermore, VCs often say "that they like founders who have strong opinions but ones that are weakly held, that is, the ability to incorporate compelling market data and allow it to evolve your product thinking." *Id.*

39. *Id.* at 51 ("VCs must invest in big market opportunities.").

40. *See* discussion *infra* Section III.B.1.

41. Will Gornall & Ilya A. Strebulaev, *The Economic Impact of Venture Capital: Evidence from Public Companies* 1 (Stan. U. Graduate Sch. of Bus., Working Paper No. 3362, 2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2681841.

porate and state pension funds, family offices, sovereign wealth funds, insurance companies, and funds of funds.[42]

The lucky few startups that receive VC funds are called VC-backed companies. It is these VC-backed companies that have wrought enormous changes on our society[43] and have given rise to an age in which corporate purpose is intertwined with this group of companies.[44]

Although less than 0.25 percent of startups receive VC financing, they account for approximately 50 percent of all "true" IPOs.[45] Public companies that were VC-backed comprised 40 percent of all IPOs in 2018, representing a fifteen-year high.[46] In 2020, VC-backed companies comprised a little less than 22% of all IPOs.[47]

Venture capital is also important from an economic perspective. Although the VC industry invests approximately 0.4 percent of the U.S. gross domestic product, its impact is substantially greater than that.[48] According to a 2015 study, VC-backed companies have invested billions in research and de-

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42. KUPOR, *supra* note 22, at 54–56. Family offices "are investment managers who are investing on behalf of very-high-net-worth families." *Id.* at 55. Sovereign wealth funds "are organizations that manage the economic reserves of a country . . . to benefit current or future generations of their citizens." *Id.* Funds of funds "are private firms that raise money from their own LPs and then invest in venture capital or other financial managers." *Id.* at 56.

43. Ilya A. Strebulaev & Will Gornall, *How Much Does Venture Capital Drive the U.S. Economy?*, INSIGHTS BY STAN. BUS. (Oct. 21, 2015), https://www.gsb.stanford.edu/insights/how-much-does-venture-capital-drive-us-economy.

44. *See, e.g.*, Jennifer S. Fan, *Woke Capital: The Role of Corporations in Social Movements*, 9 HARV. L. BUS. REV. 441, 464–66 (2019) (discussing private company opposition to the Muslim Ban).

45. Steven N. Kaplan & Josh Lerner, *It Ain't Broke: The Past, Present, and Future of Venture Capital*, 22 J. APPLIED CORP. FIN. 36, 37 (2010). "The median firm closes about 4 deals per year. . . . [F]or each deal in which a VC firm eventually invests or closes, the firm considers roughly 100 potential opportunities." Gompers et al., *supra* note 33, at 16.

46. NVCA & PITCHBOOK, NVCA 2019 YEARBOOK 6 (2019); *See also* Gornall & Strebulaev, *supra* note 41, at 5 (finding that VC-backed public companies represented one-fifth of market capitalization as of 2014). VC funds have generally outperformed the public markets net of fees, on average. *See* Robert S. Harris, Tim Jenkinson & Steven N. Kaplan, *Private Equity Performance: What Do We Know?*, 69 J. FIN. 1851, 1865 (2014).

47. NVCA & PITCHBOOK, NVCA 2021 YEARBOOK 37 (2021).

48. KUPOR, *supra* note 22, at 40–41.

velopment ("R&D") and comprise 44 percent of all R&D spending of U.S. public companies.[49] They have also accounted for 42 percent of all IPOs in the United States over a forty-year period (1974-2014).[50] Once public, these same companies created 63 percent of the total market capitalization of public companies that formed between 1974 and 2014.[51] Approximately $778 billion of new capital went into the private markets in 2018.[52] Also, funding rounds over $1 billion in VC financings comprised 25 percent of all VC deal volume.[53] In 2021, VC firms invested more than $329 billion into deals—their highest level ever.[54]

But what makes VC financings and, by extension, the VCs that accompany such money so special as a source of funding? Their influence is not limited to the amount of money that they bring to the startups, which are also called portfolio companies. Venture capitalists monitor and add value to their portfolio companies in a variety of ways. Based on a survey of nearly 900 VCs, business scholars found that VCs provided the following services to startups post-investment: "strategic guidance (87%), connecting investors (72%), connecting customers (69%), operational guidance (65%), hiring board members (58%), and hiring employees (46%)."[55] Additionally, VCs

49. Gornall & Strebulaev, *supra* note 41, at 8.

50. *Id.* at 5. The reason 1974 was chosen as the beginning of the study instead of 1979 (the year the "prudent man rule" passed, opening up VC investments to pension funds; prior to that, it was primarily family offices, university endowments, and philanthropic foundations) was to capture one or two significant companies, such as Apple, which otherwise would not have been included in the study. *Id.* at n.6.

51. *Id.*

52. McKinsey & Co., Private Markets Come of Age 4 (2019), https://www.mckinsey.com/~/media/mckinsey/industries/private equity and principal investors/our insights/private markets come of age/private-markets-come-of-age-mckinsey-global-private-markets-review-2019-vf.ashx.

53. *Id.* at 19.

54. PitchBook et al., Venture Monitor: Q4 2021 3 (2021). 2021 set new annual records for VC-backed companies at all stages of fundraising in terms of the total money invested and the total number of deals. *Id.*

55. Gompers et al., *supra* note 33, at 6. Venture capitalists are critical in hiring outside managers and directors. Paul A. Gompers, Vladimir Mukharlyamov & Yuhai Xuan, *The Cost of Friendship*, 119 J. Fin. Econ. 626, 638 (2016). They also have substantial influence over the board structure. Josh Lerner, *Venture Capitalists and the Oversight of Private Firms*, 50 J. Fin. 301, 302 (1995).

are not passive investors; in fact, they are the exact opposite. The time they spend on their portfolio companies demonstrates their commitment, which goes far beyond a monetary one. "Over 25% [of VCs] interact multiple times per week and an additional one-third interact once a week, indic[a]ting that 60% of VCs report interacting at least once per week with their portfolio companies."[56] On average, this is equivalent to eighteen hours per week.[57] In sum, VCs add value to their startups in myriad ways that are not related to money.[58]

In return for their money, expertise, and time, VCs expect certain things from a contractual perspective since they are paying a premium for their preferred stock when compared to the holders of common stock. Specifically, VCs negotiate contract terms such as cash flow, control, and liquidation rights in their investments.[59] When VCs structure their investments, they "indicated that they were relatively inflexible on pro-rata investment rights, liquidation preferences, anti-dilution protection, vesting, valuation and board control. They were more flexible on the option pool, participation rights, investment amount, redemption rights, and particularly dividends."[60] As an example, in a large-scale survey to VCs, scholars found that "[p]ro rata rights, which give investors the right to participate in the next round of funding, are used in 81% of investments. Participation rights that allow VC investors to combine upside and downside protection . . . are used on average 53% of the time."[61]

If a company is incorporated in Delaware (as most startups are),[62] the default voting for corporate actions is based on Delaware law. The protective provisions can be thought of as an additional layer on top of that which "grant[s] the preferred shareholders (generally the VCs) additional say in vari-

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56. Gompers et al., *supra* note 33, at 27.

57. *Id.* at 33 (The survey found that "VCs spend the single largest amount of time working with their portfolio companies, 18 hours a week.").

58. *Id.*

59. *Id.* at 24.

60. *Id.* at 6.

61. *Id.* at 24.

62. KUPOR, *supra* note 22, at 174 (noting that "most startups are incorporated in Delaware because it has the most well-developed set of laws and legal opinions on corporate governance and shareholder rights").

ous corporate matters."[63] In other words, they provide "protection against an erosion of the economic value" with each subsequent round of financing.[64] "In general, you want to avoid smaller minority investors in later rounds having greater governance control than they have economic interests."[65]

In the VC context there are two classes of shares: common stock and preferred stock.[66] Founders and employees receive common stock and options to purchase common stock, respectively; preferred stock is issued to investors.[67] There are typically many rounds of preferred stock financings, and each round after the seed round is assigned a letter (e.g., Series A, Series B, Series C, etc.).[68] With each of these rounds comes an opportunity for corporate governance to evolve, but this evolution is influenced by board members (the founder-management director, the investor director, and the independent director).[69] Furthermore, the stage of the company and the growth-at-all-costs mentality also impact how corporate governance measures are implemented.[70]

Venture capitalists are dual fiduciaries when they serve on a board of a private company, because "there are times when the [general partner's] economic interest—as a holder of preferred shares with different rights and privileges—may diverge from those of the common shareholder."[71] The dual fiduciary context can be difficult, because VCs serve as fiduciaries to the limited partners who invest in their VC fund as well as board members required to act in the best interest of the common stockholders; balancing the two, sometimes competing, interests can be challenging.[72] As a dual fiduciary, a director of a

63. *Id.*
64. *Id.* at 177.
65. *Id.* at 174.
66. BRAD FELD & JASON MENDELSON, VENTURE DEALS 38 (3d ed. 2016).
67. *Id.*
68. *Id.*; CONSTANCE E. BAGLEY & CRAIG E. DAUCHY, THE ENTREPRENEUR'S GUIDE TO LAW AND STRATEGY 455 (5th ed. 2018).
69. *See infra* Section III.B.1.
70. *See infra* notes 414–17 and accompanying text.
71. KUPOR, *supra* note 22, at 202.
72. *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 41 (Del. Ch. 2013) (holding "it will be the duty of the board . . . to prefer the interests of the common stock . . . to the interests created by the special rights . . . of preferred stock." (internal citations omitted)). *See also* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993) (holding "directors are charged

startup who is either a principal or employee of a fund may have a conflict if the decision has an impact on such fund.[73]

3. *Independent Directors*

The third category of directors is the independent director. Attracting qualified, independent board members for startups can prove difficult.[74] In lieu of the cash compensation one might expect for public company board members, startup board members are compensated in equity and identified through business and personal relationships.[75] However, courts may find that, as a result of these relationships, the directors are not independent, which means that if there is a transaction that involves self-dealing, the transaction would be subject to an entire fairness review instead of the business judgment rule.[76]

Scholars have argued that independent directors are the swing votes in decisions made by the board.[77] The findings in

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with an unyielding fiduciary duty to protect the interests of the corporation and to act in the best interests of its shareholders").

73. *See In re* Trados Inc., 73 A.3d at 46–47.

74. *See* Steven E. Bochner & Amy L. Simmerman, *The Venture Capital Board Member's Survival Guide: Handling Conflicts Effectively While Wearing Two Hats*, 41 DEL. J. CORP. L. 1, 9 (2016).

75. FELD & MENDELSON, *supra* note 66, at 69–70; *see also* Olav Sorenson & Toby E. Stuart, *Syndication Networks and the Spatial Distribution of Venture Capital Investments*, 106 AM. J. SOC. 1546, 1584–85 (2001).

76. *Cede & Co.*, 634 A.2d at 361, 371 (holding "[u]nder the entire fairness standard of judicial review, the defendant directors must establish to the *court's* satisfaction that the transaction was the product of both fair dealing *and* fair price"); *see also* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (holding the business judgment rule is a presumption that in making a business decision, the corporation's directors acted on an informed basis, in good faith, and in honest belief that action taken was in the best interests of the company).

77. Broughman, *supra* note 24, at 464. Brian Broughman refers to this arrangement as "'ID-arbitration' to emphasize the independent director's position as quasi-arbitrator." *Id.* He argues that if there are disputes between the entrepreneur (CEO/founder) and VC (investor), the independent director can settle the dispute and avoid a deadlock that may otherwise leave the other two parties open to unilateral actions by a controlling party. *Id.* "Adding an independent director to the board allows a new alternative [avoiding opportunistic behavior from VC or entrepreneur control]: control of the board can be shared with an independent director acting as the tie-breaking vote." *Id.* at 464. "Independent directors . . . typically occupy a tie-breaking seat on the board." *Id.* at 508.

Part III below, however, offer a vastly different view of the independent director—one in which such directors play a secondary role and are, in fact, not the swing vote.[78]

Independence becomes important where a conflict of interest arises. Under Delaware law, whether a director has a conflict is a fact-specific question;[79] she is not conflicted out merely because her appointment was made by a particular class or series of stock or a particular stockholder.[80] The Delaware courts have also looked at facts that help to determine whether a director is independent in other contexts, such as a close family relationship between a director and another party,[81] a long friendship intertwined with business dealings,[82] or special benefits that a director may receive.[83]

4. *Staying Private Longer and Growth-At-All-Costs*

Corporate governance issues are also impacted by how long a startup stays private. The number of unicorns[84] has

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78. *See* discussion *infra* Section III.B.2.

79. Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1049–50 (Del. 2004) ("Independence is a fact-specific determination made in the context of a particular case. The court must make that determination by answering the inquiries: independent from whom and independent for what purpose?"); Calesa Assocs., L.P. v. Am. Capital, Ltd., No. 10557-VCG, 2016 WL 770251, at *11 (Del. Ch. 2016).

80. *See In re* KKR Fin. Holdings LLC S'holder Litig., 101 A.3d 980, 996 (Del. Ch. 2014). "Delaware law does not contain bright-line tests for determining independence but instead engages in a case-by-case fact specific inquiry based on well-pled factual allegations." *Id.*

81. *See* Chaffin v. GNI Grp., Inc., No. Civ.A. 16211-NC, 1999 WL 721569, at *5 (Del. Ch. 1999) (determining that the director lacked independence because of his son).

82. *See* Del. Cnty. Emps. Ret. Fund v. Sanchez, 124 A.3d 1017, 1022–23 (Del. 2015) (finding that fifty-year long friendship impacted certain business dealings).

83. *See In re* Trados Inc. S'holder Litig., 73 A.3d 17, 45–46 (Del. Ch. 2013) (considering a situation where a member of management was to share in a management incentive plan); *Calesa Assocs., L.P.*, 2016 WL 770251, at *12 (finding that ongoing employment played a role in determining the lack of independence).

84. Unicorns are private companies valued at $1 billion or more. Jennifer S. Fan, *Regulating Unicorns: Disclosure and the New Private Economy*, 57 B.C. L. REV. 583, 583 (2016). The way that unicorns are valued varies. Valuations "reflect[ ] the current state of business as valued within the current state of the financing world." KUPOR, *supra* note 22, at 118. Fred Wilson, a well-known VC from Union Ventures, observes that "valuations in the private

risen dramatically—as of February 2022, there were 1,000 unicorns worldwide with a total cumulative valuation of approximately $3,308 billion.[85] Accompanying the rise of unicorns was a corresponding decrease in IPOs. In 1997 there were 8,491 publicly listed companies in the United States; in 2017 there were 4,496.[86] However, recently more unicorns have

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markets, particularly the late-stage private markets, can sometimes be irrational." Fred Wilson, *The Great Public Market Reckoning*, AVC (Sept. 29, 2019), https://avc.com/2019/09/the-great-public-market-reckoning. Also, instead of relying on net present value or discounted cash flow techniques, VCs "rely on multiples of invested capital and internal rates of return." Gompers et al., *supra* note 33, at 36. But this way of valuing a company has its flaws and valuations of private companies still remain a "black box." Will Gornall & Ilya A. Strebulaev, *Squaring Venture Capital Valuations with Reality*, 135 J. FIN. ECON. 120, 121 (2020). In many cases, the post-money valuation becomes a proxy for the relative success (or failure) of a company. *Id.* However, some scholars point out that because unicorns rely on preferred stock terms to measure firm value, they may be unreliable in determining fair value. Robert P. Bartlett, III, *A Founder's Guide to Unicorn Creation: How Liquidation Preferences in M&A Transactions Affect Start-up Valuation*, *in* RESEARCH HANDBOOK ON MERGERS AND ACQUISITIONS 123, 124 (Claire A. Hill & Steven Davidoff Solomon eds., 2016). Two business scholars, Will Gornall and Ilya A. Strebulaev, also make a compelling case for why calculating the fair valuation of the company in that way is inaccurate. *See* Gornall & Strebulaev, *supra* note 41, at 121–22. Although equating post-money valuation to a fair valuation of a company works for public companies that typically have one class of share (e.g., common stock), the same formula does not work for private companies that have different shares with different terms. *Id.*

85. *The Complete List of Unicorn Companies*, CB INSIGHTS, https://www.cbinsights.com/research-unicorn-companies (last visited Feb. 8, 2022).

