Beach Money Exits

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I. INTRODUCTION

Venture capital (VC) markets fund the development of high-risk, high-growth technology startups. VCs must overcome acute information asymmetries when they invest.[1] Early-stage startups may lack the metrics—earnings, revenue, or even customers—that investors use to value mature businesses. There is generally no liquid market for a startup's shares.[2] Startup founders[3] know more about their technology, team, skill, and work ethic than their VC investors can learn.[4] VCs also face an agency cost[5] or moral hazard[6] problem. They cannot easily observe a startup's progress towards

1. *See, e.g.*, Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1076 (2003) (explaining that VC contracts are shaped by, inter alia, extreme information asymmetry); PAUL A. GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 160 (2d ed. 2006) (arguing that the tools that VCs employ should be understood, in part, as a response to information asymmetry).

2. Some startup equity is traded on secondary capital markets. *See infra* Part IV.D.

3. Throughout this article, I use the term "founder" to mean a person who (1) manages a startup; (2) serves on its board of directors; and, (3) holds a large portion of its equity. This category partially overlaps with the set of people who call themselves "founders" in startups and who are named in the incorporation documents. The literature generally uses "entrepreneur" instead. That usage can misleadingly suggest that startup founders have atypical risk preferences. "Entrepreneur" also lacks a subtle connotation that "founder" carries—that the relationship between a founder and her startup is more than purely transactional. This close identification of a startup with its founders is a source of founder power. *See infra* Part III.B.2.

4. *See* Gilson, *supra* note 1, at 1076–77 (identifying the "quality of the company's management" and the "the fact that the portfolio company's technology involves cutting-edge science" as contributing to the information asymmetry).

5. *See, e.g.*, Robert P. Bartlett, III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 61–80 (2006) (explaining features of VC contracts with a dynamic agency cost model); Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 971 (2006) (stating that "[t]he literature on VC investment arrangements suggests that VCs' cash flow and control rights reflect the parties' efforts to minimize agency costs"); *see also* Gilson, *supra* note 1, at 1076 (explaining that VC contracts are shaped by agency costs); GOMPERS & LERNER, *supra* note 1, at 159–63 (reviewing the economics literature on VC contracts and agency problems).

6. *See, e.g.*, Robert E. Hall & Susan E. Woodward, *The Burden of the Nondiversifiable Risk of Entrepreneurship*, 100 AM. ECON. REV. 1163, 1166 (2010) (reviewing the economics literature that describes VC

commercialization, so they need a mechanism to ensure that the founders are putting their cash to good use rather than just extracting private benefits from ownership.

The primary mechanism VCs use to motivate founders is the equity that founders hold in their startups.[7] Founders take below-market salaries.[8] As Ronald Gilson explains, "the overwhelming percentage of management's compensation is dependent on the [startup's] success. Low salaries are offset by the potential for a large increase in the value of the entrepreneur's stock ownership . . . ."[9] In most cases, founders' equity will be worth zero.[10] But founders know that, if their startup successfully "exits" through an initial public offering (IPO) or acquisition, they will receive an extremely lucrative payout for their shares. The equity incentives push founders to manage the business in a way that maximizes shareholder value.[11]

But the strong equity incentives of VC-backed startups make them vulnerable to value-destroying opportunism. When a successful startup receives an acquisition offer that is below the expected value (EV) of the business, founders with a large equity stake may be motivated to accept it. Founders cannot diversify their financial risks like VCs can, because their equity is concentrated in one company, rather than spread across a portfolio of companies.[12] An acquisition that is not EV-maximizing for shareholders could give founders more risk-adjusted value than remaining independent would.

Additionally, founders deciding whether to accept an acquisition offer may face a diminishing marginal utility of wealth.[13] An offer below the EV of the business may give the founders "beach money"—financial security for life.[14] The payout to founders can be high enough that VCs cannot persuade them to forgo it for the prospect of even greater wealth later. I call a startup acquisition that is *not* EV-maximizing for the business but is in the founders' private financial interest, given nondiversifiable risk and diminishing marginal utility, a "beach money exit."

Founders often have the power to force a beach money exit over the objections of

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contracting as a mechanism to address moral hazard); Fried & Ganor, *supra* note 5, at 971 (stating that "VCs' enhanced cash flow and control rights may reduce the moral hazard problems associated with financing entrepreneurs").

7. VCs also use convertible preferred stock with a liquidation preference, staged investments, and syndication to reduce information asymmetry, agency costs, and moral hazard. *See infra* Part II.B.

8. *See* Noam Wasserman, *Stewards, Agents, and the Founder Discount: Executive Compensation in New Ventures*, 49 ACAD. MGMT. J. 960, 968 (2006) (finding, based on executive salary data from 528 private companies, that founder executives received $25,000 less in annual salary than non-founder executives). Non-founder startup employees may receive higher salaries than they would at established companies. *See* J. Daniel Kim, *Is There a Startup Wage Premium? Evidence from MIT Graduates*, 47 RES. POL'Y 637, 642 (2018) (finding, based on surveys of 2,064 graduating students and alumni from MIT, that "VC-backed startups on average pay 8–13% higher wages than their mature counterparts").

9. Gilson, *supra* note 1, at 1083; *see also* Bartlett, *supra* note 5, at 53 ("Management salaries at start-up companies will often be set at relatively low amounts, with a significant component of compensation consisting of stock options or shares of restricted stock that vest over time.").

10. *See* Hall & Woodward, *supra* note 6, at 1171 (finding, in a large database of VC-backed startups from 1987 to 2010, that between 58 and 87 of entrepreneurs ultimately received zero value for their equity).

11. *See, e.g.*, Bartlett, *supra* note 5, at 53 ("[E]quity-based compensation is intended to minimize the risk that managers will shirk their duties or pursue private benefits that do not accrue to the company's stockholders generally.").

12. *See infra* Part III.A.1.

13. *See infra* Part III.A.2.

14. "Beach money" is the polite version of this term. *See infra* note129.

VCs. In a minority of cases, founders will control the board outright or effectively control it with a friendly independent director.[15] But even when founders do not control the board or the VCs have a contractual right to block an acquisition, founders may still have the power to force the exit. In many early-stage startups, the founders' reputation in the market, their expertise with the startup's technology, and the loyalty of their hand-picked team are the main sources of enterprise value.[16] When founders in successful startups push for an exit, VCs have no attractive options. They cannot force the founders to manage the business against their will. They cannot replace the founders without destroying value and risking mass employee defections. They cannot sue without risking their reputation among prospective founders.[17] From a VC's perspective, a 2–5x return is underwhelming.[18] But to almost everyone else, founders who deliver 2–5x growth look successful.

Because VCs know that their options after a beach money exit offer are limited, VCs anticipate and try to prevent them.[19] They screen prospective founders to make sure their expectations about exit are aligned with the VCs' expectations. Then they monitor founders to ensure they are building long-term value for the business, rather than courting prospective acquirers. VC investment contracts usually include "blocking rights"—negative covenants that give VC directors the right to veto a sale, even when they lack a board majority.[20] VCs' insistence on blocking rights is notable because VCs also have liquidation preferences, which entitle them to a return of 1x before common shareholders are paid out in an acquisition.[21] The combination of blocking rights and liquidation preferences suggests that VCs worry about founders forcing sales even in moderately successful startups.[22] Tellingly, sometimes blocking rights only allow VCs to veto exits

15. *See* Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 289–90 (2003) (finding, based on a sample of 119 VC-backed companies, that "the VC has the majority of the board seats in 25% of the cases, the founders in 14% of the cases, and neither in 61% of the cases").

16. *See infra* Part III.B.2.

17. *See* Vladimir A. Atanasov et al., *Does Reputation Limit Opportunistic Behavior in the VC Industry? Evidence from Litigation Against VCs*, 67 J. FIN. 2215, 2218 (2012) (finding that VCs who litigate against entrepreneurs "invest in a smaller number of deals, raise smaller funds, and syndicate with a smaller number of VCs relative to their non-litigated peer").

18. *See infra* Part II.A (explaining that the VC business model relies on some startups in their portfolio generating 10x or higher returns).

19. *See infra* Part IV.