86. *America's Public Markets Are Perking Up. Can it Last?*, THE ECONOMIST (Mar. 17, 2018), https://www.economist.com/finance-and-economics/2018/03/17/americas-public-markets-are-perking-up-can-it-last. IPOs may be experiencing a turnaround. *Id.* There was a sharp uptick in the number of IPOs in 2021. *See* EY, 2021 EY GLOBAL TRENDS REPORT 5 (2021) ("With 2,388 deals raising US$453.3b, 2021 became the most active year for IPOs in the past 20 years. . . . Year-over-year (YOY), global IPO activity was up 64% and 67% by deal numbers and proceeds, respectively."). *See also* Dan Primack, *Top of the Morning*, AXIOS PRO RATA (June 28, 2021), https://www.axios.com/newsletters/axios-pro-rata-372981eb-a35c-4282-b18a-b1efee36d0ae.html?utm_source=Newsletter&utm_medium=email&utm_campaign=newsletter_axiosprorata&stream=top ("Q2 2021 is expected to go down as the busiest quarter for U.S. IPOs since 2000, while June 2021 will be the busiest month since that same year."). *But cf.* Echo Wang, *Analysis: U.S. IPO Slowdown Slams Door on Tech Unicorns Looking to Cash Out*, REUTERS (Feb. 3, 2022, 9:26 AM), https://www.reuters.com/technology/us-ipo-slowdown-slams-door-tech-unicorns-looking-cash-out-2022-02-03/ (noting a recent slowdown in U.S. IPOs).

gone public—whether this trend continues remains to be seen.[87]

Companies stay private longer because of the funds available in the private markets; in fact, the average amount of time it takes a U.S. private company in the technology sector to go public has risen from an average of four years in 1999 to eleven years in 2014.[88] The lengthier timeline to a liquidity event means that limited partners take a longer time to realize returns and employees and investors will seek liquidity through the secondary market.[89] A company can also be forced to go public under Securities and Exchange Commission ("SEC") rules if it exceeds the number of stockholders allowed as a private company.[90]

However, it is not only due to the amount of money in the private markets that private companies remain private longer. Many theories have been offered for why it now takes a longer time for a private company to go public (i.e., have an IPO). First, going public costs too much money.[91] Second, efficiency rules, such as the Regulation Alternative Trading System and Decimalization and Regulation National Market System, "disproportionately affected the trading dynamics for companies

87. *See, e.g.*, Paul R. La Monica, *Unicorns Are off to a Hot Start in 2021. Many More Are on the Way*, CNN BUSINESS (July 12, 2021, 11:32 AM), https://www.cnn.com/2021/07/12/investing/ipos-spacs-direct-listings/index.html.

88. Begum Erdogan et al., *Grow Fast or Die Slow: Why Unicorns Are Staying Private*, MCKINSEY & COMPANY (May 11, 2016), https://www.mckinsey.com/industries/technology-media-and-telecommunications/our-insights/grow-fast-or-die-slow-why-unicorns-are-staying-private.

89. Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. PA. L. REV. 179, 186, 193–95 (2012).

90. Erdogan et al., *supra* note 88. The threshold is now 2,000 investors; prior to that it was 500. *Id.* Under the new threshold, however, it is unlikely that private companies would ever find themselves in the position to go public because of the way that shareholders are counted. There are now discussions underway to "consider whether to recalibrate the way issuers must count shareholders of record under Section 12(g) (and Rule 12g5-1) in order to hew more closely to the intent of Congress and the [SEC] in requiring issuers to count shareholders to begin with." Allison Herren Lee, Comm'r, U.S. Sec. & Exch. Comm'n, Remarks at The SEC Speaks in 2021, Going Dark: The Growth of Private Markets and the Impact on Investors and the Economy (Oct. 12, 2021), https://www.sec.gov/news/speech/lee-sec-speaks-2021-10-12.

91. See, for example, Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745, which increased the number of financial disclosures that needed to be made by a company going public.

that have smaller capitalizations and therefore lower trading volume."[92] Third, most large mutual funds tend to concentrate in "large-cap highly liquid stocks, because they need to be able to put large amounts of money to work in individual stocks," and smaller capitalization stocks do not scale as well.[93] Fourth, there is more capital available from corporate venture capital ("CVC"),[94] mutual funds,[95] sovereign wealth funds,[96] family funds,[97] private equity,[98] and others that allow private companies to stay private longer.[99] Lastly, the increasing number of activist investors may also explain the decreasing number of IPOs.[100]

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92. KUPOR, *supra* note 22, at 107.

93. *Id.* at 108.

94. CVC is "equity investments in external startups made by corporations or investment entities designated by corporations." Fan, *supra* note 19, at 341. For an overview of CVC, see *id.*

95. *The Investors Fueling the Mega-Round Phenomenon*, CB INSIGHTS (May 16, 2016), https://www.cbinsights.com/research/hedge-mutual-funds-investing-big-deals-tech-startups/; *see also* Sungjoung Kwon, Michelle Lowry & Yiming Qian, *Mutual Fund Investments in Private Firms*, 136 J. FIN. ECON. 407 (2020). Historically, mutual funds have focused their investments in public companies, "but that has shifted over the past few years as investors sought more exposure to private firms that were waiting longer to go public." Kevin Dugan, *Fidelity Executive Who Backed Uber, WeWork, to Depart*, THE INFO. (Nov. 18, 2019, 2:31 PM), https://www.theinformation.com/articles/fidelity-executive-who-backed-uber-wework-to-depart?eu=FB1687babca518909f13&utm_content=article-4060&utm_campaign=article_email&utm_source=sg&utm_medium=email.

96. *See* Paulina Pielichata, *Sovereign Wealth Funds Increase Venture Capital Deals in 2018*, PENSIONS & INVS. (May 23, 2019, 1:00 AM), https://www.pionline.com/article/20190523/ONLINE/190529930/sovereign-wealth-funds-increase-venture-capital-deals-in-2018.

97. *See* Interview with Lawyer #6 (on file with author); *see also* KUPOR, *supra* note 22, at 55.

98. *See* Harris et al., *supra* note 46, at 1–2, 25*; see generally* Interview with Lawyer #18 (on file with author) (describing private equity as having a controlling interest on the board and in ownership and stating that they are often LLCs who have opted out of fiduciary duties that corporations are subject to and they ask for more onerous control provisions).

99. *See* KUPOR, *supra* note 22, at 108. *See also supra* note 29 (discussing non-traditional investors).

100. *Id.* Special purpose acquisition companies (SPACs) became a popular alternative to IPOs beginning in October 2019; however, the market for SPACs has cooled significantly as regulators scrutinize SPACs and the VC markets continue to be a rich funding source. Berber Jin, *As SPAC Market Unravels, Startups Seek Alternatives*, THE INFO. (May 12, 2021 6:01 AM), https://www.theinformation.com/articles/as-spac-market-unravels-startups-seekal-

The fact that the goals of non-VC firms are not necessarily aligned with VC firms also creates issues.[101] As an example, in the corporate VC context, the goals are both strategic and monetary; in the VC firms, the aim is to maximize the return of the limited partners who invested in the funds managed by the VC firms.[102] As a result, the private ordering that is meant to serve as a checks-and-balances mechanism for the different constituencies in VC financings changes in significant ways.[103] This change in private ordering also means that the economic and control levers that undergird VC financings do not work as more traditional players have come to expect. One particularly telling example was the announcement of SoftBank's $100 billion Vision Fund; the landscape of VC shifted with the infusion of that money.[104] Valuations climbed to dizzying heights[105] only to come back down to reality when companies went public.[106]

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ternatives#:~:text=after%20the%20coronavirus%20pandemic%20jump,to%20visit%20pharmacies%20in%20person; *see also* Catherine Thorbecke, *What to Know About the SPACs Craze and Why It's Concerning Economists*, ABC NEWS (Mar. 30, 2021, 5:01 AM), https://abcnews.go.com/Business/spacs-craze-economists/story?id=76747045.

101. *See* Fan, *supra* note 19, at 343, 417.

102. *Id.* at 343 n.6.

103. *Id.* at 358.

104. *SoftBank Group Corp. to Establish SoftBank Vision Fund*, SOFTBANK GRP. CORP. (Oct. 14, 2016), https://group.softbank/en/news/press/20161014; *see also* Raymond Zhong, *SoftBank Unveils New Tech Fund to Expand Its Sprawling Portfolio*, N.Y. TIMES (July 26, 2019), https://www.nytimes.com/2019/07/26/technology/softbank-vision-fund-2.html ("SoftBank's aggressive approach . . . has helped upend the venture capital market, and has even changed the way entrepreneurs build new tech companies.").

105. *See* Erin Griffith, *$100 Million Was Once Big Money for a Start-Up. Now, It's Common*, N.Y. TIMES (Aug. 14, 2018), https://www.nytimes.com/2018/08/14/technology/venture-capital-mega-round.html?module=inline.

106. In fact, many private companies experienced down rounds upon going public because they were overvalued as private companies. *See, e.g.*, David Trainer, *The Unicorn Bubble Is Bursting*, FORBES (Oct. 7, 2019, 9:21 AM), https://www.forbes.com/sites/greatspeculations/2019/10/07/the-unicorn-bubble-is-bursting/#80bf79f88198. The Second Vision Fund came later, but with less fanfare. *See Launch of SoftBank Vision 2 Fund*, SOFTBANK GRP. CORP. (July 26, 2019), https://group.softbank/en/news/press/20190726. In part, SoftBank's recent, highly public investment failures have contributed to its inability to raise money from limited partners for its second Vision Fund. The second Vision Fund has not reached its initial fundraising goal of $108 billion. Instead, SoftBank is entirely funding the endeavor and has so far invested $30 billion in the second Vision Fund. *See* James Thorne, *SoftBank*

Second, private companies are not valued by standard metrics that most other companies are valued by. Instead, investors ascribe a numerical value of the firm based on the founder(s) and potential of the company.[107]

As companies stay private longer and are not subject to the rules and regulations that accompany becoming a public company (one of the "disciplining mechanisms" that forces companies to strengthen their corporate governance measures), the evolution of corporate governance practices to better suit a more mature company may not occur; instead, there may be stasis with respect to corporate governance matters.

In sum, the founders, investors, and independent directors who comprise the board each bring a unique set of skills and characteristics that influences startup corporate governance in different ways. The survey and interview data presented in Part III will provide more information about the role of each of these board members in corporate governance. Additionally, the ramifications that startups staying private longer and operating in a growth-at-all-costs mindset present will be discussed in greater detail in Part III. Findings about best practices in corporate governance in good versus bad economic times and the impact of DEI issues on corporate governance will also be covered below.

III.
KEY FINDINGS FROM SURVEY AND INTERVIEWS

Using survey and interview methodologies, Part III highlights four key findings. First, a founder-centric model of governance animated by a growth-at-all-costs mindset emerged after the Great Recession. Second, independent directors do not play the role of tiebreaker or swing vote as assumed in corporate law scholarship; in fact, the board is driven by a consensus building process. Third, although corporate governance is generally framed using best practices, corporate governance is valued, implemented, and sustained differently in good versus

Goes It Alone on Vision Fund 2 as Portfolio Profits Leap, PITCHBOOK (May 12, 2021), https://pitchbook.com/news/articles/softbank-earnings-vision-fund-2-fundraising.

107. *See* FELD & MENDELSON, *supra* note 66, at 43–44 (discussing different factors which VCs typically consider when deciding how to value a potential investment).

bad economic times. During good economic times, a growth-at-all-costs mindset influences the decision-making process and who has decision-making power. In contrast, during bad economic times, such as COVID-19, the backdrop here, boards prioritize the implementation of corporate governance and faithfully follow good corporate governance practices as a general matter. Lastly, although there may be discussions about DEI initiatives under the corporate governance umbrella, there is very little action. Companies are more focused on growth or survival; DEI issues are a secondary consideration, if they are considered at all. Most of the prior legal scholarship in this area do not use surveys, although several studies employ interviews. This Article provides the first empirical analysis of corporate governance in startups post-Great Recession and how the pandemic impacted said corporate governance.

A. *Survey and Interview Design*

Before delving into the findings from the survey and interviews, this Part provides more details on the survey and interview design that provide the basis of the Article's empirical findings. In consultation with the University of Washington statistics department, the author developed an exploratory survey to provide some insight into what the lawyers who routinely work with such startups and investors are doing at the frontlines of corporate governance in VC-backed companies.[108] This Article focuses on lawyers, because they are the intermediaries between founders and directors and understand corporate governance from a legal perspective in a way that investors and founders do not.[109] The author approached partners at various law firms to distribute the survey within their emerging companies (or equivalent) practices.[110] Some partners distributed the survey to their entire practice groups and others distributed it to a select few that they thought would be responsive. The survey was open from November 21,

108. *See* Jennifer S. Fan, Survey: Corporate Governance in Venture Capital-Backed Private Companies (2020) (unpublished survey) (on file with author) [hereinafter Corporate Governance Survey].

109. While interviewing founders and investors would have added more context, the focus of this Article is from the perspective of the lawyers who have the legal background and VC deal experience to provide a nuanced legal perspective of how corporate governance works in startups.

110. The author also had one in-house counsel respond.

2019, to February 14, 2020. Ultimately, twenty-eight lawyers responded out of 130 for a yield rate of 21.5 percent.[111]

Over 67 percent of the survey respondents had been in practice for twelve or more years; 17.9 percent had been practicing law eight to eleven years. The remaining 14.3 percent had practiced law four to seven years.[112]

Approximately 79 percent of the respondents were partners and nearly 18 percent were associates.[113] They practice in cities all across the United States: Atlanta, Austin, Boston, Chicago, Los Angeles, Palo Alto, Redwood City, Reston, San Francisco, and Seattle.[114] The largest number of respondents came from California (39.3 percent), with Washington State respondents coming in second at 25 percent.[115] Given the dispersed geographical nature of the respondents and small number of responses, no broad generalizations can be made about the findings. However, the exploratory survey does give some interesting insights that likely require further consideration and study.

The respondents generally had deep experience in VC deals, with 75 percent having done one hundred or more deals and 14.3 percent having done between fifty to ninety-nine deals.[116] All of the respondents had experience representing both investors and the companies that receive VC funds.[117]

Using a combination of a Likert scale[118] and a ranking system, the author asked the respondents to answer twenty-

111. The yield rate was calculated by dividing the number of responses received (numerator) by the numbers that the lawyers gave the author regarding who they circulated the survey to; some were approximations.

112. Corporate Governance Survey, *supra* note 108.

113. *Id.* The remaining percentage of respondents were former or current in-house counsel at VC-backed private companies. *Id.*

114. *Id.*

115. *Id.*

116. *Id.*

117. *Id.*

118. The Likert scale is one of the most widely used forms of attitude measurements in survey research. The Likert scale is typically a five-point scale which is used to measure an individual's level of agreement with a particular statement. *See* ENCYCLOPEDIA OF SURVEY RESEARCH METHODS 427 (Paul J. Lavrakas ed., 2008). The respondents were asked to choose "Strongly Agree," "Agree," "Neutral," "Disagree," or "Strongly Disagree" in response to different statements. Corporate Governance Survey, *supra* note 108.

three corporate governance questions. The results of the survey are included in the analysis of the role of the board in corporate governance below.