20. *See* D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 346–47 (2005) (reporting that 299 of 367 sampled VC contracts included a negative covenant giving VCs a veto right over a decision to engage in business combinations and concluding that "[t]his pattern of contracting suggests that venture capitalists protect themselves against forced exit through the use of negative covenants"); *see also* Bartlett, *supra* note 5, at 76 (explaining that "a VC investor may seek specific class veto rights that guarantee it a blocking right over a company's acquisition"); Fried & Ganor, *supra* note 5, at 987 (noting that VCs usually have protective provisions enabling them to veto a sale); Jeffrey Engerman, *Key Concerns in Follow-On Financing Rounds*, *in* N.Y. STOCK EXCHANGE, THE ENTREPRENEUR'S ROADMAP: FROM CONCEPT TO IPO 7 (Bonnie Hyun ed., 2017) (explaining that "[i]n all but the most unusual cases, emerging companies with significant investor capital will be subject to an investor consent requirement prior to undertaking a specified set of actions" including an acquisition).

21. Brian J. Broughman & Jesse M. Fried, *Carrots and Sticks: How VCs Induce Entrepreneurial Teams to Sell Startups*, 98 CORNELL L. REV. 1319, 1343 (2013) (reporting that, in a sample of 50 VC-backed startups, the VCs' liquidation preference was set to 1x in 46 of 50 first rounds of financing but varied more in subsequent rounds).

22. VCs may also worry that other VCs will force them into a non-EV-maximizing sale, but that scenario—

below a certain value.[23] This suggests that there is a range of returns—likely somewhere in the 2–5x range—where VCs will sometimes support and sometimes oppose an acquisition, depending on their assessment of the startup's EV.

In some cases, VCs can turn to an independent director to arbitrate the exit dispute.[24] In other cases, VCs can defuse pressure for a beach money exit by facilitating the purchase of founder equity on the secondary capital markets.[25] Secondary capital provides founders with liquidity and sometimes helps them resist attractive acquisition offers.[26] But the more that founders cash out on the secondary capital markets, the more that prospective investors in later rounds will worry that founders' forward-going incentives are weak.

Delaware fiduciary law likely would not provide redress either.[27] At first glance, a founder-director pursuing her own financial interest at the expense of the interest of the shareholders appears to be violating her fiduciary duty of loyalty to the corporation. But beach money exits do not fit well with existing doctrine. Founders do not receive any benefit outside the deal consideration. They receive the same payout per share as all other shareholders, since the VCs' preferred shares will convert, or be paid out as if converted, to common shares in the acquisition. The VCs' case that the acquisition is not in the shareholders' interest may rely on the value that could be created if founders continued to manage the firm. But founders' fiduciary obligations do not require them to continue managing the business. VCs would face similar obstacles to exercising their appraisal rights, given Delaware's increasing deference to deal prices.[28]

Beach money exits matter. The difference between a startup board's estimate of the startup's EV as an independent company and the lower EV implied in the acquirer's offer indicates that the acquirer may put the startup's assets and employees to a less productive use. An acquirer can destroy value by weakening the strong equity incentives of former startup employees prematurely.[29] It may also direct the former startup's efforts to serve its existing customers, rather than new, potentially larger markets. It may not plan to use the startups' assets at all—the acquisition may be designed simply to buy off a potential competitor. If IPOs continue to decline and acquisitions become the dominant startup exit strategy,[30] founders will have an even greater incentive to push for early sales.

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a VC majority supporting a sale with a VC/founder minority coalition opposing—is unlikely until the startup has raised multiple rounds of funding.

23. *See* Ola Bengtsson, *Covenants in Venture Capital Contracts*, 57 MGMT. SCI. 1926, 1931 (2011) (finding, in a sample of 182 contracts from first round VC financing, that 100% of contracts included a restrictive covenant allowing VCs to veto an exit and noting that "[f]or some contracts, a merger above a certain transaction value is allowed").

24. *See infra* Part IV.C.

25. *See* Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1, 27–29 (2012) (explaining that VCs can use secondary capital purchases to defuse entrepreneur-VC conflicts over exits).

26. *See id.* at 29 ("The party seeking the early exit can sell in the direct [secondary] market, while the other party can hold its shares and wait for the start-up to have a traditional exit."); *see also* Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. PA. L. REV. 179, 204 (2012) (explaining that "the secondary markets provide an exit option at the individual level, rather than at the company level as with an acquisition").

27. *See infra* Part V.B.

28. *See infra* Part V.C.

29. *See infra* Part VI.

30. *See* Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 HASTINGS L.J. 445, 454–55 (2017) (explaining that "[f]rom 2001 through 2012, there were an average of only 99 IPOs per year, compared to 310 IPOs per year between 1980 and 2000" while "the total number of U.S. startups grew overall"); Xiaohui Gao et al., *Where Have All the IPOs Gone?*, 48 J. FIN. & QUANTITATIVE ANALYSIS 1663,

Researchers have acknowledged that VCs investing in startups worry about forced exits.[31] They have noted that founders may support early sales because their personal rate of return on their equity will be higher than the VCs' rate of return.[32] But researchers have not addressed beach money exits, their causes, or their effects. There is a rich and illuminating law and economics literature on startup exits, but it largely focuses on cases in which the nominal payout per share of preferred shareholders—i.e., VCs—and common shareholders—i.e., founders and employees—diverges.[33] These divergences happen on the "moderate downside," when a startup is not growing rapidly but has not burned all of its cash.[34] In those situations, the VCs' liquidation preference entitles them to a greater per-share payout from an acquisition than common shareholders would receive.[35] Founders might seek to resist an exit in the hope that the startup's fortunes improve enough to generate a return for common shareholders, while VCs just want to cut their losses.[36] Jesse Fried and Mira Ganor, for example, argue that VCs are biased towards exit[37]—and on the moderate downside, their case is compelling.[38]

Beach money exits happen on the largely uncharted "moderate upside," where VCs will convert, or be paid out as if converted, to common shares in an exit. On the surface, the financial interests of VCs and founders should be aligned in such a case: seek the highest EV exit for all common shareholders. But a thicker behavioral[39] account of founder

1677–79 (2013) (reviewing the data). Total assets under management (nominal) by US VCs has risen in recent years from $163.45 billion in 2004 to $358.86 billion in 2017. NAT'L VENTURE CAP. ASS'N, NVCA 2018 YEARBOOK DATA PACK 10 (2018). The number and total deal size (nominal) of acquisitions of US VC-backed companies have generally increased in the period from 2004-17, though the number (but not total deal size) has decreased in the past few years. *See id.* at 31. In 2017, the IPOs of "US companies raised $49bn—double the $24bn of listings in 2016, which was the worst year for IPOs in more than a decade." Nicole Bullock et al., *Global Number of IPOs Highest Since Financial Crisis*, FIN. TIMES (Dec. 27, 2017), https://www.ft.com/content/ae9e6500-e69b-11e7-8b99-0191e45377ec. It is, of course, too early to tell if 2017's results suggest an end to the recent trend of declining IPOs.

31. *See, e.g.*, Smith, *supra* note 20, at 319 ("In the early stages of a venture capital relationship, the venture capitalist is concerned primarily with protecting himself from forced exit.").

32. *See* Ibrahim, *supra* note 25, at 28 (reporting that angel investors say that "entrepreneurs (and angels) desire even small-dollar trade sales because they produce high returns for early investors, but that VCs choose to wait for higher-value exits").

33. One interesting exception is Gompers' theory that inexperienced VCs engage in "grandstanding"—seeking premature IPOs to establish their reputation. *See generally* Paul A. Gompers, *Grandstanding in the Venture Capital Industry*, 42 J. FIN. ECON. 133 (1996) (articulating the VC grandstanding hypothesis).

34. The VCs may also "want to take control of the assets and replace [the founders] on a moderate downside scenario." William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 901 (2002).

35. *See* Fried & Ganor, *supra* note 5, at 995 ("Liquidity events promise a certain payout, much of which the preferred shareholders can capture through their liquidation preferences. Continuing to operate the firm as an independent company may expose the preferred-owning VCs to risk without sufficient opportunity for gain.").

36. *See* Broughman & Fried, *supra* note 21, at 1323–24 (explaining that entrepreneurs may oppose a sale because of the VCs' liquidation preference).

37. *See* Fried & Ganor, *supra* note 5, at 994 ("[P]referred shareholders are likely to have a bias toward exit—that is, a preference for immediate liquidity events (e.g., dissolution, private sale, or IPO) even when the expected value of remaining an independent private company is higher.").