Next, in order to delve deeper into some of the preliminary findings of the survey described above, the author used a semi-structured interview format to conduct an exploratory study of thirty-one lawyers.[119] The purpose of the exploratory study is to create a "grounded theory" with the expectation that further research will be pursued in the future to confirm the hypotheses offered here.[120] In the exploratory stage, researchers "confirm . . . their emergent generalizations rather than an ensemble of priori predictions."[121] There are methodological advantages to an exploratory study in this context (lawyers' perspectives on corporate governance in VC-backed startups), which outweigh the potential concerns about sample size.[122]

According to the Oxford Handbook on Qualitative Research, the purpose of semi-structured interviews is to produce descriptions of the interviewees' lives in order to interpret the meaning of the described phenomena.[123] Unlike the structured interview, "semi[-]structured interviews can make better use of the knowledge-producing potentials of dialogues by allowing much more leeway for following up on whatever angles are deemed important by the interviewee."[124] There is no preset interview guide. In contrast to the unstructured interview, the interviewer in the semi-structured format "has a greater say in focusing the conversation on issues that he or she deems important in relation to the research project."[125] One re-

119. *See* ROBERT A. STEBBINS, EXPLORATORY RESEARCH IN THE SOCIAL SCIENCES 27 (2001) (arguing that to ensure adequate numbers for the data analysis, a good working number to aim for is thirty people per group, process, activity, or situation studied). Some legal scholars have used fewer interview subjects than the recommended amount. *See, e.g.*, Cable, *supra* note 2, at 325.

120. *See* STEBBINS, *supra* note 119, at 6 (noting that exploratory studies emphasize development of theory from data).

121. *Id.* at 7.

122. *See* Cable, *supra* note 2, at 891.

123. Svend Brinkmann, *Unstructured and Semi-Structured Interviewing, in* THE OXFORD HANDBOOK OF QUALITATIVE RESEARCH 277, 286–87 (Patricia Leavy ed., 2014).

124. *Id.* at 286.

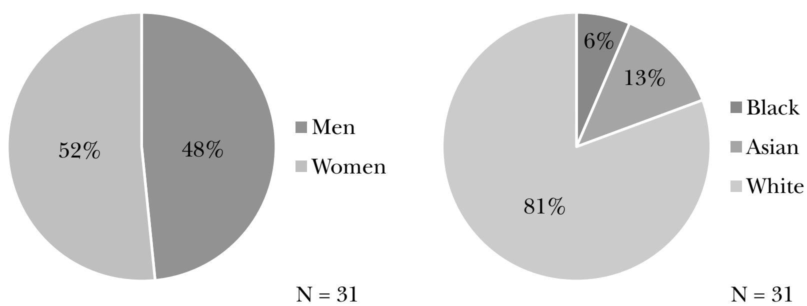
125. *Id.*

searcher describes semi-structured interviewing as the "standard form of qualitative interviewing today."[126]

Sample sizes in exploratory studies may be smaller than in confirmatory research.[127] Robert Stebbins also notes that statistical tests used in confirmatory research to prove validity and reliability are inappropriate formulas to apply to exploratory studies.[128] Accordingly, this Article does not apply statistical reliability or validity tests to the survey data.

The author used personal and professional networks to locate interview subjects. Using the "snowball" sampling technique, interviewees were asked for referrals to other lawyers in the target firms and advice on what other firms should be included that were not on the author's original list.[129]

FIGURE 1: INTERVIEWEE DEMOGRAPHICS



When the survey was conducted, COVID-19[130] was not dominating our daily lives. As the pandemic worsened, however, so did our economy.[131] The survey gave the author a

126. *Id.* at 297.

127. Cable, *supra* note 2, at 889–90 (citing STEBBINS, *supra* note 119, at 30–41). Cable conducted nineteen interviews, reasoning that he felt he had reached a point of "theoretical saturation"—where no additional categorizations can be found by collecting additional data. *Cf.* STEBBINS, *supra* note 119, at 27 (asserting that thirty is the ideal number).

128. STEBBINS, *supra* note 119, at 30.

129. Cable, *supra* note 2, at 890.

130. *See generally Listings of WHO's Response to COVID-19*, WORLD HEALTH ORG. (June 29, 2020), https://www.who.int/news-room/detail/29-06-2020-covidtimeline.

131. David J. Lynch, *IMF Says Global Economic Collapse Caused by Coronavirus Will Be Even Worse than Feared*, WASH. POST (June 24, 2020), https://

macro-level understanding of corporate governance during good economic times, but the interviews provided deeper insight on the mechanics of corporate governance during both times of prosperity and market downturns. The interviews were conducted in April, May, June, July, August, and September 2020, primarily with firm lawyers who were partners or senior associates in the Bay Area (e.g., San Francisco and Silicon Valley) and Seattle that worked for law firms well-known for their expertise in VC financings and work with high-tech startups. The author also interviewed three former or current general counsels of VC-backed private companies. Sixteen of the interviewees were women and fifteen were men; six identified themselves as minorities.[132] See Figure 1 for a demographic breakdown of interviewees. The author chose the Bay Area and Seattle because they are both epicenters of high-tech activity. Although this sample size appears small, the number of lawyers who work in this specialized area is limited to "entrepreneurial hot spots."[133] This Part looks at how lawyers define corporate governance, how boards are structured, how board meetings are conducted, how boards vote, how board composition evolves over time, the particular role of each type of director, the impact of economic conditions on corporate governance practices, and whether the preliminary survey results aligned with what was discussed during the interviews. The interviews support the viewpoint that a founder-centric model has emerged, which has impacted board dynamics. Furthermore, they reveal that boards operate using a consensus-driven process. After the Great Recession, boards leveraged a norm-based system of corporate governance to adapt to an environment where private companies remain private longer and a growth-at-all-costs mindset pervades. The interviews also controvert the theory that independent directors play a tiebreaker role; in fact, the reality is that they exert far less influence than

www.washingtonpost.com/business/2020/06/24/imf-global-economy-coronavirus/.

132. Four of the interviewees identified as Asian; two were Black.

133. Abraham J.B. Cable, *Startup Lawyers at the Outskirts*, 50 WILLAMETTE L. REV. 163, 165 (2014). *See also* Cable, *supra* note 2, at 891 (describing its use of a smaller sample size consisting of a distinct type of participants it was seeking). *See generally* FELD & MENDELSON, *supra* note 66, at 14–15 (noting the importance of lawyers experienced in VC financings to the success of a deal).

prior legal scholarship purports. Although the study is small and cannot make broad claims, the lawyers coalesced around a few key corporate governance points, each of which could be a future area of study.

B. *Four Key Findings From Survey and Interviews*

The four key findings discussed in this Part are based on what happens (or does not happen) in the boardroom and the dynamics among the different board members. Therefore, to better contextualize the findings, a brief description of what transpires both in and outside of the boardroom, and the personalities involved, follows.

In an early-stage startup, there may be no meetings; instead, most things are passed by consent.[134] The legal issues that lawyers focus on with their clients often include equity grants and classifying individuals as employees or consultants, to cite a few examples.[135] Lawyers also may help founders (who are typically also the founder-management directors) frame certain discussions with the board. As an example, lawyers may assist founders in presenting information about options and benchmarking their value.[136]

When companies hold board meetings, they present metrics that are indicators of the health of the business, such as whether marketing is generating enough leads for its product.[137] The CEO runs the meeting and gives high level highlights and challenges related to sales, revenues, marketing, customer success, and then engineering and products.[138] Law-

134. Interview with Lawyer #21 (on file with author); Interview with Lawyer #3 (on file with author) (noting that companies frequently use unanimous written consents if there is no regularly scheduled meeting that is imminent).

135. Interview with Lawyer #3, *supra* note 134.

136. *Id.*

137. Interview with Lawyer #30 (on file with author).

138. *Id.* (noting that 99% of the time, the very first segment is sales and sales pipeline (e.g., what do sales and revenues look like in the current quarter), the next segment is marketing (e.g., extending pre-sales to get qualified leads to salespeople), then customer success, and finally engineering and products).

yers also help to guide first-time CEOs on how to run board meetings.[139]

The cadence of board meetings is determined by the founder-management directors.[140] It is common practice for outside counsel to attend these meetings for free.[141] One lawyer characterized board meetings as "investor check-in calls" and the means by which corporate governance is done.[142]

Well-functioning boards are ones who work together over a number of years, trust each other, and discuss matters.[143] In fact, the fate of management and investors is intertwined.[144] In order to raise more money, they need to present a unified front.[145] This, in part, explains why board meetings follow a consensus-driven process.[146] "[T]he role each member will play depends on personality and backgrounds."[147]

The interviewees were mixed in their responses to the question regarding which directors are the best monitors; this was similar to the results in the survey. The disparity in answers is likely because there is a wide variety of directors and each one serves a different role. As one lawyer observed, the different directors "balance each other" and monitor different

139. Interview with Lawyer #6, *supra* note 97 (noting that lawyers advise their clients to use a particular formula each time they present, have meaningful data, and have specific asks of the board).

140. Interview with Lawyer #28 (on file with author).

141. Interview with Lawyer #10 (on file with author) (noting that by attending board meetings for no charge, the lawyers can be up to date about what the company is doing and may bring law firm business opportunities later on in the form of potential transactions); Interview with Lawyer #3, *supra* note 134 (concurring that attending board meetings is a business opportunity and helps lawyers build relationships with board members).

142. Interview with Lawyer #2 (on file with author).

143. Interview with Lawyer #26 (on file with author) (noting that if trust falls apart then everything is conflicting, nothing is getting done, and there are side arguments, disagreements, and people wanting to get out of the situation).

144. *Id.*; *see also* Interview with Lawyer #15 (on file with author) (observing the unavoidable fact that founder-management directors and investor directors have their own interests, and although these interests are conflicted, the conflict is not due to a question of character or integrity).

145. *See* Interview with Lawyer #26, *supra* note 143 (noting that the company needs to find additional investors to support them and that doing so has a galvanizing effect on the management and existing investors).

146. Interview with Lawyer #3, *supra* note 134.

147. Interview with Lawyer #26, *supra* note 143.

things.[148] Those who said VC investor directors were the best monitors[149] stated that this was because they want to monitor their investments and have the most experience on boards.[150] In particular, lawyers pointed out that VCs were able to identify conflicts of interest, who should be on different committees, and who ought to be independent directors or new recruits to the board.[151] Ultimately, who the best monitor was depended on the circumstances.[152] For example, in a growth-at-all-costs culture, the company and board may lose sight of governance, and monitoring is given a lower priority.[153]

Some held the view that founders were too close to the business and lacked a broader perspective to be the best monitors.[154] Startups get more introspection from independent directors.[155]

Different directors also have different motivations that may affect how they monitor a company.[156] For example, founder-management directors may be satisfied with a 2x return whereas a VC investor director wants a 10x return.[157] This difference in expectation could impact how they view certain board issues, such as an acquisition.

148. Interview with Lawyer #12 (on file with author).

149. Interview with Lawyer #10, *supra* note 141.

150. *Id.*

151. *Id.* (explaining that, for example, VC investor directors will raise issues if the company has a strategic investor who also does a deal with the company thereby becoming a customer or partner of the company).

152. Interview with Lawyer #14 (on file with author) (suggesting that the best monitor against WeWork-type malfeasance should be the investor director because they are economically incentivized to counter balance; however, if the investor director is "drinking the Kool-Aid then [they] may ride [the] 'ridiculous wave' depending on economics").

153. Interview with Lawyer #12, *supra* note 148 ("People cut corners for a reason.").

154. Interview with Lawyer #29 (on file with author) (citing the need for founders to be optimistic all the time, but acknowledging that some founders were self-reflective).

155. *Id.*

156. The different types of directors have different functions that they fulfill: the investor director is focused on preserving its portfolio, the founder-management director is focused on preserving the company, and the independent director serves as an advisor. Interview with Lawyer #25 (on file with author).

157. Interview with Lawyer #12, *supra* note 148.

1. *The Emergence of the Founder-Centric Board Post-Great Recession*

The first key finding from the survey and interviews is that a founder-centric board emerged post-Great Recession. The importance of founders to a startup is reflected in the terms that highly sought-after founders can negotiate.[158] One example of founders' outsized influence can be found in the board composition itself. The lawyers interviewed by and large agreed that in the period before the Great Recession the board composition of a startup looked quite different than in the period following it. If a startup raised institutional money, the board typically had three board members: a representative of the preferred stock (usually the lead investor), a representative of the common stock (typically designated as the CEO, who may be the founder), and one that was mutually designated (an independent director who was mutually agreed upon by the holders of common stock and preferred stock).[159] In the next round, the company would have two common stock designated directors, two preferred stock designated directors, and one mutually designated director.[160] In later rounds, there would be a shift to balance the board.[161]

158. Scott Galloway, New York University Professor of Marketing, stated, "Founders are now assigned this Christ-like association." David Gelles, *C.E.O.s Are Not Here to Save Us*, N.Y. TIMES (Sept. 28, 2019), https://www.nytimes.com/2019/09/28/business/wework-juul-ebay-ceo.html. Oftentimes, the founders are also part of management (e.g., CEOs). Promising startups are often courted by a number of VCs and other investors. The hot market gives the founders of such companies significant leverage. *See* Tomio Geron, *The 10-Year Power Shift in VC Land*, PROTOCOL: PROTOCOL PIPELINE (Jan. 30, 2021), https://www.protocol.com/newsletters/pipeline/venture-capital-power-shift?rebelltitem=2#rebelltitem2.

159. Interview with Lawyer #14, *supra* note 152; Interview with Lawyer #15, *supra* note 144 (noting that life science companies still have this board composition at the beginning; founders have less power, VCs comprise majority of the board by Series B or C, there is more willingness to bring in outside directors because it is a regulated industry, and there are also more rounds and more investors).

160. Interview with Lawyer #14, *supra* note 152.

161. *Id.* The lawyer also noted there is an exception for the balancing of the board if it is a "rocket ship company." *Id. See also* Interview with Lawyer #15, *supra* note 144 (noting that from the end of the Great Recession to December 31, 2019, the trends were: 1) greater power to founders; 2) more instances where common stock, i.e., founder-management directors, had a bigger percentage of the board seats and held those board seats for a longer

The advent of founder-friendly terms post-Great Recession was accompanied by a change in the board structure that favored founders. Scholarship on corporate governance in startups pre-Great Recession emphasized the diminishing roles of the VC director and the founder director (with a few notable exceptions) as the startup grew.[162] However, post-Great Recession boards in the early stages sometimes had two (or even three) management or founder directors at the seed stage.[163] Then, when institutional investors joined in Series A, the board would be comprised of two founders and one investor.[164] The next round (Series B) is when a second large investor comes in.[165] At this point, the startup has two representatives of common stock (a CEO and founder), two representatives of investors, and one seat for an independent member that is typically left vacant until someone can be identified.[166] Whether the company has an industry expert depends on the stage of the company.[167] By the time a company reaches the Series B (or Series C) round, control is typically split between founder-management directors and investor directors.[168] In future rounds, if companies have Series C and D rounds, then there are three investor directors, two independent directors,

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term during the growth of the company; and 3) mutually agreed upon board members, i.e., independent directors, who were chosen by the common stock and agreed upon by other directors); Interview with Lawyer #26, *supra* note 143 (noting changes in board composition in later series).

162. *See* Bartlett, *supra* note 30, at 37–45 (analyzing VC investment contracts and finding that startups must balance vertical agency problems between investors and managers as well as horizontal agency problems among VC investors); *see also* Brian Broughman, *Investor Opportunism and Governance in Venture Capital*, *in* VENTURE CAPITAL: INVESTMENT STRATEGIES, STRUCTURES, AND POLICIES 347, 347 (Douglas J. Cumming ed., 2010) (discussing VCs who use their control rights in startups opportunistically).

163. *See* Interview with Lawyer #10, *supra* note 141. Recently, some founders have even insisted upon a "'common-controlled' board, meaning that there are more board members representing the common shareholders than other classes of shareholders." KUPOR, *supra* note 22, at 172.

164. Interview with Lawyer #26, *supra* note 143.

165. *Id.*

166. *Id.* (noting that the board composition becomes less prescriptive after this stage).

167. Interview with Lawyer #12, *supra* note 148.

168. *Id.* Interview with Lawyer #11 (on file with author) (noting that Series B is an "inflection point" where the company is stockpiling money and a more balanced board emerges).

and two founder-management directors.[169] At some point, the Series A investor director may leave the board if she does not maintain her VC fund's percentage interest in the company.[170] Typically, there is no more than one independent member until the company ramps up.[171] For example, at the Series D stage, the company may want an additional independent director for optics or connections.[172] If there are non-traditional investors, such as a mutual fund or CVC, they may get a board observer seat.[173]

Seven directors is generally the maximum size of the board.[174] Companies do not want more than seven directors; five or six directors is optimal.[175] In the lead-up to IPOs the true independent directors are recruited.[176] The VC investor directors will then remain until the company goes public, particularly if they have a significant stake, and all their shares are distributed to their limited partners.[177] Others may leave the board before the company goes public because they do not want the liability or responsibility.[178]

In addition to boards, some high-tech companies have advisory boards filled with customers to both get their insight and reward them with equity.[179] There may also be board observers who do not have fiduciary duties but have all the influ-

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169. Interview with Lawyer #26, *supra* note 143. Lawyer #15 offers a slight variation on the board composition: at the time the company is founded there are two founder directors; one seed director is elected at seed round, one director is elected at Series A (that "XYZ fund selects" per voting agreement signed at the time of financing), another director is elected at Series B (every other board seat after that "is a fight"), and one or two additional seats are mutually agreed upon or identified by common stock and reasonably acceptable to preferred stock or with the approval of a specific fund. Interview with Lawyer #15, *supra* note 144.

170. *See* Interview with Lawyer #10, *supra* note 141.

171. Interview with Lawyer #12, *supra* note 148.

172. *Id.*

173. *See* Interview with Lawyer #26, *supra* note 143; Interview with Lawyer #5 (on file with author) (noting that family funds, angels, and CVC funds typically secure board observer seats).

174. Interview with Lawyer #21, *supra* note 134.

175. Interview with Lawyer #15, *supra* note 144 (stating that seven directors is a good number to go public).

176. Interview with Lawyer #10, *supra* note 141.

177. *Id.*

178. *Id.*

179. Interview with Lawyer #15, *supra* note 144.

ence of a director.[180] In addition to the board structure, companies will have "real" audit and compensation committees as they mature.[181]

In early-stage companies, it is rare for management to not also be founders.[182] Therefore, the board seats in this category may be more accurately described as founder-management directors. In board meetings, founder-management directors will do most of the talking; the other directors will provide feedback or react.[183]

Founder-management directors can be a "mixed bag."[184] They may be sensitive to the needs of the common stockholders but not attuned to corporate governance issues; instead, they are more focused on their personal circumstances as common stockholders.[185] They also may not have the requisite experience in operating a company.[186] The length of time founder-management directors remain on boards is often dictated by investor directors.[187]

Founder-management directors are more connected to their employees and company; they know how their employees will react to things and are generally loyal to them.[188] They

180. *Id.* The lawyer also remarked that if a new investor comes in and does not get a board seat, it is common to give them board observer rights. *Id.*

181. Interview with Lawyer #10, *supra* note 141. The lawyer also observed that VCs will even have suggestions about who to recruit to these committees. *Id.*

182. Interview with Lawyer #6, *supra* note 97. The lawyer also noted that if a member of management is on the board, but is not the founder, she is most likely the CEO. *Id.*

183. Interview with Lawyer #18, *supra* note 98.

184. Interview with Lawyer #13 (on file with author).

185. *Id.*

186. Interview with Lawyer #31 (on file with author); *see also* Interview with Lawyer #22 (on file with author) (noting that often founders do not have a background in corporate governance and are not sure what to do, and therefore it is up to the other more experienced directors to introduce some system of controls and look out for compliance with various laws).

187. Interview with Lawyer #9 (on file with author). The lawyer also noted that overly large boards do not make sense for early-stage companies. *Id. See also* Interview with Lawyer #3, *supra* note 134 (observing that if investor directors want someone off the board, such as the CEO, independents will typically go along with them).

188. Interview with Lawyer #21, *supra* note 134. The lawyer also noted that investor directors see employees as cost centers. *Id.*

also have a deeper understanding of the company than anyone else on the board.[189]

Although founder-management directors know their business, employees, various teams, and where the business needs help,[190] they can also be myopic.[191] They do not have visibility into peer companies—whether with regard to human resources, recruiting, or other departments. Instead, they are "laser-focused" on their own companies.[192] Despite their "very narrow view," founder-management directors want to succeed and are the most committed of all the directors.[193]

If there are multiple founders who also happen to be board members there will likely be issues.[194] For example, there may be a professional disagreement that one of the founder directors has with the other board members regarding the course of the company.[195] If a founder leaves the company, it is highly negotiated whether they are allowed to stay on the board.[196]

There is a difference between those who are founder-management directors and those who are management directors. Particularly with respect to VC-backed companies, the founder's identity matters. There is a culture of belief around a founder and "directors can be hard pressed to push back on

189. *See id.* (observing that these "inside directors" know that, while metrics and revenues may show one thing, contact with customers may show how they are headed in a different direction).

190. Interview with Lawyer #17 (on file with author) (observing that founder-management directors are good at reporting to the board on business-related issues).

191. *Id.* (explaining that this narrow vision is due to the fact that they "only see what's happening at their [own] company"); Interview with Lawyer #15, *supra* note 144 (noting the "very narrow view" of these directors).

192. Interview with Lawyer #1 (on file with author). The lawyer also noted that founder-management directors don't have the privilege of seeing other companies, but are much more "deep in the weeds" and have a better understanding of what will be effective or not for their business. *Id.*

193. Interview with Lawyer #15, *supra* note 144.

194. *See* Interview with Lawyer #1, *supra* note 192.

195. *Id.* The lawyer also observed that the same characteristics that make good entrepreneurs may make them difficult people. *Id.*

196. Interview with Lawyer #6, *supra* note 97. The lawyer also noted that in the voting agreement, the formulation of key holders, like a founder who holds the majority of common stock, may maintain their seat on the board by tying it to a service component—they only remain on the board if they continue to serve in some capacity, such as officers or consultants. *Id.*

that person."[197] If the director is management and not a founder, she is held to a different standard and receives less deference.[198]

The founder-management directors have a vision and passion for the company; they are also the most optimistic about the company's outlook.[199] Founder-management directors set the agenda and drive the conversation;[200] the investor directors and independent directors provide feedback.[201] The roles of CEO, director, and de facto chairperson of the board are typically held by founder-management directors, even if they are not officially appointed.[202] At times, they may lack experience and knowledge of the board process.[203] Essentially, their role is a reporting one: they inform the board of the current situation at the company and make recommendations. In sum, the founder-management directors are "singularly responsible for how well [the] board functions."[204]

There is also a particular subspecies of founder-management director: the rock star founder director. Having a rock star founder on the board can also lead to a different social dynamic. The survey, taken by lawyers from various law firms with deep experience in the VC space, gives greater insight into the relationship between rock star founders and VCs. The respondents indicate a balance between VCs wanting to gain access to promising startups to increase their chances of getting an outsized return for their fund and placating the founder by allowing them to implement corporate governance measures at a slower pace than they otherwise might think is prudent.

Although rock star founders are not common, "when they crop up, VCs often enable the rock star by making governance an afterthought."[205] Other survey respondents observed the in-

197. Interview with Lawyer #31, *supra* note 186.
198. *Id.* (observing that the board places more pressure on the management director to lead in ways that the board wants, rather than deferring to her as they would a founder).
199. *See* Interview with Lawyer #4 (on file with author).
200. Interview with Lawyer #9, *supra* note 187.
201. Interview with Lawyer #18, *supra* note 98.
202. Interview with Lawyer #9, *supra* note 187.
203. *Id.* (describing individuals with managerial, but no board experience).
204. Interview with Lawyer #26, *supra* note 143.
205. Corporate Governance Survey, *supra* note 108.

creased leverage of rock star founders[206] and the willingness of investors to keep out corporate governance terms.[207] "[C]orporate governance is arguably more important when there is a rock star personality in play, because it's so easy for them to pull [the] wool over investors' eyes."[208] Two-thirds of the survey respondents agreed/strongly agreed with the following statement: "The problem is not with existing corporate governance mechanisms, but the fact that they are not implemented properly."[209] As one respondent observed, "[p]eople often take short cuts or avoid the hard discussions and then find themselves in an awkward spot."[210] One respondent took the view that "[i]f you want to throw crazy valuations at founders and not exercise meaningful control, that's your prerogative."[211] Underlying this response is the fact that VC deals are ultimately on an as-bargained-for basis. Some investors may choose to offer a high valuation and have fewer controls over the founders in order to be included in the deal. Given the premium placed on a "rock star founder," VCs may find themselves allowing the founder to engage in behavior that some might find objectionable for economic reasons. In other words, VCs may not speak out about bad behavior due to a competitive market where one does not want to get on the "bad side" of founders whose companies one wants to invest in.

2. *The Role of Independent Directors*

The second key finding from the survey and interviews is that independent directors are not the tie-breaking or swing vote. In fact, board votes are typically unanimous. In comparison to the other founder-management directors and investor directors, independent directors play a secondary role and rarely drive the conversation. The interviewees generally

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206. *Id.* at Question 7 ("[R]ock stars can get many investors chasing them so the rock star has more leverage.").

207. One respondent replied, "A hot [c]ompany can use access to the deal to keep corporate governance related terms out of their financing documents since Investors value getting into the deal more than the potential governance concerns." *Id.*

208. *Id.*

209. *Id.* at Question 15.

210. *Id.*

211. *Id.*

agreed that it is extraordinarily rare to be in a boardroom where there is disagreement. "Almost everything is just decided by consensus."[212] Independents are "rarely [the] loudest voice in rooms"; they provide the outside perspective.[213] "Founders and investors are loud voices."[214] In practice, board votes are almost always unanimous and independent directors are not tiebreakers.[215] If an issue is especially contentious, even if the company has the vote to pass the matter, they still want to build consensus and not just have a simple majority.[216]

Independent directors come from myriad backgrounds. In the early stages of a company, independent directors tend to be friends of the founder or investor so they are not truly independent.[217] Some have industry expertise in a parallel business or may be C-level executives themselves.[218] Others are CEOs of companies and can provide an operator perspective that investor directors cannot.[219] They may also have past investor experience or may have retired as a partner from an

212. Interview with Lawyer #26, *supra* note 143. Interviews with nearly every lawyer confirmed that boards rarely come to a split vote.

213. *Id.*; *see also* Interview with Lawyer #18, *supra* note 98 (observing that independent directors in general are not loud, vocal leaders in the boardroom, but investor directors are the loud ones); Interview with Lawyer #4, *supra* note 199 (characterizing independent directors as quiet); Interview with Lawyer #24 (on file with author) (concurring that independent directors are collegial and respectful though they are influenced by the ecosystem around them).

214. Interview with Lawyer #26, *supra* note 143.

215. Interview with Lawyer #1, *supra* note 192 (stating that, in his many years of practice, he can count on one hand the number of times there has been a divided board vote, and often times they are driven by two founders, one of whom would ultimately be transitioned off the board); Interview with Lawyer #9, *supra* note 187; Interview with Lawyer #10, *supra* note 141; Interview with Lawyer #12, *supra* note 148; Interview with Lawyer #16 (on file with author); Interview with Lawyer #25, *supra* note 156; Interview with Lawyer #14, *supra* note 152 (noting 98–99% of board decisions are unanimous).

216. Interview with Lawyer #18, *supra* note 98. The lawyer also cited an example of a CEO renegotiating the terms of her employment agreement, where the negotiation continues until everyone on the board feels good about the renegotiated terms. *Id.*

217. *Id.*

218. Interview with Lawyer #28, *supra* note 140; Interview with Lawyer #1, *supra* note 192. Independent directors with industry experience in a parallel business are the "boots on the ground." Interview with Lawyer #28, *supra* note 140. *See also* Interview with Lawyer #25, *supra* note 156.

219. Interview with Lawyer #1, *supra* note 192.

accounting firm or law firm.[220] Often times, independent directors have operational experience[221] and can serve as mentors to management.[222] Independent directors understand employees and the common stockholder base better than investor directors do because of this experience.[223] They are also "versatile and tactical in decision making."[224] In particular, independent directors show their value in times of crisis.[225] For example, they can help with management issues (e.g., transitions) because of operational experience, availability, and time.[226] They serve as "insulator[s]" against disgruntled stockholders, not so much as tiebreakers; ultimately, they follow whoever has leverage.[227] Corporate governance decisions are subjective and nuanced; therefore, when issues are disputed, whoever's voice is the loudest is most likely to sway the independent director.[228] At their best, independent directors have the perspective of the startup's industry and what it takes to be successful; they will provide mentorship and advice to the founder-management directors.[229]

In the early stage of the company, it is difficult to identify independent board members because there is no incentive to become one. Instead, independent directors more commonly join startups in the Series B or Series C stage.[230] Optically, it looks good for a company to have an independent director;

220. *Id.* Independent directors are more mature in terms of chronology—they are current in business or recently retired. *Id.* To identify independent directors, companies could put together a skills matrix to determine what other qualities could round out the board. Interview with Lawyer #31, *supra* note 186.

221. Interview with Lawyer #28, *supra* note 140.

222. Interview with Lawyer #15, *supra* note 144; Interview with Lawyer #22, *supra* note 186.

223. Interview with Lawyer #18, *supra* note 98.

224. *Id.* (noting that independent directors need to add value or they will no longer be on the board).

225. Interview with Lawyer #25, *supra* note 156.

226. *Id.*

227. Interview with Lawyer #14, *supra* note 152 (emphasizing that decisions are driven by management and VC investors; "independent directors are along for the ride").

228. *Id.*

229. Interview with Lawyer #17, *supra* note 190.

230. Interview with Lawyer #29, *supra* note 154 (noting that independent directors can be helpful as the company scales and that they bring an operational perspective); Interview with Lawyer #21, *supra* note 134 (confirming

however, while companies may create a seat early on, it may be left vacant.[231] In particular, the independent directors provide "[a] lot of value in Series B and C"[232] and are helpful for business connections.[233]

Independent directors have a different understanding of the industry compared to the others on the board.[234] They are there to ask the right questions and weigh in on their areas of expertise.[235] A good independent director is akin to a "super advisor" and identifies the way she can help; often the most helpful pieces seem to happen outside of the boardroom.[236] "Good independent directors [bring a] particular vein of experience that is otherwise missing from the board."[237] For example, assume that the company has a CEO who is a tech genius but has no marketing expertise. While a VC could help, an independent director with that experience could be brought in. The independent director then becomes not only a mentor, but also brings complementary expertise and an outside perspective.

Independent directors are selected because they have some prior relationship with another person on the board, such as the VC.[238] They can be appointed to the board in dif-

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that independent directors are brought in at a later stage in the company and bring another voice into the boardroom).

231. Interview with Lawyer #17, *supra* note 190 (observing that it can be hard to find someone who wants to take time for an early-stage company).

232. *Id.*

233. *Id.*

234. Interview with Lawyer #26, *supra* note 143. An independent director can be helpful to a startup if the industry component is critical—e.g., if selling into a particular vertical requires understanding of that vertical, and sometimes the only person who understands it is the independent director. *Id.*

235. *Id.* (observing that independent directors have limited power and "can't drive anything on front end or back end").

236. *Id.*

237. *Id.*

238. Interview with Lawyer #6, *supra* note 97; Interview with Lawyer #8 (on file with author) (analogizing independent directors to independent voters—very few of them are truly independent; they come in with a point of view and set of relationships and were likely chosen for those reasons); Interview with Lawyer #10, *supra* note 141 (noting that typically VCs recommend the independent directors). An independent director is brought on by a vote of the preferred stock and common stock separately or together. Interview with Lawyer #21, *supra* note 134. *But cf.* Interview with Lawyer #16, *supra*

ferent ways: a vote of the preferred stock and common stock, separately or together, or perhaps a vote from all other directors.[239] Ultimately, the role of the independent director depends on what she was brought on the board to do.[240]

When choosing independent board members, the most important consideration is industry experience in areas where the company strategically needs more guidance or perspective; secondarily, there are considerations around diversity, equity, and inclusion.[241] This group of directors is more likely to observe and reserve judgment instead of convincing other members of the board to vote in a particular way.[242] Put differently, the directors are trying to build consensus[243] and independent directors are not there as an arbitrator or a tie-breaking vote.[244] In fact, the lawyers interviewed generally agreed that independent directors will most likely not do something contrary to what investor directors or founder-management directors want.[245]

Pursuant to the survey data, it seems that independent directors do not typically play the function of neutral arbiter, but rather serve on the boards of startups because of their industry

note 215 (opining that independent directors are more aligned with founders).