38. Fried and Ganor are clear that they are not claiming "that preferred-controlled boards will always choose low-value strategies over high-value strategies, or that they will always choose exit when remaining independent generates more value for shareholders." *Id.* at 996.

39. I do not mean to imply that my account of founder incentives requires one to accept the behavioral economics critique of the rational actor model. The assumptions the argument requires are that risk diversification

incentives, which accounts for their non-diversifiable risk and diminishing marginal utility, suggests that founders will be more biased towards exit than VCs on the moderate upside.

The risk of founder-forced exits may have been obscured by VCs' contractual rights to block an exit. But the power dynamics of successful startups and the reputational constraints on VCs make them reluctant to use the blocking rights in practice. As Noam Wasserman has observed, "academic research has paid more attention to the investors and acquirers than to the founders, and we lack a detailed picture of the factors that affect founders' decisions to exit."[40]

Beach money exits have remained a hidden problem, because VCs have an incentive to declare an acquisition of one of their portfolio companies a success, even if they privately disagreed with the decision to exit. Concluding that a particular acquisition was a beach money exit would require access to the confidential deliberations of the startup's board of directors. Therefore, the Article does not make any claim about how frequent these acquisitions are. It defends a more modest claim: that the standard law-and-economics account of VC markets, combined with the (empirically plausible) assumption that founders' risk preferences are heterogenous, predicts that some startups will agree to beach money exits. To add perspective from practitioners, this Article draws on responses to an anonymous, open-ended questionnaire on disagreement about startup exits conducted by TechGC, a national organization of general counsels of VC-backed startups and VC firms.[41]

The Article has five Parts. Part II reviews the law and economics literature on VC markets, with a focus on why VCs' and founders' preferences about exit can diverge. Part III presents the beach money problem. It explains why founders have the incentive to push for value-destroying exits and how they can force VCs to accept them. Part IV argues that VCs cannot fully contract around the risk of beach money exits. Part V argues that corporate law does not fully deter them either. Part VI shows how the buyers in beach money exits can destroy value.

II. THE STRUCTURE OF VC MARKETS

VC markets supply capital to startups, so they can develop technology and scale before the startups become self-sustaining or are absorbed into self-sustaining businesses. Even successful startups can hemorrhage money for years. VCs invest cash in exchange for an equity stake. They profit by selling their equity stake in exits: when the startup is acquired or after it has an IPO. The VC business model depends on massive exits. Exits are the focus of VC investment contracts and startup governance. The power to decide when and how to exit—whether formal or informal—is the power that matters most in a

concerns and diminishing marginal utility motivate behavior.

40. NOAM WASSERMAN, THE FOUNDER'S DILEMMAS: ANTICIPATING AND AVOIDING THE PITFALLS THAT CAN SINK A STARTUP 376 (2012).

41. The TechGC questionnaire was conducted from July 19–25, 2017. Participation was voluntary. Participants were told their responses would be kept anonymous, though they were asked to identify whether they were affiliated with a VC-backed startup or a VC firm. In total, 33 TechGC members completed the questionnaire. The results should be considered only as anecdotal evidence. The questionnaire did not attempt to capture a representative sample of VC-backed startups or VC firms, nor could it have. The set of participants would have been subject to selection biases, including the selection bias introduced by a VC-backed startup's or a VC firm's decision to hire in-house counsel. The text of the questionnaire and the anonymized results are on file with the author.

startup.[42]

Of course, VC investment is not the only way that startups raise money. Some founders initially bootstrap their business or take investment from friends and family.[43] The first significant funding a startup raises often comes from angel investors, wealthy individuals who invest as a hobby.[44] Angels generally take a modest equity stake in the startup in exchange for a six or seven figure investment.[45] They use informal contracts with minimal lawyering, which reduces the transaction costs of investing.[46] Angels often mentor founders[47] and sometimes serve on the startup's board of directors.[48] But when startups want to raise more money than the founders' and angels' bank accounts permit, they turn to the VC markets.[49]

A. The VC Business Model

VC firms are financial intermediaries.[50] They raise money from large institutional investors—mutual funds, university endowments, etc.—to invest in portfolios of startups.[51] A VC firm's General Partners (GPs) actively manage its funds.[52] The institutional investors, or Limited Partners (LPs), are passive once the fund is raised.[53] Each fund that VCs raise has a fixed duration.[54] The GPs are expected to distribute the returns to their LPs on an annual basis.[55]

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42. VCs may seek board control for other reasons. *See* Fried & Ganor, *supra* note 5, at 989–90 (noting that "[t]he standard explanations for VCs' acquisition of board control involve entrepreneur agency costs," including the ability to replace unsuccessful entrepreneurs).

43. *See* Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1417 (2008) (noting that, in the early stages of a startup, "friends, family, and the entrepreneur's own efforts may provide some funding (up to $100,000 or so), but this is hardly enough to sustain the rapid-growth start-up for very long"); *see also* WASSERMAN, *supra* note 40, at 252 (describing founders' experiences of self-funding).

44. For an analysis of the behavior of angel investors, see Ibrahim, *supra* note 43, at 1425–27.

45. A study using a dataset of 215 startup investment rounds found that the mean investment by angel investors was $1.28 million in angel-only rounds and $0.88 million when angels co-invested. Andrew Wong et al., *Angel Finance: The Other Venture Capital*, 18 STRATEGIC CHANGE 221, 224 (2009).

46. *See* Ibrahim, *supra* note 43, at 1433–35 (explaining angel investor's informal contracts as a means to reduce transaction costs).

47. *See id.* at 1419 ("Many entrepreneurs believe that an angel's advice is as important as her financial capital.").

48. Andrew Wong found, in his study of rounds financed entirely by angels, that "[b]oard seats are granted in less than half of all funding rounds." Wong et al., *supra* note 45, at 224.

49. Darian Ibrahim predicts that more startups will rely exclusively on funding from angel investors in the future. Darian M. Ibrahim, *Should Angel-Backed Start-Ups Reject Venture Capital?*, 2 MICH. J. PRIV. EQUITY & VENTURE CAP. L. 251, 253 (2013).

50. George Triantis, *Financial Contract Design in the World of Venture Capital*, 68 U. CHI. L. REV. 305, 309 (2001).

51. *See* Gilson, *supra* note 1, at 1070 ("The typical transactional pattern in the U.S. venture capital market is for institutional investors—pension funds, banks, insurance companies, and endowments and foundations—to invest through intermediaries, venture capital limited partnerships . . .").

52. *Id.* at 1071.

53. *See id.* ("Consistent with the legal rules governing limited partnerships, the limited partners may not participate in the day-to-day management of the fund's business, including especially the approval of particular portfolio company investments.").

54. *Id.* at 1075.

55. *Id.* at 1071 (explaining that a VC "partnership will be in partial liquidation during much of its term because realized profits from exiting an investment are required to be distributed to the limited partners on an

GPs' formal compensation is partially fixed and partially incentive-based. They receive an annual management fee of about 2-2.5% of committed capital.[56] They receive approximately 20% of the fund's profits in the form of carried interest.[57] Those numbers may understate the strength of the GP's incentives, because, as Gilson explains, "[a] GP's track record, as revealed by the performance of its previous funds, is the GP's principal tool for persuading investors to invest in successor funds."[58] There is empirical evidence that manager performance in VC investing is consistent over time, relative to other asset classes.[59] The evidence does not necessarily mean that there are significant differences in skill among VCs. A recent study found that VC firms' "access to deal flow," rather than skill, accounted for performance consistence in VC funds.[60]

The returns of a successful VC fund over its life resemble a J-curve.[61] During the first few years of the fund's life, the GPs will purchase equity stakes in startups, developing their portfolio. The startups will put that cash to work paying salaries and rents, buying materials, and developing IP. The return on the VCs' investment in the first few years will usually be a net negative. As one partner at a VC firm puts it, "lemons ripen early."[62] But later in the life cycle of the fund, some of the startups in the portfolio will exit, and, if the fund is successful, the net returns will rapidly rise into the black.

VC returns are notoriously spiky. Wasserman explains that, "[w]ithin each portfolio, VCs tend to have a few 'home runs' they hope will make up for the majority that either fail or produce only small returns."[63] Chris Dixon, a partner at the VC firm Andreesen Horowitz, reports that he received performance data from an LP "on the distribution of investment returns across the hundreds of VC funds [that the LP had] invested in since 1985."[64] According to Dixon, the data revealed that "about ~6% of investments representing 4.5% of dollars invested generated ~60% of the total returns."[65] Dixon also reports that "[t]he home runs for good funds are around 20x, but the home runs for great funds are almost 70x."[66] As Bill Gurley, a partner at the VC firm Benchmark Capital, famously said, "[v]enture capital is not even a home run business. It's a grand slam

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annual basis").