239. Interview with Lawyer #21, *supra* note 134; Interview with Lawyer #19 (on file with author) (giving examples of the different ways an independent director can be selected: she could be a non-affiliate, mutually agreed upon by other directors, or the CEO could nominate the director as long as the other investors approve).

240. Interview with Lawyer #22, *supra* note 186.

241. Interview with Lawyer #11, *supra* 168; Interview with Lawyer #12, *supra* note 148; Interview with Lawyer #16, *supra* note 215; Interview with Lawyer #19, *supra* note 239; Interview with Lawyer #23 (on file with author).

242. Interview with Lawyer #8, *supra* note 238 (explaining that they want to get along with as many board members as possible; in the end, however, they have very little stake in the company).

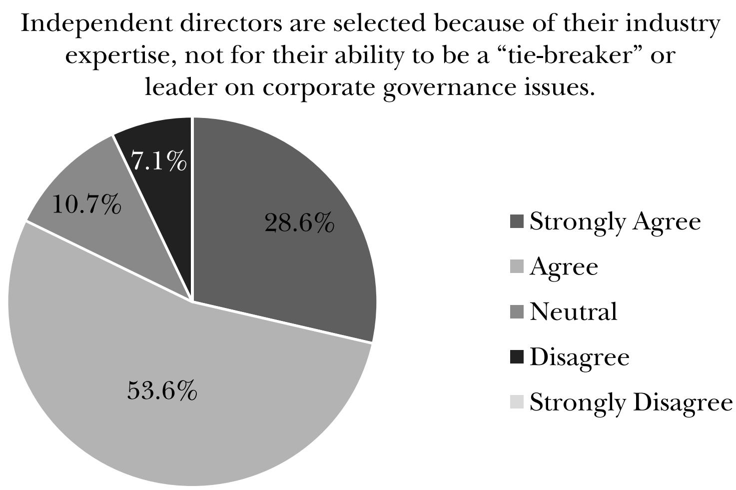
243. Interview with Lawyer #23, *supra* note 241 (explaining that the founder and VCs are trying to convince the independent director to align with their respective positions; independent directors are not the ones trying to convince the founders or VCs to come to a certain decision); Interview with Lawyer #8, *supra* note 238 (explaining that independent directors want to get along with as many people on the board as possible).

244. Interview with Lawyer #6, *supra* note 97 (explaining that independent directors are a neutral voice and potential ally; they do not drive the conversation and other directors attempt to get the independent director on their side in adverse situations); Interview with Lawyer #9, *supra* note 187.

245. *See generally* Interviews with Lawyers #1–31 (on file with author).

expertise or to ostensibly provide balance.[246] Over 82 percent of the respondents in the survey agreed/strongly agreed with the following statement: "Independent directors are selected because of their industry expertise, not for their ability to be a 'tie-breaker' or leader on corporate governance issues."[247]

FIGURE 2: SURVEY RESULTS



Furthermore, as noted above, there are rarely non-unanimous votes on boards where independent directors would need to act in this type of capacity.[248] Instead of the independent board member serving as neutral arbiter, all of the directors are working together to build consensus, and the investor director is there to help guide the conversation.[249]

Independent directors are not as personally invested the company as the other directors because they do not have the personal or financial ties to it in the way that founders or investors do.[250] They receive cash compensation and an option grant for their service; therefore, the limited personal stake may affect whether independent directors take on the role of

246. *See* Corporate Governance Survey, *supra* note 108, at Question 12.
247. *Id.*
248. *See supra* text accompanying note 215.
249. Interview with Lawyer #23, *supra* note 241; Interview with Lawyer #19, *supra* note 239.
250. *See* Interview with Lawyer #15, *supra* note 144.

director at all.[251] Independent directors also have the least power on the board and often are not well-versed in corporate governance.[252] Furthermore, this is not their only job. They often have full time jobs or are retired—this has an impact on their motivation and energy.[253] There are also certain independent directors that could in fact be detrimental to the company if they are selected to add stature or status to company. For example, sometimes celebrities or government officials do not understand what their job is, do not do the job, or can be "odd or unpredictable."[254]

In the private company realm, the role of the independent director is not clear-cut. There is "not good guidance about what that person is supposed to do or how they conduct themselves in this dynamic."[255] Setting aside fiduciary duties, one lawyer opined that not one case is transformative in determining how directors should act.[256] Instead, Delaware cases provide incremental guidance, and lawyers then consider those cases when providing guidance to their clients.

At the beginning of a company, there are very few contentious issues and not a lot of areas where independent directors need to weigh in.[257] However, during economic downturns, independent directors can play an important role in providing an outsider's perspective for an insider-led financing.[258] The

251. Interview with Lawyer #25, *supra* note 156 (hinting that the compensation structure may not be lucrative enough to draw in an independent director); Interview with Lawyer #9, *supra* note 187 (noting independent directors transition from receiving equity exclusively to a combination of cash and equity compensation).

252. Interview with Lawyer #20 (on file with author). *But cf.* Interview with Lawyer #18, *supra* note 98 (noting that there are exceptions to this, particularly if the independent director has served on boards before).

253. Interview with Lawyer #14, *supra* note 152 (describing independent directors as slightly more disengaged and lacking bandwidth).

254. Interview with Lawyer #15, *supra* note 144 (citing experiences where such directors are as likely to fail as they are to succeed; government officials in particular can be hypersensitive to reputational concerns as a director).

255. Interview with Lawyer #13, *supra* note 184 (noting that it would be helpful to have a case on this topic to provide guidance on what independent directors were expected not to do).

256. *Id.*

257. Interview with Lawyer #18, *supra* note 98.

258. *Id.* (stating that another area where independent directors are important is in the sale of a company because they are examining the fairness of the deal for every stockholder).

most effective independent directors are those who have been operators because they know how to run companies.[259] Independent directors may also serve as a sounding board, but seldom are they the critical swing vote.[260]

3. *Best Practices Framework*

The third key finding from the survey and interviews is that, while a best practices framework is used to implement corporate governance infrastructure within a startup, such implementation is influenced by stage of growth and board dynamics. This becomes especially evident when contrasting how corporate governance is prioritized in good versus bad economic times. During good economic times, founders determine how quickly (or slowly) corporate governance measures are implemented. However, in economic downturns, investor directors play a disciplining function, similar to how a looming IPO or acquisition would incentivize startups to speed up the implementation of corporate governance practices.

a. Stage of Growth and Board Dynamics

The lawyers each emphasized the importance of process and decision-making around corporate governance when asked for a definition.[261] Access to information was also considered critical.[262] They noted the importance of the board ensuring that minority stockholders and common stock stockholders are protected.[263] The lawyers' comments were also

259. *Id.* (observing that those independent directors know how to manage real world issues that arise and understand employees and common stockholder base better than investor directors do).

260. *Id.* (noting that independent directors keep the other directors honest).

261. *E.g.*, Interview with Lawyer #30, *supra* note 137 (noting that the board is involved in the company's material decision making for things like strategic direction, responding to crises, and generally guiding a company through all of its significant events); Interview with Lawyer #13, *supra* note 184 (corporate governance "relates to everything around decision making at the intersection of board, management and stockholders").

262. Interview with Lawyer #9, *supra* note 187 (noting that access to information and process are the keys to governance).

263. Interview with Lawyer #18, *supra* note 98 (observing that those without power must be adequately protected); Interview with Lawyer #10, *supra* note 141 (describing corporate governance as "the things you need to do to

based on the assumption that the startup ecosystem is by and large comprised of good actors.[264]

The interviewees appeared to agree that a number of corporate governance structures can work.[265] The interviewees also by and large concurred that in private companies there is an evolution of corporate governance and that the pace of that evolution differs for each company.[266] The interviewees explained that, in part, the pace of the incorporation of corporate governance mechanisms may also be due to resource constraints, such as lack of time, money, or experience.[267] As the company matures, the general counsel and outside counsel, along with various directors, will make suggestions related to the corporate governance process.[268] One lawyer described corporate governance as "adherence to [a] pre-existing set of principles and policies" that involves the board, stockholders, and management.[269] However, there may be changing standards on best practices in corporate governance given relevant social issues. For example, anti-harassment covenants were added to the National Venture Capital Association's model Inves-

make sure company is held accountable to stockholders, customers, community at large, and employees"; subscribes to stakeholder theory).

264. Interview with Lawyer #12, *supra* note 148. Although, even if there is a general belief of good actors, investors still conduct background checks on company founders. Interview with Lawyer #3, *supra* note 134.

265. *E.g.*, Interview with Lawyer #28, *supra* note 140; Interview with Lawyer #3, *supra* note 134 (observing that a corporate framework only works to the extent people make a good faith effort to follow the rules).

266. *E.g.*, Interview with Lawyer #2, *supra* note 142 (explaining that the board wants to solidify its company's infrastructure a few years before the IPO to professionalize the board); Interview with Lawyer #3, *supra* note 134.

267. Interview with Lawyer #4, *supra* note 199; Interview with Lawyer #19, *supra* note 239. Clients generally will implement corporate governance mechanisms when lawyers suggest it, but it may take some time because they're focused on other things at the company. Interview with Lawyer #4, *supra* note 199. Founder-management directors in particular fall into this category and experienced counsel can help these directors—typically first-time entrepreneurs—head off challenges at the outset regarding proper documentation and learning what requires board-level decisions. Interview with Lawyer #19, *supra* note 239.

268. Interview with Lawyer #2, *supra* note 142 (describing the corporate governance process as a "training wheel exercise").

269. Interview with Lawyer #12, *supra* note 148 (citing investment policy, budget, mission statement, etc.).

tors' Rights Agreement in the aftermath of the #MeToo movement.[270]

Theoretically and practically, management is focused on the operation of the business.[271] Management is supervised by the board, which is elected by stockholders.[272] The lawyers need to ensure that management is aware of what must and should be approved based on fiduciary duties of care and loyalty.[273] It is important for the board, with the help of counsel, to understand when the vote of stockholders is required.[274] Some of these votes are regulated by contract, while others are necessitated by the Delaware General Corporation Law.[275]

The interviewees largely agreed that when the company is doing well, the board focuses on growth and how to maximize the rate or return; it does not prioritize compliance.[276] However, the investor directors, with the help of counsel, implement processes to ensure that management does not abuse its power; the less power VCs have, the less governance is prioritized.[277]

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270. *Model Legal Documents: Investors' Rights Agreement*, NAT'L VENTURE CAP. ASS'N, https://nvca.org/model-legal-documents/ (last visited Dec. 4, 2021). This was likely tied to the spotlight shown on sexual harassment in the aftermath of the #MeToo movement. Press Release, Nat'l Venture Cap. Ass'n, NVCA Unveils Resources to Help Address Sexual Harassment in Venture Ecosystem, https://nvca.org/pressreleases/nvca-unveils-resources-help-address-sexual-harassment-venture-ecosystem/; Interview with Lawyer #16, *supra* note 215 (noting that these type of riders appeared after #MeToo); Interview with Lawyer #3, *supra* note 134 (noting more attention regarding foreign investments and the Committee on Foreign Investment in the United States compliance).

271. Interview with Lawyer #13, *supra* note 184.

272. *Id.* (observing that stockholders delegate their power to the board to supervise management executives).

273. *Id.*

274. *Id.* (pointing to material transactions and mergers as needing stockholder approval).

275. *Id.* For example, under DGCL § 271, stockholder approval is required before the board may enter a transaction to sell, lease, or exchange all or substantially all of a corporation's assets. DEL. CODE ANN. tit. 8, § 271 (1953).

276. Interview with Lawyer #12, *supra* note 148; *see also* Interview with Lawyer #7 (on file with author) ("When a company is doing well . . . [there is] more comfort on relaxing oversight on the corporate governance side . . . [, which] can be correlated with good economic times.").

277. Interview with Lawyer #12, *supra* note 148.

As noted previously, there is a wide variety of investors in startups. The primary investors discussed in this Article are VCs, focusing on how they fulfill their role as investor directors.[278] Venture capitalists are often thought of as the better monitors when compared to the founder-management directors or independent directors.[279] As one survey respondent stated in responding to the question about which board member is the better monitors for startups, "[t]he question really has two facets: VCs are financial investors who know the [c]ompany's space and are motivated to more carefully monitor and assist the [c]ompany as it scales. They may have conflicts in some cases, of course, which is where corporate governance protections apply."[280] One respondent also cautioned about investor directors that defer to persuasive founders (implying that it may be to the company's detriment).[281]

As investor directors, VCs may also modify their positions on the type of corporate governance mechanisms they want to implement based on the other institutional investors on the board. For example, a VC investor director may take a riskier stance on corporate governance matters if they are the sole institutional investor as compared to when there are other institutional investors on the board.[282]

Venture capital investor directors can be bifurcated in two ways: those from large VC firms and those from small ones. Investors from large VC firms sometimes bring other, more junior partners to the boardroom with them.[283] This may change the dynamic as optically there are more people in the room associated with the VCs.[284] In contrast, the investor di-

278. *Cf.* Interview with Lawyer #26, *supra* note 143 (observing that CVC investors are flexible when companies want them to stay away). In contrast to VCs, most active, sophisticated corporate investors shy away from board seats and take board observer seats. *Id.*

279. *See* Pollman, *supra* note 3, at 200.

280. Corporate Governance Survey, *supra* note 108, at Question 14.

281. *Id.*

282. Interview with Lawyer #23, *supra* note 241 (observing that it becomes a question of how much power an investor director will exert if there are other investor directors to keep them in check).

283. Interview with Lawyer #6, *supra* note 97 (noting that more junior investors will do financial modeling and diligence for the company).

284. *Id.* Large VCs may have formal observer rights for the investors that accompany them or a handshake arrangement with the company that allows them to attend at the discretion of the company. *Id.* One lawyer noted that

rectors from small VC firms, although perhaps not as influential as the other board members, may be "more in the weeds" and more plugged in to what the company is doing.[285]

Seasoned investor directors are extremely valuable because of the broad network they can bring to bear.[286] They can also help to focus the meeting in a constructive way because they have a reflexive understanding of the market; they see a number of similarly-situated companies in the same space.[287] Put differently, investor directors have a wealth of experience and perspective that management does not have.[288] Their biggest input is on which individuals should comprise management and their support (or lack thereof) of that team.[289] Investor directors also serve an important role in getting other sources of funding.[290] In addition, they value and have protective provisions to insulate them from downside scenarios.[291] Since many VCs are early-stage investors, they generally are not looking for a quick exit and intend to be a partner to the company for the long term.[292] At their best, investor directors do everything that they can to help the company succeed: they bring connections to bear to help grow the business, serve as a

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some VC investors who did not get a board seat may be given a board observer seat instead and that she advises boards to be thoughtful about how many people are in the board room as it may affect board dynamics. Interview with Lawyer #19, *supra* note 239. *See also* Interview with Lawyer #6, *supra* note 97; Interview with #15, *supra* note 144.

285. Interview with Lawyer #6, *supra* note 97.

286. Interview with Lawyer #29, *supra* note 154; *see* Interview with Lawyer #18, *supra* note 98 (explaining that investor directors have industry contacts including accountants, bankers, and lawyers). Seasoned director investors can offer guidance informed by experience. Interview with Lawyer #29, *supra* note 154 ("I've had a client that went through what you're going through. This is how they handled it.").

287. Interview with Lawyer #29, *supra* note 154 (describing investor directors as doing an audit of the company's direction).

288. Interview with Lawyer #26, *supra* note 143 (citing investor directors' broad experience with other portfolio companies).

289. *Id.*

290. *Id.* An investor director's fundraising effectiveness also depends on their background (e.g., investment banker or chief investment officer). *Id.*

291. Interview with Lawyer #20, *supra* note 252.

292. Interview with Lawyer #23, *supra* note 241. However, investor directors are ultimately investing to make money. *Id.* Investors may also temper the optimism of founders with the reality that they observe across their portfolio companies. *Id.*

sounding board, and play the role of coach to key management.

A herd mentality may also be present among the VC investor directors. For example, if a prominent VC invests, others likely will follow.[293] There is the tension of whether the investor directors are thinking about their fiduciary duties as board members or their VC firm's reputation.[294] Based on years of experience, some lawyers believe that investor directors have a "heightened focus on bigger, more valuable companies."[295]

On the positive side, VC investor directors are aligned with the company because they want it to succeed.[296] They are very engaged and have a sense of what the company's metrics should be.[297] These directors also have a good understanding of corporate governance matters.[298] Investor directors understand corporate governance more than the other directors. They will know when it is necessary to bring lawyers into a discussion and will ask about necessary approvals and conflicts.[299]

The lawyers were all in agreement that one of the biggest contributions of investor directors is that they can give insight into what they see other portfolio companies do and make connections for critical hires, customers, and future board members.[300] If they understand their fiduciary duties, they will also ask probing questions.[301] However, they may not give the same degree of attention to each of their portfolio compa-

293. Interview with Lawyer #29, *supra* note 154.

294. Interview with Lawyer #2, *supra* note 142.

295. Interview with Lawyer #28, *supra* note 140.

296. Interview with Lawyer #30, *supra* note 137. Investors are comfortable giving founders more power to make decisions because they understand that "they are boots on the ground" and are more aware of what needs to happen for a company to grow. Interview with Lawyer #28, *supra* note 140; *see also* Interview with Lawyer #12, *supra* note 148.

297. Interview with Lawyer #30, *supra* note 137 (explaining that VC investors are "deep in the rhythm" of what metrics companies should be hitting because they are on numerous boards); Interview with Lawyer #1, *supra* note 192 (noting that investor directors invest for a living and have a wider view based on experience with peer companies).

298. Interview with Lawyer #18, *supra* note 98 (explaining that investor directors will often query whether lawyers should get involved, what approvals may be required, and if any conflicts exist).

299. *Id.*

300. Interview with Lawyer #17, *supra* note 190 (explaining that investor directors can help management deal with high level issues).

301. *Id.*

nies.[302] Since they cannot necessarily devote the time each company requires, they may rely more on management.[303] Ultimately, as non-management directors, investor directors' ability to see things through is limited.[304]

The investor directors' perspective is also influenced by the fact that they are compensated by their firms to sit on boards; they are effectively professional board members. Also, investor directors have not necessarily been managers in the past, so they cannot necessarily bring that particular experience to bear in their director capacity.[305]

Some investor directors may sit on up to ten boards.[306] From a practical perspective they may need to acquiesce on some matters so they can be a part of an investment. In downturns, the investors have "more backbone" and are likely to be adamant about the downside protections they will need in order to invest in a company.[307] Ultimately, when a company takes investor money, both parties are agreeing to share power.[308] At some points, each side may have more or less leverage.

In order to attain exponential growth and to dominate the market, the founders and investors who are on the board may also opt to be unconstrained by corporate governance mechanisms that would otherwise be in place if capital were not so abundant and non-traditional investors (also known as tourist VCs or tourist investors) did not abound.[309] Over three-fourths of the respondents in the survey strongly agreed/agreed with the following statement: "As long as valuations of private companies remain high and 'tourist VCs' continue to invest, corporate governance matters will be less important than obtaining high valuations for such companies."[310] One

302. *Id.*

303. Interview with Lawyer #25, *supra* note 156 (stating that investors are going to be forced by necessity to rely on management to execute business plans).

304. *Id.* ("[D]irection com[es] from [the] board, but [investor directors are] relying on executives to execute.").

305. *Id.*

306. Interview with Lawyer #15, *supra* note 144. Investor directors on multiple boards may have teams of people helping them to review things. *Id.*

307. *Id.*

308. *Id.*

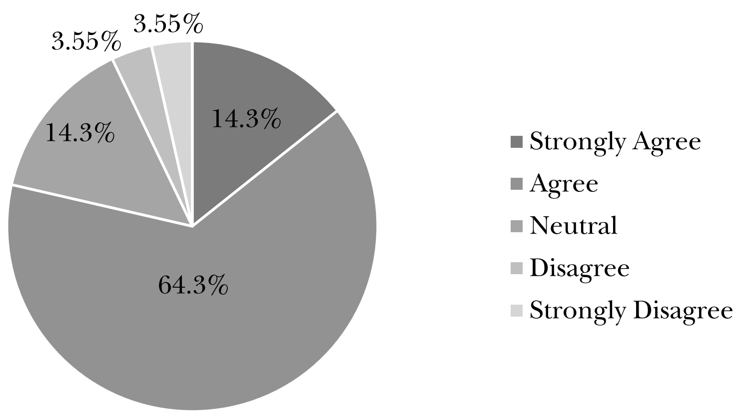
309. *See supra* note 29 and accompanying text.

310. Corporate Governance Survey, *supra* note 108, at Question 16.

respondent analogized the large amounts of money available to startups to being inebriated and said that less money needed to be offered before startups focused on corporate governance matters: "Startups are no different than the rest of the market. Someone needs to take the punch bowl away if you want everyone to sober up."[311] For some, the potential for a big payout for investors was the ultimate motivating factor. "Unicorns cure a lot of sins for early investors."[312]

FIGURE 3: SURVEY RESULTS

As long as valuations of private companies remain high and "tourist VCs" continue to invest, corporate governance matters will be less important than obtaining high valuations for such companies.



This, in turn, impacts the private ordering that occurs as a result of the staged financings.[313] According to Marc Andreessen and Ben Horowitz, the co-founders of the VC firm Andreessen Horowitz, "to make the decision to be a founder (a job fraught with likely failure), an individual needed to be so confident in her abilities to succeed that she would border on being so self-absorbed as to be truly egomaniacal."[314] Andreessen and Horowitz continue by stating that given the high failure rates of startups, "[founders] have to be partly delusional

311. *Id.*
312. *Id.*
313. *See* Gilson, *supra* note 19, at 1069.
314. KUPOR, *supra* note 22, at 47.

to start a company given the prospects of success and the need to keep pushing forward in the wake of the constant stream of doubters."[315] It is in the face of this narrative—larger-than-life founders (e.g., Travis Kalanick and Adam Neumann) with a single-minded focus who are able to do as they please—where the corporate governance mechanisms may begin to function poorly. The investor directors may have given the founder-management director more control than is prudent.

According to the interviewees, one of the biggest challenges to corporate governance is board dynamics.[316] Analogizing VCs to the "cool kids," one lawyer observed that there is a constant tension between the VCs and the rest of the board; VCs also still struggle with whether they are acting in what is in the best interest of their VC firm or the company.[317] An additional complication arises when new directors join the board; it is like "introducing new fish into an aquarium."[318] The corporate governance structure as currently constructed keeps the company on task.[319] One lawyer estimated that "90% of [the] landscape" is what he would describe as "best practices."[320] Lawyers work with the management team and board on what they want the governance to look like—"it's season to taste."[321] The assumption is that the board wants oversight, but that may not be true.[322] It is important to communicate and set up a system that works for everyone.[323] For example, management could use practical tools such as getting a "thumbs up approval" where the material terms of the deal are socialized

315. *Id.* at 47–48.

316. Interview with Lawyer #2, *supra* note 142 (citing the need for EQ to succeed and that it was "all relationships" at the end of the day).

317. *Id.*

318. *Id.*

319. Interview with Lawyer #29, *supra* note 154 (noting that the conversations among board members help to keep the corporate governance structure running smoothly).

320. Interview with Lawyer #1, *supra* note 192.

321. *Id.* Some boards may be less involved and not want to vote on certain things that other boards may want to vote on—for example, they may want a lease approved even if it is not required. *Id.*

322. *Id.* The lawyer gave the example of a company asking for board approval for a $10,000 bonus to an employee, and the board responding that this matter does not need approval; the CEO should have the flexibility to give the bonus if she thinks it's appropriate and the board does not need to be involved. *Id.*

323. *Id.*

in between a regularly scheduled board meeting before it is voted on to ensure that that the company has support for the deal from the board. In essence, the deliberative process and conversations have already occurred outside of the board meetings.[324] The lawyers add value by giving data points on how other companies have voted on other deals and what points they consider in making their decision.[325] Lawyers also work with their startup clients to have governance measures gradually implemented. It is a "huge win" if a company receives board consent in the early stages of a company.[326] The goal is to get founders to understand their roles and that the entity is not them as individuals.[327] Ultimately, the feedback loop created in corporate governance in private companies leads to a normative/narrative framework, which is one of the reasons why corporate governance can work in startups without bright-line rules. The implementation of corporate governance is an iterative process that evolves over time; it is influenced by board dynamics that are unique to each board because of the different individuals with different motivations and goals involved.

For early-stage companies, the bare minimum is to convince founders to act according to their respective titles. For example, founders need to understand that they must sign in their capacity as directors (not founders) when board matters are concerned and that records must be kept for certain matters.[328] Early-stage corporate governance also involves 701 compliance, 409A reports, and option approvals.[329] Only founders who have a "ton of leverage and confidence" have later-stage board control.[330] With respect to founder-friendly terms, if a company has investment interest from a number of parties,

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324. *Id.*

325. *Id.* (noting that lawyers are routinely in board meetings and can share relevant data points).

326. Interview with Lawyer #21, *supra* note 134.

327. *Id.* (noting that it may take some time for founders to understand this).

328. *Id.*

329. Interview with Lawyer #2, *supra* note 142 (explaining that options need to be granted correctly and the $10 million trigger for disclosure needs to be monitored)*; see also* I.R.C. § 409A; 17 C.F.R. § 230.701 (2021).

330. Interview with Lawyer #21, *supra* note 134.

the leverage model is inverted, and the investors will agree to such terms being a part of the deal.[331]

As startups mature, they create committees and hold regular board meetings.[332] By Series B or Series C, the company operates with more corporate governance mechanisms in place.[333] For example, the company begins to form committees and have discussions about which directors are independent.[334] With later-stage companies, the issues are different too. Companies may be considering buying another company or being acquired; therefore, there might be conflicts of interest.[335] Early-stage corporate governance is analogous to starting kindergarten and, in later stages, it is like attaining a Ph.D.[336] There is a correlation between the maturity of the business and the sophistication of the issues. Generally, the lawyers did not necessarily believe that more governance is better; ultimately, since each company was uniquely situated, there was "no cookie cutter answer."[337] There are times, however, when lawyers point out that certain matters, ranging from important personnel matters to highly unique terms in a term sheet, need to go to the board.[338]

The hard decisions, such as capital planning and exit planning, to name a few, all have the potential for conflict. To make these decisions from a corporate governance perspective, the startups need to know what is required by statute and

331. Interview with Lawyer #1, *supra* note 192 (citing Uber as an example of a company that received founder-friendly terms).

332. Interview with Lawyer #21, *supra* note 134. Before financing or the first outside director, board meetings are held rarely, especially if there is only one founder, in which case the board usually acts by unanimous written consent. *Id.*

333. *Id.* (analogizing this change to training wheels coming off).

334. *Id.* (noting that the first committee to be formed is usually the compensation committee).

335. Interview with Lawyer #1, *supra* note 192. For example, how should the board address the potential conflict created by its VC investor's investment in one of the companies the board was looking at acquiring? The board needs to understand if there is a conflict of interest and whether the VC investor director needs to be recused from the vote deciding whether to pursue the acquisition. *Id.*

336. *Id.*

337. *Id.* (noting that corporate governance can sometimes be distracting or paternalistic).

338. *Id.*

by governing documents.[339] More nuanced fiduciary duties are overlaid on top of that.

b. Corporate Governance in Good Economic Times

Startups are staying private longer.[340] Former Chair of the SEC, Mary Jo White, gave a talk in Silicon Valley, which many regarded as a wake-up call to private companies to put corporate governance mechanisms in place.[341] Adopting such mechanisms, however, is a gradual process.[342] Especially during good economic times, the board focuses less on corporate governance issues and may not ask the tough questions.[343] Put differently, the board will not affirmatively seek out information.[344]

There is not a "binary shift" in corporate governance in good versus bad economic times.[345] Corporate governance is not perfect but works well.[346] Many of the owners sit around

339. Interview with Lawyer #26, *supra* note 143 (referring to governing documents prepared in connection with financings regarding board composition and negative covenants, i.e., certain decisions in which investors have blocking rights).

340. Pollman, *supra* note 3, at 175. *See* Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337 (2013) (discussing the public–private divide and when a private enterprise should be required to take on public status); *see also* George S. Georgiev, *The Breakdown of the Public–Private Divide in Securities Law: Causes, Consequences, and Reforms*, 18 N.Y.U. J.L. & BUS. 221 (2021).

341. Mary Jo White, Chair, U.S. Sec. Exch. Comm'n, Keynote Address at the SEC-Rock Center on Corporate Governance Silicon Valley Initiative (Mar. 31, 2016), https://www.sec.gov/news/speech/chair-white-silicon-valley-initiative-3-31-16.html (stating that the SEC would pursue fraud and urged startups to put internal controls and disclosure controls in place). SEC Commissioner, Allison Herren Lee, recently called for more disclosure by private companies, noting that "disclosure obligations that do exist are mostly a matter of contract rather than regulation, an approach that may affect both compliance and accuracy." Lee, *supra* note 90 (citing Fan, *supra* note 84).

342. Interview with Lawyer #2, *supra* note 142 (noting that the process starts with committees and off-the-shelf company charters).

343. Interview with Lawyer #10, *supra* note 141; Interview with Lawyer #30, *supra* note 137 (noting that as long as a company is perceived by investors as a hot deal there is not as much scrutiny, but that there is increased scrutiny if the company is not doing as well).

344. Interview with Lawyer #1, *supra* note 192.

345. Interview with Lawyer #15, *supra* note 144.

346. *Id.*

the board table and the board understands what really matters to a business in a way that public company boards do not.[347]

One of the biggest differences in private companies, other than valuation in good versus bad economic times, is the evolution of corporate governance.[348] Before the advent of founder-friendly terms, there would be numerous protective provisions, a separate series vote, and a more balanced board.[349] In the founder-friendly era after the Great Recession, in order not to increase a company's valuation, VCs would give holders of common stock more control over the board or control over the nomination of an individual director.[350] There would also be fewer protective provisions.[351] Although baseline material control decisions remained intact, investor directors no longer had a say in operational decisions.[352] In this way, the parties were potentially misaligned in terms of their goals, and this resulted in corporate governance functioning in a way that was unintended because the founder had all the leverage.[353] One could also argue that VCs may create bad governance because they are financially motivated.[354] Regardless of what structure is put in place, the corporate governance framework "is all there; it's just whether it is utilized or not."[355] In good times it is easier for boards to "go

347. *Id.*

348. Interview with Lawyer #14, *supra* note 152. Public company boards can also face dynamics similar to private company boards, although public companies operate under a robust set of stock exchange and SEC rules. *See, e.g.*, 17 C.F.R. § 249.310 (requiring public companies meeting certain criteria to submit annual reports); NASDAQ, INITIAL LISTING GUIDE (2021), https://listingcenter.nasdaq.com/assets/initialguide.pdf (detailing Nasdaq requirements for public companies).

349. Interview with Lawyer #14, *supra* note 152 (noting that VCs would use the board control lever so as not to impact economics in a competitive environment).

350. *Id.*

351. *Id.* (explaining that protective provisions would be limited to four or five, including those related to sale of the company, new financing, dividends/distributions/redemptions, change in the number of directors, and changes in charter or bylaws). There would also be a blended preferred vote instead of a series vote. *Id.*

352. *Id.* (e.g., blocks over debt, equity incentive plans).