56. Kate Litvak, *Venture Capital Limited Partnership Agreements: Understanding Compensation Arrangements*, 76 U. CHI. L. REV. 161, 173 (2009).

57. *Id.* at 175. Kate Litvak has discovered that the distribution rules of VC funds effectively serve as an interest-free loan from LPs to GPs. *See id.* at 179–82.

58. Gilson, *supra* note 1, at 1090; *see also* Litvak, *supra* note 56, at 189 (finding evidence that past performance predicts future fund size).

59. Ramana Nanda et al., *The Persistent Effect of Initial Success: Evidence from Venture Capital* 4 (Harv. Bus. Sch. Entrepreneurial Mgmt., Working Paper No. 17-065, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2900862.

60. *Id.* at 5. This conclusion supported previous research finding that "entrepreneurs accept lower valuations and less attractive terms from more prestigious VC firms when choosing between offers" and that "[p]rominent VC firms also gain access to a wider and better range of investment opportunities through syndicate partners who want to co-invest with them." *Id.* at 6.

61. Scott Kupor, *16 Definitions on the Economics of VC*, ANDREESEN HOROWITZ (Sept. 11, 2016), https://a16z.com/2016/09/11/vc-economics/.

62. *Id.*

63. WASSERMAN, *supra* note 40, at 269.

64. Chris Dixon, *Performance Data and the 'Babe Ruth' Effect in Venture Capital*, ANDREESEN HOROWITZ (June 8, 2015), https://a16z.com/2015/06/08/performance-data-and-the-babe-ruth-effect-in-venture-capital/.

65. *Id.* (sic).

66. *Id.*

business."[67]

The VC business model explains why VCs hate beach money exits. Startups that return 10x are hard to find. A startup with an early acquisition offer that represents a 2–5x return may sound like a success to laypeople, but to VCs, a beach money exit is a missed opportunity to hit a grand slam.

B. The Mechanisms of VC Contracts

VC contracts are designed to manage the information asymmetries and agency costs or moral hazard inherent in VC investing.[68] To recap, there are information asymmetries because founders know more about their technology, team, skill, and work ethic than their VC investors can learn.[69] There is an agency cost or moral hazard problem because VCs cannot easily observe a startup's progress towards commercialization and founders may use the VCs' funds to extract private benefits.[70] One contributor to both problems is that startups lack the conventional metrics—earnings, revenue, or even customers—that financial analysts use to value mature businesses. The strategies VCs use to solve these problems are strong equity incentives for the founders, convertible preferred stock with a liquidation preference, staged investments, and syndication.[71]

1. Strong Equity Incentives

Founders' equity motivates them to grow the business.[72] Because founders take below-market salaries,[73] most of the EV of their compensation is in equity. Founders usually receive their shares at incorporation and pay a nominal amount for them. Founders' shares are subject to reverse-vesting: the company's right to repurchase their shares lapses over time.[74] Founders' shares also often come with acceleration clauses, which extinguish

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67. *Id.*

68. *See, e.g.*, Gilson, *supra* note 1, at 1076 (explaining that VC contracts present the agency cost problems inherent in all financial contracts "in an extreme form"); Hall & Woodward, *supra* note 6, at 1166 (explaining that the "mechanism design problem" in VC contracting is overcoming moral hazard).

69. *See, e.g.*, Gilson, *supra* note 1, at 1076–77 (describing the information asymmetries between investors and entrepreneurs); Bartlett, *supra* note 5, at 51 (explaining that startup "managers know more about the company and about their own abilities than investors do").

70. *See* Gilson, *supra* note 1, at 1076–77 (describing the agency problems created by the divergence between founders' and VCs' interests); Bartlett, *supra* note 5, at 51 (explaining that "managers may . . . fail to exert an optimal level of effort . . . and may also have other incentives to use firm resources to create private benefits").

71. *See, e.g.*, Michael Klausner & Kate Litvak, *What Economists Have Taught Us About Venture Capital Contracting*, *in* BRIDGING THE ENTREPRENEURIAL FINANCING GAP 54, 58–64 (Michael J. Whincop ed., 2001) (explaining that staged investments, management compensation largely in equity, and convertible preferred stock with a liquidation preference are standard terms in VC investments). George Triantis argues that, except for convertible preferred stock, the contractual mechanisms VCs use are not distinctive. *See* Triantis, *supra* note 50, at 306 ("[N]one of the techniques adopted by venture capitalists is particularly novel. Instead, they have close functional parallels in bank financing of similarly situated firms.").

72. Startup employees, especially at early stages, also receive equity compensation, and one justification for that practice is to motivate them to monitor their coworkers. *See* Sharon Hannes, *Reverse Monitoring: On the Hidden Role of Employee Stock-Based Compensation*, 105 MICH. L. REV. 1421, 1438–49 (2007).

73. *See* Wasserman, *supra* note 8, at 963.

74. *See* Matthew Bartus, *Establishing the Ownership Culture: Stock vs Options*, COOLEYGO, https://www.cooleygo.com/establishing-ownership-culture-stock-vs-options/ (last visited Sept. 5, 2019) (explaining the differences between reverse-vesting and vesting).

the company's right to repurchase some or all of their shares in the event of a change of control.[75] As the startup grows, the dollar value of the founders' equity stake grows proportionally, minus any dilution from future financing rounds. If the startup is acquired, founders' acceleration clauses ensure that they will receive a larger part of the proceeds than they would have received if some of their equity remained unvested. Founders' equity also serves as a screening device. Many professionals, including executives at public companies, receive some incentive-based compensation, but startup founders' low base salary with massive upside potential is unusual. Robert Hall and Susan Woodward find that, with normal risk aversion and $100,000 in savings, the certainty equivalent of founding a startup is "slightly negative."[76] Accordingly, founder compensation selects for managers who are especially confident in their proposed technology, product, business plan, or team—their "idiosyncratic vision" of the world.[77]

Equity incentives, however, may not select for founders with an atypical tolerance for risk. One review of the extensive literature on the risk preferences of entrepreneurs concluded:

> [T]he evidence that entrepreneurial entry can be explained by a group of people with very different general risk attitudes than the general population is quite mixed and inconclusive. Some studies suggest that those who start firms are more risk seeking, but others find no association. Indeed, perhaps the most compelling tests from the viewpoint of a critical economist—those in which incentivized elicitation of risk preferences is employed—do not find strong evidence of such entrepreneur versus non-entrepreneur heterogeneity.[78]

Therefore, we should not assume that the set of people who opt for the equity incentives of founders will deviate too much from the base rate of observed risk-aversion. Additionally, the screening device of equity incentives does its selection at the time of founding and investment. If founder risk preferences are not stable character traits, their willingness to accept equity incentives at the time of founding may not predict a willingness to gamble with their wealth at the time of an acquisition offer.

2. Convertible Preferred Stock

VCs invest in startups by purchasing convertible preferred stock.[79] It has both debt-like and equity-like features. One debt-like feature is a liquidation preference, which

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75. *See* Scott Kupor, *Prenups for Co-Founders*, ANDREESEN HOROWITZ (Oct. 19, 2015), https://a16z.com/2015/10/19/prenups-for-co-founders/ ("In [an] acquisition scenario, founders will often have single trigger or double trigger acceleration provisions."). A double trigger acceleration clause entitles the person who has it to a payout in the event that (1) there is a change of control and (2) she is terminated involuntarily without cause.

76. Hall & Woodward, *supra* note 6, at 1164.

77. *See* Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 577 (2016) (introducing the concept of "idiosyncratic vision" and defining it as "the entrepreneur's belief that a proper implementation of her strategy will produce above-market returns").

78. Thomas Åstebro et al., *Seeking the Roots of Entrepreneurship: Insights from Behavioral Economics*, 28 J. ECON. PERSP. 49, 57 (2014).