353. *Id.* The argument on the other side would be that management control eliminates potential misalignment with venture investors. *Id.*

354. *Id.*

355. *Id.*

astray."[356] The investors want to keep the founder-management directors happy because they want their pro rata share of a company in future rounds.[357]

When a company meets its metrics and management exhibits credibility to the board, the board may relax oversight on corporate governance.[358] There are also fewer corporate governance issues in good economic times. The primary responsibility of the board in good economic times is holding regular board meetings and making sure the board has oversight.[359] The "[r]epeat entrepreneur who's been successful will be given more deference."[360] In fact, there is less reason for there to be conflict even with different economic interests among the directors because the expectation is that everyone benefits.[361] There are also certain types of transactions that are more likely to occur in good economic times, such as the repurchase of stock and secondary transactions.[362]

c. Corporate Governance in Bad Economic Times

The interviewees concurred that in bad economic times, boards are even more engaged and meet more frequently.[363] Due to COVID-19, boards are "meeting a lot more . . . because portfolio companies [are] facing unique challenges right now."[364] This is true of both companies that are doing well and those that are in trouble.[365] Investor directors take an ac-

356. Interview with Lawyer #21, *supra* note 134.

357. *Id.* (observing that the way VC financings are structured incentivizes VC investors to play along with the founder/management directors in good economic times).

358. Interview with Lawyer #7, *supra* note 276.

359. *Id.*

360. *Id.*

361. Interview with Lawyer #15, *supra* note 144 (noting that directors are "all co-equals around the board table").

362. Interview with Lawyer #17, *supra* note 190.

363. Interview with Lawyer #28, *supra* note 140; Interview with Lawyer #13, *supra* note 184 (noting that rocky economic times and potential insolvency mean that boards need to meet more often and establish a record that reflects engagement and the preservation of resources); Interview with Lawyer #17, *supra* note 190 (observing that since the pandemic, investor directors are more cautious, asking more questions, and digging deeper into management thinking).

364. Interview with Lawyer #7, *supra* note 276.

365. Interview with Lawyer #28, *supra* note 140.

tive role.[366] One lawyer characterized VC investor directors as "dictatorial" on changes in the business when they have leverage.[367] Founder or management directors are in frequent contact with board members outside of board meetings.[368] "Governing is more at the forefront of what people are thinking about . . . [a] large part of it is [the] media spotlight."[369] When things are going well, people tend to not look at underlying issues, or they're not noticeable.[370]

Everyone is also more careful in bad economic times.[371] Typically, the minutes reflect: "Questions were asked and answered. Discussion ensued."[372] But when economic times become difficult, the board requests that more discussion be reflected in minutes. For example, the minutes will state the factors discussed by the board (without attributing the comments to any specific individual) and the board will meet multiple times.[373] In a pay-to play-situation (where prior investors need to participate in their full pro rata percentage in a financing otherwise they lose certain rights), the minutes reflect that the company reviewed other term sheets, and that a banker or third-party evaluator was hired.[374] If there is an interested board member in a transaction, the minutes will reflect that

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366. *Id.* (describing, for example, investor directors specifically stating the company needs to close certain offices or have layoffs); Interview with Lawyer #17, *supra* note 190 (observing that with an engaged board, investor directors offer their networks, help with employee talent and financials, and meet informally on a more regular basis). *But cf. id.* (noting CEOs keep investor directors informed, but that VCs may not be responsive unless the company is a promising one).

367. Interview with Lawyer #13, *supra* note 184.

368. Interview with Lawyer #28, *supra* note 140 (observing that companies are getting advice from board members and strategizing about how to raise more money; for those founders who are less quantitative, and haven't been through a downturn, the hard cuts are more difficult).

369. Interview with Lawyer #10, *supra* note 141.

370. Interview with Lawyer #30, *supra* note 137. Prior to the financial crisis in 2008, companies were hiring for growth and understood there were inefficiencies but thought they could raise another round of funding. *Id.* After 2008, companies were forced to address the underlying issues and the question became how to "right size the business." *Id.*

371. Interview with Lawyer #21, *supra* note 134.

372. *Id.*

373. *Id.* (describing an example in which a board discussed factors relating to the "necessity" of PPP loans and recorded those discussions in the minutes, even when rejecting the money).

374. *Id.*

other board members discussed the deal without that member present.[375] Although board decks are presented at the meeting and saved, they may not be attached to the board minutes because the entire deck is not self-explanatory.[376] More committees are generally formed during these periods as well.[377]

In the era of Paycheck Protection Program ("PPP") loans,[378] startups agonized over whether they should even apply for the loans.[379] The guidance from the U.S. Treasury was unhelpful, ambiguous, and changed rapidly.[380] In contemplating whether to take the loans, many board members considered what people might say in hindsight.[381] In evaluating whether to apply for such loans, investor directors have been more conservative than founder-management directors.[382] Robust records were created as part of the decision making process.[383] The lawyers and the board wanted to document the conflict around PPP loans to show that the board faced the issues and wrestled with them. They were intentional about allowing discussion to spill over into an actual board meeting;

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375. *Id.*

376. *Id.*

377. *Id.*

378. One lawyer described PPP loans as a "surgical exercise." Interview with Lawyer #29, *supra* note 154.

379. Interview with Lawyer #10, *supra* note 141 (sharing that some companies even applied for loans without telling their boards, so the boards needed to ratify such loans and have a more fulsome discussion).

380. Interview with Lawyer #14, *supra* note 152 (noting "terrible guidance").

381. Interview with Lawyer #10, *supra* note 141 (noting that in many instances, when the board discusses something contentious, the minutes need to reflect lengthier discussions and factors involved in decision making process; "minutes are more art than science" and there is a "fine line between having too much or too little").

382. Interview with Lawyer #7, *supra* note 276 (stating that this is in part due to the fact that founders are dealing with the day-to-day pain and investors are not).

383. Interview with Lawyer #5, *supra* note 173; Interview with Lawyer #29, *supra* note 154 (noting how their law firm developed internal processes regarding PPP loans which included reviewing relevant documents implicated by PPP loans, conducting a preliminary analysis regarding potential pitfalls, and working with government contracts lawyers to understand PPP loans; lawyers also suggested ways to move the process forward); Interview with Lawyer #14, *supra* note 152 (sharing that lawyers advised companies on how to build a file as a backstop against future regulatory inquiries about whether the company should have taken the loan or not).

these discussions also reflected the fact that guidance was changing in real time and views may have changed based on evolving guidance.[384] Management would present a memo to the board about why they needed the money and the board would review the memo.[385] More robust practices around hiring and firing also are implemented during bad economic times, such as obtaining releases with severance or approaching compensation differently to conserve cash.[386]

Generally, in bad markets, "internal controls and financial attention ramp[ ] up; people [are] watching everything more closely."[387] In downturns, the focus is on operations.[388] Companies are more careful when they do not have access to capital that is not "massively dilutive."[389] There is also more scrutiny on financials of the company, and the VCs do not want to give money earlier than they need to.[390]

In recessionary times, everyone cannot win.[391] No single set of terms is standard in bad economic times. Either independent or investor directors (who are not lead directors like Series A with difficult economics) are the "moderating voice

384. Interview with Lawyer #26*, supra* note 143 (noting that companies would often turn to lawyers for guidance).

385. Memos provided the board with information about the impact of COVID-19 and the related economic fallout based on their business, including: measures the company had already taken to address the fallout (e.g., management took pay cuts), how the economic fallout impacted the company's operating plan, and quantitatively and qualitatively how it affected the operating plan and the company). *Id.*

386. Interview with Lawyer #11, *supra* note 168.

387. Interview with Lawyer #12, *supra* note 148 (noting that the ramp-up of internal controls and financial attention are more a function of management than investors).

388. Interview with Lawyer #30, *supra* note 137 (giving examples of what clients look at from an operational perspective: monthly burn, cash flow, how runway could be extended). During a downturn, companies focus on the existential risk of not getting a round of funding. *Id.*

389. Interview with Lawyer #12, *supra* note 148 (observing that companies in such situations behave better).

390. Interview with Lawyer #17, *supra* note 190 (noting that generally there is a fifteen to twenty-four month burn rate for startups; in the beginning of the pandemic pre-money valuations were down and there was a wait-and-see approach).

391. Interview with Lawyer #26, *supra* note 143 (citing liquidation preferences and anti-dilution adjustments and the fact that investors putting in new money will ask for special preferences in bad economic times).

looking out for interests of all stockholders."[392] There are inside transactions, down rounds, recapitalizations, and exits in which some or all investors are taking liquidation preference instead of as-converted preference.[393] There also may be down round financial arrangements, which come with a whole suite of potential peril.[394] In addition, there are more distressed-company-type exits in which no one gets consideration.[395] Lawyers play an educating role and help boards to think through what happens when things do not go well.[396] There are fact patterns that come up far more often in recessionary periods, and governance questions become increasingly difficult.[397] These patterns include existing investors funding rounds. These inside rounds create governance issues that are harder and more complex because there is less alignment, and there may not be a disinterested director.[398] Companies enter into a "morass of conflicts"[399] with investor directors when there is a down round, which is more likely to be led by past investors who now sit on the board. If there is a pay-to-play provision, this may cause economic hardship to insiders who cannot meet their pro rata share. This is where the company encounters significant corporate governance challenges because those who are setting the terms have fiduciary duties.[400] Corporate governance becomes even more important during these times because there are more immediate consequences to what the board is doing, and startups need to ensure that

392. Interview with Lawyer #7, *supra* note 276.

393. Interview with Lawyer #26, *supra* note 143 (stating that lawyers spend a lot more time counseling on the issues above, process points, documentation on thought process, and explaining why the transactions are best for the stockholders).

394. Interview with Lawyer #7, *supra* note 276 (citing related party transactions, insider-led rounds and lawsuits as examples).

395. *Id.* (pointing to example of startups not clearing preference stack (e.g., *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 36 (Del. Ch. 2013))).

396. *Id.* (noting how lawyers help startups think through issues; for PPP loans there were a lot of conversations at the board level and lawyers looked at affiliation and necessity certification).

397. Interview with Lawyer #26, *supra* note 143 (stating that in part the difficult corporate governance issues are due to the capital structure of a company—e.g., how liquidation preference and anti-dilution protections are set-up).

398. *Id.*

399. Interview with Lawyer #13, *supra* note 184.

400. *Id.*

they are following corporate governance practices, such as giving adequate notice for board meetings.[401] There may also be an increasing number of side letters at the convertible note stage that may carry over to equity financings.[402]

Out of self-preservation, "when [the] ability to access capital markets is restricted, people will [significantly] tighten governance."[403] When a budget is set, the company will stay within the confines of the budget.[404] In bad economic times, the "economic divergence [among stockholders] becomes more meaningful."[405] Most VCs are aware of risks and give more attention to process than they did ten years ago.[406] In deals, more onerous terms, redemption, liquidation preference, and the like become increasingly common.[407]

The board is always managing for the future, but particularly when there is an economic downturn, boards are evaluating the company's liquidity position, the right time to raise capital and how to minimize subsequent dilution (which is not aligned with the company's interests or the interests of stockholders).[408] If the fund of an investor director does not have dry powder to invest in future rounds, it creates a significant challenge within the board dynamic.[409] The COVID-19-related downturn also created unique challenges that differed from other downturns because of social media and the PPP loans.[410] People wanted to be *perceived* as doing the right thing, whether

401. Interview with Lawyer #22, *supra* note 186.

402. Interview with Lawyer #5, *supra* note 173 (observing that the number of side letters are "astronomical" for smaller investors post-COVID even at the Seed or Series A stage of financing and that negotiating with both the lead investor and smaller investors is costly for companies).

403. Interview with Lawyer #12, *supra* note 148.

404. *Id.*

405. Interview with Lawyer #15, *supra* note 144; *see also* Interview with Lawyer #18, *supra* note 98 (citing tendency to diverge in what path the startup takes—selling company, taking on more debt, or raising more equity).

406. Interview with Lawyer #15, *supra* note 144.

407. Interview with Lawyer #18, *supra* note 98 (noting that deals are getting done, but terms are getting uglier).

408. Interview with Lawyer #9, *supra* note 187.

409. *Id.* (noting that the investor director's voice may carry less weight and management may become frustrated with them).

410. Interview with Lawyer #24, *supra* note 213.

it was with respect to taking the PPP loans or bringing employees back to the office.[411]

In the absence of an economic downturn, IPOs and acquisitions can serve a disciplining function as well.[412] Down rounds—financing rounds in which the company receives a lower valuation than in prior rounds—also have a disciplining effect.[413] The disciplining function mentioned at various times throughout this Article entails implementing more robust corporate governance measures to correspond to the increasing complexity and size as the startup matures. "Investors generally wait to[o] long to call Founders out on bad decisions and to make management changes, even when they have the power to do so."[414] As one survey respondent observed, more attention is given to corporate governance issues at the later stages of the company because they "have more at stake, [and] the dollars involved are higher."[415] Furthermore, "later[-]stage companies are more likely to shift focus to governance, and to take governance matters seriously."[416] There are also differences in severity of corporate governance problems at a later stage. "The governance problems at the early stage are generally procedural (everyone is aligned but not going through the full governance process) and the later-stage problems are substantive."[417]

Some of the commentary pointed to the importance of appropriate corporate governance, regardless of stage or value of the company.[418] For example, in the event that early-stage companies have corporate governance issues, they could po-

411. *Id.* (observing that people's reputation could go "in a nanosecond" if they were perceived to have made the wrong decision).

412. Corporate Governance Survey, *supra* note 108, at Question 19. However, acquisitions were a far more frequent occurrence than IPOs until recently. *Id.* One respondent noted that "in regulated industries, the regulatory environment itself is an important disciplining factor." *Id.*

413. *Id.*

414. *Id.* at Question 22.

415. *Id.* at Question 17.

416. *Id.*

417. *Id.*

418. *Id.* at Question 18 ("The importance of appropriate corporate governance remains the same regardless of value."). *But cf. id.* (Another respondent said, "Governance is important at all levels, though I do think its importance does grow with the company.")

tentially lead to larger problems later on.[419] In fact, "earlier stage companies are more likely to have corporate governance glitches because . . . they may not be well advised. The issues are just more glaring in late-stage companies."[420] In essence, each VC-backed private company forms its own narrative in this regard based on a set of norms that is influenced by case law, contracts, and best practices—to varying degrees.

Much of the criticism of VC-backed private companies centers around the growth-at-all-costs model that some view as "the sole driving mantra of Silicon Valley and the tech startup industry."[421] One person has characterized venture capital as the "'Wild West' where rule-breaking is a foundational principle."[422] On one hand, such a "philosophy can have enormous psychological benefits to entrepreneurs, who are often trying to accomplish what can seem impossible. By liberating themselves from the idea that things must remain the way they have always been, entrepreneurs take risks, challenge the status quo, and can even change the world."[423] But breeding such a culture can mean "that rules simply don't apply in [the VC] industry."[424]

4. *Diversity, Equity, and Inclusion Challenges*

The fourth and final key finding from the survey and interviews is that, while DEI issues took center stage in the public company corporate governance landscape,[425] there was not a

419. *Id.* at Question 17 ("The groundwork usually starts early. Bad governance practices early will compound in later rounds.").

420. *Id.*

421. Evan Epstein, *Why Governance Matters for Your Startup*, MEDIUM (Apr. 12, 2018), https://medium.com/@evan.epstein/why-governance-matters-for-your-startup-4424a3967882; *see also* Scott Lenet, *Venture Capital Desperately Needs More Governance*, FORBES (June 20, 2019, 1:52 PM), https://www.forbes.com/sites/scottlenet/2019/06/20/venture-capital-desperately-needs-more-governance/amp/.

422. Lenet, *supra* note 421.

423. *Id.*

424. *Id.* The author then points out that there is no school to learn how to be a VC nor are there any major or degree programs. *Id.* Furthermore there are no requirements for continuing education, professional certifications, or trainings. *Id.*

425. *See, e.g.*, CAL. CORP. CODE § 301.3 (West 2021). In addition to California, many other states have either passed or proposed some type of board diversity measure. Jennifer Fan, *Diversifying Startups and VC Power Corridors*,

similar prioritization in the startup ecosystem. In fact, the VC ecosystem continues to face challenges on the DEI front that may negatively impact corporate governance. Although U.S. fundraising continued to break records,[426] the beneficiaries of such funds were not women and minorities. Woman investors only comprise 13 percent of the VC industry, and two-thirds of VC firms still have no women partners;[427] for men and women of color, that number is even lower.[428] Women and minorities also receive less funding due to the interest in funding serial entrepreneurs and working within existing networks—which tend to advantage white males.[429] Furthermore, there are fewer women and minorities who are founders of companies and, in the age of COVID-19, the numbers contracted even

TECHCRUNCH (Aug. 29, 2021, 8:32 AM), https://techcrunch.com/2021/08/29/diversifying-startups-and-vc-power-corridors/.