79. *See* Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 875 (2003); *see also* Smith, *supra* note 20, at 347 (finding that 98.37% of the VC investment contracts in his sample included a liquidation preference).

protects VCs on the moderate downside.[80] The preference is usually set to 1x, which means that preferred shareholders must receive back the amount they invested before the common shareholders receive any payout in an exit.[81] In a more successful exit, preferred shareholders will convert, or be paid out as if converted, to common stock. In that case, the VCs' investment gives them the same payout per share as any other shareholder. Liquidation preferences mitigate downside risk for VCs, while the ability to convert to common allows them to participate in the upside.

The VCs' liquidation preferences influence exit decisions. VCs would, of course, prefer a successful exit in which they are paid out like common shareholders. But if a startup grows slowly, the liquidation preference gives VCs an incentive to take a low-value, but non-zero, exit and cut their losses. Founders have the opposite incentive. They know that, because of the VCs' liquidation preferences, they will receive a disproportionately smaller share of the exit proceeds in low-value exit.[82] This predictable conflict of incentives is what attracts researchers' attention to the moderate downside.[83]

3. Staged Investments

VCs do not fund a startup's business plan in full at the outset. Instead, each financing round funds the next 12-24 months of the company's life.[84] VCs stage investments to reduce their risk exposure and counteract the information asymmetry. VCs retain the option not to participate in subsequent financing rounds if the startup performs badly or if the VCs acquire information that decreases their confidence in the startup's chances.[85] VCs usually reserve the right to purchase enough shares in subsequent rounds to preserve their pro rata share of the company, notwithstanding dilution.[86] The new shares will usually be more expensive, but the VCs will have more information about the management team and its business plan when they purchase them. The revealed preferences of outside investors in subsequent rounds provide useful information to a startup's existing investors about its value.

Staged investments, like equity incentives, also serve to screen prospective

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80. *See* Gilson & Schizer, *supra* note 79, at 883.

81. *See* Broughman & Fried, *supra* note 21, at 1343 (reporting data in which the VCs' liquidation preference was 1x in 46 of 50 first rounds of financing, but varied more in subsequent rounds); Smith, *supra* note 20, at 347 (noting that in his sample of VC investment contracts, the liquidation preference was "usually the amount of the original investment").

82. *See* Broughman & Fried, *supra* note 21, at 1333 (explaining that common shareholders may resist a sale because of the VCs' liquidation preferences).

83. For a hypothetical illustrating how liquidation preferences cause founders' and VCs' interests to diverge, see Brian J. Broughman, *The Role of Independent Directors in Startup Firms*, 2010 UTAH L. REV. 461, 471–74 (2010).

84. *See* Sebastian Quintero, *How Much Runway Should You Target Between Financing Rounds?*, MEDIUM (Oct. 26, 2017), https://medium.com/radicle/how-much-runway-should-you-target-between-financing-rounds-478b1616cfb5 (explaining that the conventional wisdom is that startups should target 12-18 months of runway, but data suggests 18 is the median time between financing rounds).

85. *See* Smith, *supra* note 20, at 323 (stating that "through staged financing, venture capitalists preserve their ability to limit losses by abandoning portfolio companies that are not making satisfactory progress").

86. *See* GOMPERS & LERNER, *supra* note 1, at 267 (reporting that the results of their empirical study confirm the view that "venture shareholders strive to maintain a constant equity share" across successive rounds of funding).

founders.[87] As Robert Bartlett puts it, "[m]anagers, realizing the consequences of failing to meet their projections, will be less likely to exaggerate a company's prospects in negotiating with a VC investor, and low-quality managers may be deterred altogether from seeking VC financing."[88] Staged investments also create regular intervals for VCs to monitor founders and assess the startup's progress.[89] Founders are strongly motivated to persuade their existing investors that they should recommit in the next round.

The relative power of VCs and founders fluctuates over the course of the fundraising cycle. Founders are at their lowest point of leverage with respect to VCs in the months before a new financing round. They need the VCs to participate in the new round, solicit other VCs to join, and vouch for the startup's progress. The possibility of accepting an acquisition offer—provided it is well above the VCs' liquidation preference—changes the dynamic. When founders no longer need to attract investment, VCs lose most of their leverage. So staged investments, like founders' equity, create strong incentives for founders to maximize shareholder value—until they receive a strong acquisition offer.

4. Syndication

VCs often do not fund all of a startup's fundraising round. They invest together with a syndicate of VC firms.[90] The investor that funds the largest share of the round is said to "lead" the round, and the other investors "follow." Syndication, like staged investments, gives VCs an outside perspective on the value of the startup.[91] The reputation of the other investors is a signal of quality. Syndication also allows VCs to diversify their risks.[92] Because they do not have to fund an entire round for any one startup, they can invest in a broader portfolio of startups. One interesting implication of syndication is that not all investors in a given class of shares will necessarily agree on an exit. Investors' preferences on exit may differ based on where they are in the life cycle of their fund and their subjective assessment of the startup's EV.

C. Incentive Misalignment and Exit

The reasons why startups decide to exit or not are heterogenous. The decision is often an EV calculation. Directors will ask whether shareholders will be better off, discounting for the time value of money, if the startup takes an acquisition offer or goes public now or if it holds out for a better deal or IPO later. These calculations will depend on, among other things: predictions about the startup's technological development, customers, revenue, costs, and market share, the set of potential acquirers and market consolidation or fragmentation, potential new entrants, regulatory and other execution risk, and macroeconomic conditions. Startup directors may disagree about an exit opportunity simply because their predictions on these factual questions differ.

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87. *See* Gilson, *supra* note 1, at 1080 ("Because the incentive created by staged financing is more valuable to a good entrepreneur than a bad one, an entrepreneur's willingness to accept an intense incentive is a signal of the entrepreneur's difficult-to-observe skills.").

88. Bartlett, *supra* note 5, at 52–53.

89. *See* Gilson, *supra* note 1, at 1081.

90. *See id.* at 1073; Bartlett, *supra* note 5, at 55.

91. *See* Bartlett, *supra* note 5, at 56 ("[T]he use of a new investor to lead subsequent financing rounds facilitates each financing by having an outside third party set the investment terms.").

92. *See id.* at 55.

Some exit disagreement, though, can be explained by the divergent incentives of VCs and founders. From the VCs' perspective, whether to exit is a question of opportunity cost.[93] They ask whether their capital and time could be better deployed in their other portfolio companies during the life of their current fund. If they think that a startup's fortunes have little chance of improving, they will cut their losses.

Consider a spectrum of potential outcomes for a startup, from the perspective of VC returns. On the extreme downside, where a startup runs out of cash and sells its remaining assets—and remember here that startups rarely have high-value tangible assets—the VCs' return will be negative and there will not be much money to argue about. At the other end of the spectrum is the extreme upside, where the VCs' return is over 10–30x. VCs would convert, or be paid out as converted, to common in an exit. Therefore, VCs' and founders' enthusiasm for exit should not diverge, or at least should not diverge in predictable ways. At least until recently, the question a startup board faced on the extreme upside was how to time the IPO.[94]

The literature has focused on the moderate downside. If the VCs' liquidation preference is set to 1x, VCs will collect all proceeds of an acquisition where the total value is less than what the VCs invested. They will receive a disproportionate amount of the proceeds from a sale at a price between the amount that the VCs invested and the amount at which the startup was valued at the time of their investment. In this range, especially as time passes, VCs should support an exit unless they think the startup has a good chance of rebounding. Founders will likely want to hold out for the chance of a rebound, no matter how low that chance is. Brian Broughman and Jesse Fried have found evidence that sometimes VCs even give a carve-out to common shareholders—a modest cash payment—in exchange for founders' supporting an acquisition in which common shareholders would otherwise receive little.[95]

The greatest potential for an exit that the founders support and VCs oppose comes on the moderate upside, where VCs will realize returns of 2–5x. Darian Ibrahim offers this example:

> For a trade sale under $30 million, entrepreneurs might receive a hundred-fold return on investment due to purchasing their shares at the start-up's inception, and angels who invest at a slightly higher valuation still make a ten-fold return. . . . VCs invest larger dollar amounts at higher valuations, so the same $30 million trade sale that paid off handsomely for entrepreneurs and angels might fetch only a three- to four-fold return for VCs. . . . [M]ost start-ups in the fund will produce *no* return. Consequently, the ones doing well must produce more than a three- to four-fold return to make up for the duds.[96]

Of course, VCs will not *always* oppose a 3x or 4x return. The VCs could believe, for example, that the startup will struggle during the next phase of its development, that a new

93. *See* Abraham J.B. Cable, *Opportunity-Cost Conflicts in Corporate Law*, 66 CASE W. RES. L. REV. 51, 53–54 (2015) ("[C]ontinued investment in a moderately promising start-up company may have a high opportunity cost for the venture capitalist because it comes at the expense of spending additional time on more promising companies in the fund's portfolio.").