426. *See, e.g.*, James Thorne, *US VC Fundraising Hits Record $69B in 2020 After a16z Closes Two Mega-Funds*, PITCHBOOK (Nov. 20, 2020), https://pitchbook.com/news/articles/us-vc-fundraising-hits-record-69b-in-2020-after-a16z-closes-two-mega-funds.

427. Erin Griffith, *Group Seeking Equality for Women in Tech Raises $11 Million*, N.Y. TIMES (Nov. 30, 2020), https://www.nytimes.com/2020/11/30/technology/women-tech-allraise.html.

428. DELOITTE, VENTURE FORWARD & NVCA, VC HUMAN CAPITAL SURVEY 8–10 (3d ed. 2021), https://www2.deloitte.com/us/en/pages/audit/articles/diversity-venture-capital-human-capital-survey.html. Over 80% of VC firms do not have a Black investor, which impacts the number of diverse investor directors. Gené Teare, *The Conversation and the Data: A Look at Funding to Black Founders*, CRUNCHBASE NEWS (June 5, 2020), https://news.crunchbase.com/news/the-conversation-and-the-data-a-look-at-funding-to-black-founders/.

429. Priyamvada Mathur, *Quarterly VC Funding for Female Founders Drops to Three-Year Low*, PITCHBOOK (Oct. 8, 2020), https://pitchbook.com/news/articles/vc-funding-female-founders-drops-low?utm_content=article-5084&utm_campaign=article_email&utm_source=sg&utm_medium=email. In 2019, only 11.5% of total venture capital funding went to teams with at least one female founder. Kate Clark, *US VC Investment in Female Founders Hits All-Time High*, TECHCRUNCH (Dec. 9, 2019, 11:06 AM), https://techcrunch.com/2019/12/09/us-vc-investment-in-female-founders-hits-all-time-high. In 2020, approximately 2.6% of total funding went to Black and Latinx founders. CRUNCHBASE, CRUNCHBASE DIVERSITY SPOTLIGHT 2020: FUNDING TO BLACK & LATINX FOUNDERS (2020), http://about.crunchbase.com/wp-content/uploads/2020/10/2020_crunchbase_diversity_report.pdf. Lawyer #11, *supra* note 168 (noting the differences in expectations between white entrepreneurs and Black entrepreneurs—white entrepreneurs will seek counsel with just an idea whereas Black entrepreneurs will not come until they have a term sheet in hand).

more.[430] Women are less likely to push for a board seat.[431] They also have a more difficult time getting funding.[432] The #MeToo and Black Lives Matter movements further highlighted the lack of diversity in the VC realm.[433] While there have been some attempts to address this issue through targeted funds and diversity riders,[434] there are still very few investors who are women and minorities.[435] As a result, there is a relative absence of such persons on the boards of startups. DEI issues continue to be one of the most intransigent issues for startups to address. Further, there is very little discussion

430. "Women own just 11 percent of founder and employee equity in start-ups, according to a study conducted by Carta, a financial technology start-up." Griffith, *supra* note 427. *See also The US VC Female Founders Dashboard*, PITCHBOOK (Nov. 5, 2020), https://pitchbook.com/news/articles/the-vc-female-founders-dashboard?utm_content=article-5084&utm_campaign=article_email&utm_source=sg&utm_medium=email. "Investments in women-led companies this year are on pace to be the worst since 2017." Mathur, *supra* note 429. Women are also underrepresented in merger and acquisition transactions. *See* Afra Afsharipour, *Women and M&A*, 12 U.C. IRVINE L. REV. 359 (2022).

431. Interview with Lawyer #5, *supra* note 173 (citing a new female startup CEO who did not get a board seat and received significantly less pay than the prior CEO).

432. *Id.*

433. *See* Natasha Mascarenhas and Jonathan Shieber, *Venture Firms Rush to Find Ways to Support Black Founders and Investors*, TECHCRUNCH (June 2, 2020, 6:43 PM), https://techcrunch.com/2020/06/02/diverse-startups-and-investors-matter/; Richard Robinson, *Venture Capitalists Must Do More Than Stand in Solidarity with Black Lives Matter*, FIN. TIMES (July 22, 2020), https://www.ft.com/content/55a4d2e1-4d2b-4f19-a9b8-11534df4c688. Despite the #MeToo movement, women, especially women of color, continue to face significant barriers. WOMEN WHO TECH, WOMEN WHO TECH STARTUP & TECH CULTURE SURVEY (2020), https://womenwhotech.com/sites/default/files/2020-09/WomenWhoTech_StartupAndTechSurvey2020.pdf.

434. Sophia Kunthara, *Investors with Proven Track Records of Diversity Funding Respond to National Crisis*, CRUNCHBASE (June 3, 2020), https://news.crunchbase.com/news/talk-is-cheap-investors-with-proven-track-records-of-diversity-funding-respond-to-national-crisis/; Alejandro Guerrero, *How Venture Capital Can Increase Diversity Where It Matters Most*, FORTUNE (Oct. 8, 2020 5:30 PM), https://fortune.com/2020/10/08/venture-capital-diversity-investing-vc-cap-table-rider/.

435. *See generally* Jennifer S. Fan, *Startup Biases*, U.C. DAVIS L. REV. (forthcoming 2023) (discussing biases faced by women and racial and ethnic minorities in startups).

about DEI issues in private companies.[436] This trend will likely continue unless DEI issues are prioritized in a meaningful way. Part IV will discuss in more detail what can be done to address this challenge in the corporate governance context.

* * *

In sum, corporate governance in startups is impacted by a variety of factors, including the power differential among the founders, investors, and independent directors who sit on the board of the startup; the influence of a founder-centric model; startups staying private longer; the race to exponential growth under the growth-at-all-costs mantra; and, more recently, an economic downturn. While VCs' economic interest animates their level of engagement in a startup, it is also tempered by a founder-centric model which translates to VCs deferring to founders and ceding control (that they otherwise might be leveraging) during good economic times. Furthermore, with respect to independent directors in the private company context, the survey and interviews suggest that they do not play the tiebreaker or moderating influence that some scholars assume. In addition, the author's empirical research demonstrates the important role that investor directors in particular play during bad economic times and how the contours of corporate governance are impacted. Lastly, despite the recent focus on DEI efforts in companies, the lawyers interviewed confirm that these efforts still remains a nascent concept from a corporate governance perspective unless a company is about to go public[437] or is addressing sexual harassment issues.[438] In some cases, there may be diversity riders.[439] There is very little

436. Interview with Lawyer #18, *supra* note 98; Interview with Lawyer #16, *supra* note 215 (noting that anti-harassment riders were added following #MeToo).

437. Interview with Lawyer #24, *supra* note 213 (stating that human resources, investor relations, and bankers are more influential in terms of diversity issues).

438. Interview with Lawyer #19, *supra* note 239 (citing language in contracts regarding the investigation and potential removal of a director if there are allegations of inappropriate conduct); Interview with Lawyer #16, *supra* note 215 (noting the addition of anti-harassment policies following #MeToo).

439. Interview with Lawyer #16, *supra* note 215 (noting that they can be found in the Investors' Rights Agreements).

discussion on such issues in the private company realm.[440] If there is any activity in DEI, it is typically in the later-stage companies and appears more in the hiring context.[441] Some lawyers have pointed out that it only becomes an issue if it is a "must," such as when WeWork was going public with an all-male board.[442] If DEI issues are discussed, such conversations are initiated by the founder-management directors or investor directors, but not the independent directors.[443]

IV.
Playbook for Corporate Governance Changes

This final Part looks at what should be changed in terms of the way that corporate governance currently operates in light of the shift to a founder-friendly model. The approach to implementing such changes will differ depending on the stage of the company, whether the founder(s) is a serial entrepreneur, and whether the company has sophisticated investors (who serve as investor directors) or independent directors.[444] Corporate governance in private companies is a delicate balance; bright-line rules or laws passed to govern private compa-

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440. Interview with Lawyer #18, *supra* note 98 (noting that even on the public company front, ISS and Glass Lewis have more influence on DEI issues); Interview with Lawyer #23, *supra* note 241 (observing that these issues are secondary and not top of mind).

441. Interview with Lawyer #6, *supra* note 97; Interview with Lawyer #17, *supra* note 190 (noting that such conversations may happen organically when someone notices that there are four men on the board and mentions that the company should have a woman director).

442. Interview with Lawyer #8, *supra* note 238 ("Boards will not address [DEI] until it feels like it must."); *see also* Jeff Green, *WeWork's All-Male Board Is Pretty Typical of IPOs These Days*, Bloomberg (Aug. 14, 2019, 1:31 PM), https://www.bloomberg.com/news/articles/2019-08-14/wework-s-all-male-board-is-pretty-typical-of-ipos-these-days.

443. Interview with Lawyer #8, *supra* note 238 (observing that with founder-management directors whether the conversation takes place depends on their own ideologies and preferences).

444. Interview with Lawyer #21, *supra* note 134 (noting that these outside directors "instill a lot of rigor"). *But cf. id.* (observing that these types of investors do not have the experience that VC investors do and also may not be as solid in their understanding of what corporate governance entails). Corporate governance does not operate as well if companies are bootstrapped at later stages or have smaller or angel investors. *Id.*

nies would not work to address its deficiencies.[445] Companies, particularly the founders who lead them, need to have the autonomy to determine what this balance looks like at different junctures in their growth.

While it is important for private companies to have the flexibility to determine how corporate governance mechanisms apply at different stages of their respective life cycles, there are still some important changes that should be considered to improve corporate governance in private companies. First, hold more trainings for directors, especially if there are first-time directors who fulfill a DEI purpose.[446] As a general matter, boards could benefit from more training either as a refresher to understanding their duties or learning about compliance issues that have increasing importance. This is particularly true of the founders who are primarily focused on the growth of the startup and may not have prioritized corporate governance, as noted in Part III above.

Second, more emphasis could be placed on forming committees. Particularly in challenging economic times, there may be transactions or matters that need to be supplemented with committees. As a company grows, the founders may experience challenges accompanied by such growth, especially if it is rapid. Committees become more important, and having dedicated time to discuss certain issues, such as compensation, ensures that proper attention is given to them. It is also an efficient process because the committee makes a recommendation to the board, and the board can immediately vote on it. As an example, if more diverse directors are prioritized, a nominating committee, similar to one in the public company setting, could be formed.

Third, as startups grow, their needs for workers change and become increasingly complex. Therefore, identifying culture risk in companies becomes important because it can affect corporate governance. Boards need to be diligent and re-

445. Pollman, *supra* note 3, at 216–20 ("The features of startup governance suggest that courts should be willing to apply fiduciary doctrine more flexibly . . . ."); *see also* Interview with Lawyer #1, *supra* note 192.

446. Interview with Lawyer #10, *supra* note 141 (stating that board trainings are typically done right before a company goes public; boards also need to be educated on topics like ESG that were not relevant 10 years ago); Interview with Lawyer #21, *supra* note 134 (noting that an education program works).

view culture and collect metrics on employee turnover, harassment complaints, diversity in the company, and the like on a regular basis. These risks need to be understood and managed at the outset, otherwise the company can become distracted by these issues instead of focused on the growth of the company.

Fourth, there should be renewed emphasis on IPOs, acquisitions, and financings as opportunities for more rigorous corporate governance measures to be implemented; founders can take the lead on this. Also, the close relationship between companies and their counsel means that there is a good chance that companies will listen to their counsel's advice about implementing corporate governance measures to prevent problems in the future. More specifically, although a late-stage private company may not be going public, preparing as if the company is going public by putting certain measures in place, such as committees and more independent directors, provides a good foundation for any opportunities that arise in the future. An economic downturn should not be the first time that corporate governance measures are implemented; by then, it could be too late, and the company may not survive. At a minimum, a company should hold regular board meetings, keep minutes, have a board vote on major decisions, and be aware of the ramifications of giving any one person, such as the founder, more power on the board. Ultimately, it is a healthy dynamic for a business to invest the time in corporate governance measures irrespective of what the company ultimately decides to do with its business. This would of course mean additional time and expense, but these additional burdens would pay off in the long term for the business. Even without the disciplining mechanism of IPOs, acquisitions, or financings, VC investor directors could be motivated to implement corporate governance mechanisms by their limited partners who demand such changes in their limited partnership agreements.[447] As an example, the limited partners could require that a certain number of board seats be allocated to diverse candidates or that interviews for key hires include such candidates.

447. Interview with Lawyer #23, *supra* note 241 (citing example of VCs wanting to avoid breach of fiduciary duties suits by stockholders if corporate governance matters go awry).

Fifth, a startup may want to limit the number of people present in the boardroom. If there are too many people present it can change the dynamic of the board. One way to have fewer individuals is to limit the participation of board observers by requiring a fund to have a threshold ownership percentage or number of shares to maintain its board observer rights, time limit the board observer right, or limit attendance or certain information. These arrangements could then be reflected in a side letter or the Investors' Rights Agreement.

Finally, in addition to some of the DEI measures discussed above, it appears that the industry needs to be intentional about how it approaches DEI issues if it hopes to make any headway in these efforts.[448] This is likely the area in which corporate governance needs to be reimagined to include more diverse candidates at every level. It will also require leadership from the founders and VCs. For example, in order to recruit more diverse boards, companies must commit to diversifying the investor base and the limited partners who invest in VC funds. One way to accomplish this is by adding diversity riders in VC financings documents, such as the Investors' Rights Agreement, to ensure diversity is a factor in determining board composition. The efforts cannot stop there, however. There needs to be a good faith effort to include Black and other underrepresented groups throughout the startup ecosystem. In addition to the board and investors, diversity needs to be considered in key hires. Depending on current networks will not suffice; a deeper pipeline needs to be built. The limited partners who invest in VC funds should also be diversified by including parties that have traditionally been excluded from the VC ecosystem, such as historically Black colleges and universities.

448. For a more in-depth discussion of these proposed solutions, see Fan, *supra* note 435. It became clear in writing this Part that this topic could be the subject of another article. A more fulsome analysis of DEI issues in startups can be found in "Startup Biases," which explores DEI issues in startups in greater depth, including a detailed accounting of the biases that women and racial and ethnic minorities face in this ecosystem and each of the proposed solutions discussed here. Fan, *supra* note 435.

Conclusion

Venture capital-backed private companies have long played an outsized role in the United States. These private companies have influenced the way we live, work, and play. Their reach even extends to our culture, law, and politics. For these reasons, it is important to understand what kind of accountability they have within the current corporate governance structure.

Through novel empirical analysis, using both survey and interview data, this Article makes several important contributions. First, it illustrates that after the Great Recession, a new founder-centric board emerged, which had implications for board dynamics. Second, independent directors do not play the outsized roles that many scholars have purported; they are neither the tie-breaking vote nor the neutral arbiter. This finding has implications for the study of private company corporate governance, as the importance of independent directors may differ from what is theorized and have an impact on how board dynamics are analyzed. Ultimately, the dynamics on the board of private companies are most impacted by whether founder-management directors or investor directors have the bigger role. Third, the normative/narrative framing of corporate governance, where there are no bright-line rules, gives boards the flexibility to determine how, when, and to what extent corporate governance guardrails are implemented. During times of economic plenty, when and how robustly corporate governance measures are enacted depends on the priorities of the company at that particular stage of growth; typically, this means that these measures are not put into place unless there is a reason, such as an acquisition or IPO. However, as the interviews revealed, during bad economic times the companies eschew such flexibility. Corporate governance guardrails are more robustly followed, and process becomes paramount. In fact, investor directors are the most influential during economic downturns. Finally, the advancement of DEI initiatives within startups is meager at best. The only way such efforts succeed is if there is the interest and the will from the founders, investors, and the board.