94. *See* de Fontenay, *supra* note 30, at 454–55 (explaining the decline in IPOs).

95. *See* Broughman & Fried, *supra* note 21, at 1325 (discussing payments by VCs to common shareholders to obtain their support for an acquisition).

96. Ibrahim, *supra* note 25, at 28–29.

entrant might bring costly competition, or that macroeconomic conditions favor a quick sale. Alternatively, the VCs could simply have run out of time in the life cycle of their current fund.[97] But a startup that has multiplied its value a few times may be a promising candidate to become one of the startups that return 10x or more in the VCs' portfolio. VCs generally will not want to squander a chance at a grand slam.

As Ibrahim's example illustrates, a 2–5x return for the VCs can be a 10x or more return for the founders, depending on when the VCs invested. But the relative return of the founders' investment is not an important motivator, unless the founders personally invested a significant amount in their startup. It is the *absolute* value of the founders' share of an acquisition that matters. For the founders, it may be beach money.

Both VCs and founders may also have nonfinancial reasons to support or oppose exits. Paul Gompers, in perhaps the only article to date to explore the moderate upside, argues that inexperienced VCs may "grandstand"—seek a flashy, but possibly non-EV-maximizing, IPO to build a reputation.[98] The beach money problem might explain why VCs can get away with grandstanding. Both parties might think that the startup will be more profitable if it develops further as a private company, but the founders get their beach money and the VC firm gets the reputational boost from the premature IPO.

Founders may also oppose an exit because they extract private benefits from managing the business.[99] Founders may value the experience of developing cutting-edge technology, leading a team, the social prestige of being a founder, or as Elizabeth Pollman puts it, "the joy of being one's own boss."[100] On the moderate downside, the founders' private benefits from running the startup heighten the potential conflict with VCs seeking to exit and deploy capital to more promising startups. On the moderate upside, VCs can appeal to the founders' enthusiasm for managing the startup to help them resist beach money exit offers.

These differing explanations for why and when founders and VCs support or oppose exits are largely compatible. Taken together, they describe how decisionmakers' preferences change depending on how quickly the startup's value has grown. The only assumptions about VC preferences that are critical for the beach money exit hypothesis are (1) that the VC business model demands that some of its startups generate returns of more than 2–5x and (2) that, fund life cycle permitting, VCs will prefer to hold onto a startup that shows moderate success and the potential for extreme success. Unfortunately for VCs, founders' preferences may tempt them to exit before that potential is realized.

III. THE BEACH MONEY PROBLEM

Suppose that Emily and Oscar found a startup, NewCo, with Emily as CEO and Oscar as COO. They incorporate NewCo in Delaware and raise a seed round from Angel. Emily, Oscar, and Angel each take a quarter of the company's equity and a seat on NewCo's Board of Directors. Emily and Oscar's stock comes with single-trigger acceleration clauses, which provide that NewCo's right to repurchase their stock fully lapses in the event of a

97. *See* Broughman & Fried, *supra* note 21, at 1324 n.18 ("VCs may wish to exit now because the fund in which the portfolio company is held is coming to the end of its life.").

98. Paul A. Gompers, *Grandstanding in the Venture Capital Industry*, 42 J. FIN. ECON. 133, 135–37 (1996).

99. Smith, *supra* note 20, at 318.

100. Elizabeth Pollman, *Team Production Theory and Private Company Boards*, 38 SEATTLE U. L. REV. 619, 630 (2015).

change in control. The remaining space on NewCo's Cap Table is allotted to early employees or set aside for options for future employees.

NewCo grows quickly and burns through cash. Emily and Oscar hit the fundraising circuit and receive term sheets for a Series A. They close a round of $10 million on a pre-money valuation of $40 million.[101] AlphaFund leads the round with a $5 million check. The balance of the round is filled out by a syndicate of follower investors. The Series A Preferred stock of NewCo carries a 1x liquidation preference.

At the close of the A round, Emily, Oscar, Angel, and the Series A investors each own ten million shares. A final ten million shares are held by current NewCo employees or set aside for future NewCo employees. AlphaFund and the other new investors pay $1 for each Series A share, which implies a $50 million post-money valuation. Al of AlphaFund joins the Board and agrees with Emily, Oscar, and Angel that Iris will join as a fifth, independent director. After the Series A, this is NewCo's Cap Table:

Shareholder	*Shares*	*Ownership (Fully Diluted)*	*Implied Cash Value*
Emily	10m	20%	$10m
Oscar	10m	20%	$10m
Angel	10m	20%	$10m
Employees	10m	20%	$10m
Series A Preferred	10m	20%	$10m
Total	**50m**	**100%**	**$50m**

NewCo grows and attracts acquisition interest. A year after the Series A, TechGiant offers to buy NewCo for $100 million, twice its post-money valuation in the A round. Suppose that 20% of the shares set aside for early employees or employee options has been granted, vested, and exercised. On those facts, each of Emily, Oscar, Angel, and the Series A investors would receive $24 million in the exit—$20 million for their 10 million shares each plus a pro rata share of the leftover from the shares set aside for employee options. The proceeds would be distributed as follows:

Shareholder	*Shares*	*Ownership (Exit)*	*Cash Value (Exit)*
Emily	12m	24%	$24m
Oscar	12m	24%	$24m
Angel	12m	24%	$24m
Employees	2m	4%	$4m
Series A Preferred	12m	24%	$24m
Total	**50m**	**100%**	**$100m**

NewCo is vulnerable to a beach money exit. For the Series A investors, TechGiant's offer is underwhelming—a 2.4x return. If the VCs are confident in NewCo's future growth trajectory, they will oppose a sale. For Emily and Oscar, who paid pennies for their stock, an acquisition means beach money. Angel's position will be somewhere in between. He will receive a more impressive return than the Series A investors will, but he will have a greater ability to diversify risk than Emily and Oscar. Iris, the independent director, will

101. A "pre-money" valuation does not include the value of the additional cash that a new fundraising round adds to the startup's books. A "post-money" valuation does.

have a modest equity stake and may serve as the arbitrator.[102]

A. Founder Incentive to Exit

Founders support beach money exits because the subjective value they place on the payout differs from the value VCs place on the payout, despite receiving the same price per share. The difference is that founders cannot easily diversify their risks, and they face a diminishing marginal utility of wealth.

1. Nondiversifiable Risk

For Emily, rejecting a beach money exit offer and remaining independent effectively means betting $24 million on one company. As William Sjostrom explains, liquidity "is important to a company founder because his ownership stake likely represents a large percentage of his net worth. Selling a portion of his holdings allows him to have a more diversified portfolio."[103] Both academic finance and mainstream financial advisors recommend diversification. Most founders will have the financial sophistication necessary to have internalized that ubiquitous advice.

Suppose, for example, that Emily believes that, within a few years, NewCo's realistic best-case scenario is a $600 million exit. NewCo would not have the cash to stay afloat that long without another infusion of capital. Therefore, Emily will need to consider the impact of dilution from another fundraising round. Imagine that NewCo raises a $37.5 million Series B on a post-money valuation of $150 million. NewCo issues new Series B Preferred shares. The Series B investors purchase shares that equal a 20% fully diluted ownership. AlphaFund and the Series A investors also purchase new shares, at the new Series B round price, to retain their pro rata share. Here is a comparison between NewCo's Cap Table after the A and after the B:

	Series A			Series B		
Shareholder	*Shares*	*Ownership*	*Implied Value*	*Shares*	*Ownership*	*Implied Value*
Emily	10m	20%	$10m	10m	15%	$22.5m
Oscar	10m	20%	$10m	10m	15%	$22.5m
Angel	10m	20%	$10m	10m	15%	$22.5m
Employees	10m	20%	$10m	10m	15%	$22.5m
Series A	10m	20%	$10m	~13.3m	20%	$30m
Series B	n/a	n/a	n/a	~13.3m	20%	$30m
Total	**50m**	**100%**	**$50m**	**~66.7m**	**100%**	**$150m**

Now suppose that Emily's best-case scenario materializes. After the Series B round, NewCo grows at an even faster pace. LaterBuyer offers to acquire NewCo for $600 million. By the time of LaterBuyer's offer, more employees have joined NewCo and more of the earlier employees' stock has vested and been exercised. The shares set aside for early

102. *See* Broughman, *supra* note 83, at 487–98 (presenting data supporting the view that VCs and entrepreneurs take steps to ensure that independent directors are not biased towards either group of directors, enabling the independent director to serve as an arbitrator).

103. William K. Sjostrom, Jr., *The Birth of Rule 144A Equity Offerings*, 56 UCLA L. REV. 409, 433 (2008).

employees and employee options have now become all NewCo employee shares.[104] Here is how the two exits stack up:

	TechGiant Exit ($100m)			LaterBuyer Exit ($600m)		
Shareholder	*Shares*	*Ownership*	*Cash Value*	*Shares*	*Ownership*	*Cash Value*
Emily	12m	24%	$24m	10m	15%	$90m
Oscar	12m	24%	$24m	10m	15%	$90m
Angel	12m	24%	$24m	10m	15%	$90m
Employees	2m	4%	$24m	10m	15%	$90m
Series A	12m	24%	$24m	~13.3m	20%	$120m
Series B	n/a	n/a	n/a	~13.3m	20%	$120m
Total	**50m**	**100%**	**$100m**	**~66.7m**	**100%**	**$600m**

Emily knows she will receive $24 million in the TechGiant deal. If NewCo remains independent, she will receive anywhere between $0 and, if the LaterBuyer offer scenario plays out, $90 million. Her EV calculation would need to account for the VCs' liquidation preference, which means that any exit for NewCo before the Series B that is below $10 million will result in $0 for Emily, and any exit below $50 million will leave her with a less-than-proportional share. After the Series B, the investors will collectively have a liquidation preference of $47.5 million. Therefore, Emily's share of any exit below $47.5 million will be $0, and her share of any exit below $150 million will be proportionally discounted by the liquidation preference.

The midpoint of the range of possible values of Emily's stock if NewCo remains independent is $45 million. The mean will be lower because of the liquidation preference. If Emily were risk-neutral, she might vote to reject the TechGiant offer and hold out for a higher dollar value exit. But, for Emily, the probability distribution is crucial. If it is a normal distribution, the risk might be tolerable. If it is a bimodal distribution—some chance of continued high growth and some chance of liquidation—she might be less inclined. If she accepts the acquisition offer and invests her $24 million in a diversified portfolio, she will dramatically reduce the odds that she will fall below an eight-figure net worth. With even a modest amount of risk-aversion, Emily should support the acquisition.

AlphaFund has a different risk profile. Its investment in NewCo represents just a small part of its diversified portfolio of startups. Even if AlphaFund's investment in each individual company in the portfolio is high-risk, the portfolio as a whole can have a tolerable level of risk. AlphaFund is at least risk-neutral, and possibly even risk-loving. Recall that VC is a grand slam industry, with most of the returns from a given portfolio coming from a small number of the corporate form of investments.[105] Accordingly, AlphaFund will be inclined to oppose TechGiant's offer even if it shares Emily's view of NewCo's chances.

The risk diversification considerations that incline founders towards below-EV exits are a byproduct of the strong equity incentives that motivate them. VCs *want* founders to have undiversified risk—skin in the game—so that they expend maximal effort on growing

104. This is a simplifying assumption. In practice, NewCo probably would have set aside more shares for employee options at the time of the Series B.

105. *See supra* Part II.A.

the startup, rather than on extracting private value from managing. Most founders, like most people, do not want all that concentrated risk and will be tempted to diversify it when the opportunity presents itself.

2. Diminishing Marginal Utility

Emily might also prefer the acquisition offer because of the diminishing marginal utility of wealth. For Emily, $24 million is beach money. If Emily places her after-tax proceeds in conservative investments just to keep pace with inflation, she can expect to fund a century of six-figure annual incomes without working again. It is difficult to imagine that the difference between $24 million and $40 million, or even $90 million, will feel as valuable to her as the difference between her pre-acquisition net worth, possibly in the hundreds of thousands, and her post-acquisition net worth, $24 million before taxes.[106]

There is no consensus among social scientists on how common and how significant the diminishing marginal utility of wealth is.[107] But Emily is likely to experience it. The absolute value at stake—tens of millions of dollars—is high. The most powerful argument against the diminishing marginal utility of wealth is that it cannot explain small-value risk-aversion.[108] For many founders, a ten-figure acquisition payout would also have a high *relative* value. Rejecting the offer would be gambling multiples of their current net worth.

Of course, there are some founders who turn down beach money-level acquisition offers. Examples of this category are easily available because some of those founders later become fabulously rich. Mark Zuckerberg famously turned down a $1 billion acquisition offer from Yahoo for Facebook.[109] But recall that empirical research does not clearly support the hypothesis that entrepreneurs are risk-loving.[110] The base rate of risk-aversion, even in the self-selected group of startup founders, may be more instructive than examples like Zuckerberg.

Even if Emily does not experience a diminishing marginal utility of wealth, she may still be loss-averse. There is a robust empirical literature, starting with Daniel Kahneman and Amos Tversky, establishing that people value avoiding losses more than the opportunity to realize gains of the same amount.[111] Loss-aversion and diminishing marginal utility are conceptually distinct. Loss-aversion is reference-dependent.[112] A person is loss-averse with respect to a given state of wealth, like the $24 million Emily

106. I ignore taxes for simplicity and because founders' situations will vary considerably. The standard advice given to founders is to make an 83(b) election, so that they are taxed on their equity when it is worth pennies and then eligible for long-term capital gains tax at sale. *See, e.g.*, Kevin Criddle, *A Founder's Guide to Making a Section 83(b) Election*, THE VENTURE ALLEY (Sept. 14, 2016), https://www.theventurealley.com/2016/09/a-founders-guide-83b-election/.

107. *See* Sarah B. Lawsky, *On the Edge: Declining Marginal Utility and Tax Policy*, 95 MINN. L. REV. 904, 919–28 (2011) (reviewing, skeptically, the evidence for diminishing marginal utility of income).

108. Matthew Rabin, *Risk Aversion and Expected-Utility Theory: A Calibration Theorem*, 68 ECONOMETRICA 1281, 1282–88 (2000).

109. Mike Hoefflinger, *Inside Mark Zuckerberg's Controversial Decision to Turn Down Yahoo's $1 Billion Early Offer to Buy Facebook*, BUS. INSIDER (Apr. 16, 2017, 12:00 PM), http://www.businessinsider.com/why-mark-zuckerberg-turned-down-yahoos-1-billion-offer-to-buy-facebook-in-2006-2017-4.

110. *See* Åstebro, *supra* note 78, at 57.

111. *See generally* Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979); Daniel Kahneman et al., *Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias*, 5 J. ECON. PERSP. 193 (1991).

112. *See* Kahneman et al., *supra* note 111, at 199–200.

would receive in the TechGiant acquisition. Diminishing marginal utility is not reference-dependent. A curve modeling diminishing marginal utility would generate predictions about wealth that Emily does not yet have available. But in a situation like Emily's, when she is considering TechGiant's acquisition offer, loss aversion and the diminishing marginal utility of wealth would have largely the same effect.

In fact, neither diminishing marginal utility nor loss aversion may perfectly capture the shape of the utility curve behind how some founders think about beach money. Some founders may have utility curves that are kinked around the Number[113]—a dollar amount that would allow them to never have to work again. But again, the practical effect is the same. Once the acquisition offer rises above the Number, the founder will place less value on the chance at even greater wealth if the startup remains independent.

Most importantly, the effects of nondiversifiable risk and diminishing marginal utility push in the same direction. It is not just that Emily would be taking on highly concentrated risk to her $24 million in pursuit of the $90 million. She is taking on higher risk *and* doing so for additional money that would give her less subjective value than its nominal value, because of the diminishing marginal utility problem. The combination of these two factors is what makes a beach money exit so attractive to founders.

Unlike founders, VC firms can diversify their risk across their portfolio while the startup remains independent. VCs also do not face diminishing marginal utility concerns. The GPs will only receive 20% of the profits of the fund,[114] and, of course, much of the returns of any particular exit will be used to offset the failure of other startups in the portfolio. It should be rare for one exit to enable a VC to leave for a life on the beach. Accordingly, VCs will be unimpressed with beach money exits.

B. Founder Power to Exit

Who prevails when founders and VCs disagree about exit? The Delaware law answer is: it depends on who controls the board.[115] Board control depends on the startup's cap table. In early-stage startups, there is no dominant pattern of control. Steven Kaplan and Per Strömberg found, in a data set of 119 VC-backed companies, "the VC ha[d] the majority of the board seats in 25% of the cases, the founders in 14% of the cases, and neither in 61% of the cases."[116] They also found that "VC board control is less common for first VC rounds."[117] Therefore, if Kaplan and Strömberg's data are representative, in a minority of startups, founders have the votes for an exit. In a larger set of startups, founders can obtain the majority by persuading the independent director or directors. In a significant minority, they would need the support of at least some of the VCs.

The reality is more complicated. Most VCs have contractual blocking rights that enable them to veto an exit, or to veto an exit below a certain level.[118] So for founders to have an unchecked formal pathway to exit, they need an effective majority and the absence

113. *Cf.* John Tierney, *Number Theory*, N.Y. TIMES (Nov. 19, 1995), https://www.nytimes.com/1995/11/19/magazine/the-big-city-number-theory.html.

114. *See* Gilson, *supra* note 1, at 1072.

115. In practice, startup boards will sometimes seek the approval of shareholders not represented on the board to satisfy the acquirer's concern that shareholders who object to the deal will file a lawsuit.

116. *See* Kaplan & Strömberg, *supra* note 15, at 289–90.

117. *Id.*

118. *See* Smith, *supra* note 20, at 346.

of blocking rights or an acquisition offer above the level at which the blocking right is set.[119] In most cases, therefore, founders will need to rely on persuasion or informal power to achieve a beach money exit.

Consider the issue from the VCs' perspective. For VCs to oppose a beach money exit, they must not only have the votes or blocking rights that cover the relevant offer. They must have the information to realize that the exit is not EV-maximizing. They must have a plan to continue to grow the business even though the founders would prefer to sell it. They must have a willingness to enforce their rights to oppose exit in court. Under realistic assumptions, any or all of those factors may be missing when a startup receives a beach money exit offer.

This is *not* to say that founders can always force an exit. There is anecdotal evidence of former founders complaining that VCs blocked an acquisition offer that the founders supported, which would have given the VCs a 2–5x return.[120] The power that founders have to force an exit is situation-specific. It may require strategic thinking or a willingness to play a risky game of chicken with VCs. Founders must play that game quietly, or else risk causing a skittish prospective acquirer to withdraw because it does not want to acquire a lawsuit. But founders' incentives to force a beach money exit are strong, and founders who are able to attract a beach money offer are likely the type who respond well to strong incentives.

1. Information Asymmetry

Most of this Article examines *witting* beach money exits, exits that happen when VCs believe that accepting an acquisition offer is not the highest EV decision for the startup but are outplayed by the founders. This part explores *unwitting* beach money exits. They happen when founders privately believe that an exit is not EV-maximizing for the startup, but, armed with asymmetric information, are able to convince the VCs that an exit is EV-maximizing—or at least sow enough doubt about the startup's prospects that the VCs are not willing to fight the exit.

Founders constantly absorb information about the value of their business in their capacity as managers.[121] They observe their employees' skill and diligence as they supervise them. They learn how their technology is developing and how it performs in internal analyses. They receive data from customers who beta-test their product. They see how quickly users are adopting the product and, at later stages, how much consumers are willing to pay for it. Founders may also take the lead in the sales process, which yields them information about how other prospective acquirers value the company and their level of interest in acquiring.

Of course, VCs will be eager to acquire this information as well. VC directors receive updates on technology, product, and employees at board meetings.[122] Similarly,

119. Arguably, they would also need to overcome a lawsuit claiming that they violated their duty of loyalty, but such a claim is unlikely to be successful under Delaware law. *See infra* Part V.B.

120. *See* Basil Peters, *Why VCs Will Block Good Exits*, ANGELBLOG, http://www.angelblog.net/Why_VCs_Block_Good_Exits.html (recounting the story of a founder complaining that VCs had blocked an exit that would have yielded a 3x return for them).

121. *See* Gilson, *supra* note 1, at 1083 ("Ongoing learning by the entrepreneur increases the information disparity and therefore the entrepreneur's discretion, which in turn increases agency costs.").

122. *See id.* (observing that VCs can check the increase in information disparity by "[o]ngoing monitoring").

prospective investors seek this kind of information in financing due diligence requests. But founders have the advantage of being able to disclose information selectively. VC directors and prospective investors may not know the right questions to ask, or the evidence may be difficult to quantify or document, leaving the founders room to portray it differently as it suits their interests. This is especially likely when the relevant knowledge is technical. Then, the information asymmetry favors the founders not simply because they have access to more information, but also because they are more skilled at evaluating it.[123]

During a financing due diligence—and to a lesser extent, at board meetings—founders generally have an incentive to emphasize the startup's strengths and downplay its challenges. When founders support an acquisition and VCs oppose it, the incentive is reversed. Founders can use the information asymmetry to raise doubts about the company's EV. Of course, VCs know founders stand to gain an outsize amount from a sale and can discount founders' arguments accordingly. Founders may be hemmed in by their previously rosy statements to the board. They also may need to talk up the value of the business to prospective acquirers at the same time they are talking it down to their fellow directors. But, on balance, founders have more access to information about their business than VCs do, and this information asymmetry may enable them to convince the VCs that the EV of the startup is below the value of the acquisition offer, even if they privately believe otherwise.

Participants in the TechGC questionnaire gave examples of situations in which founders supporting an exit used their private information in arguments to fellow board members. One VC firm lawyer stated that "[s]ometimes founders can mention something like internal discord to explain that the situation for the company is not as simple as an analysis of traction, financials, [or market comparables]." Another VC lawyer reported that the founders told the board that the "team" was "out of gas." It is difficult to imagine VCs credibly disputing these kinds of claims.[124]

A beach money exit may even be unwitting *to founders*. Founders, like all human beings, are prone to confirmation bias—the propensity to interpret ambiguous evidence in the light most favorable to one's desired conclusion.[125] Given that founder-directors have a fiduciary obligation to the corporation, it would be extremely convenient if that obligation overlapped with their private financial interest.[126] In a mature business, where the metrics for valuing a company—earnings, revenue, customers, etc.—are more objective, misleading oneself about the value of a deal is less likely. In a startup, any EV prediction is highly uncertain. Again, it depends on, for example: the set of potential acquirers, potential new entrants, execution risk, and macroeconomic conditions. In such an

123. *See* Manuel A. Utset, *Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital–Financed Firms*, 2002 WIS. L. REV. 45, 57 (2002) (explaining that a startup entrepreneur "will not only have greater access to information related to the ongoing development of the innovation, but will also have a better ability to judge and use that information since she will generally have superior technical knowledge").

124. This point raises the interesting suggestion that VCs should develop relationships with rank-and-file employees at their portfolio companies to have an internal source of information about its prospects that is independent from the founders.

125. For a review of the literature, see generally Raymond S. Nickerson, *Confirmation Bias: A Ubiquitous Phenomenon in Many Guises*, 2 REV. GEN. PSYCHOL. 175 (1998).

126. To be sure, the founder-director's fiduciary obligations may not be enforceable in a beach money exit suit. *See infra* Part V.B (explaining why a fiduciary-duty lawsuit brought against founder-directors for taking a beach money exit likely would not succeed).

information-weak environment, founders may convince themselves that they are not betraying their duty of loyalty—they are simply being sober about the risks facing the business. Thus, motivated cognition may contribute to beach money exits.

2. Founders' Contribution to Enterprise Value

When founders and VCs disagree about a proposed exit, founders' power to impose their will depends on how entangled the value of the business is with the contributions of the founders. In a successful early-stage startup, the entanglement can run deep. The technology that the startup is developing might require special expertise that only the founders and a few others possess. The founders might be well-respected figures in the industry, whose departure would raise questions about the viability of the company. The founders might also command intense loyalty from the management team and key employees, so much that if the founders were to leave, the company would disintegrate. In these situations, replacing the founders as managers will be costly for the VCs.

If prospective acquirers are primarily interested in an acquihire or otherwise place a premium on the founders' future labor, the VCs' viable exit strategies will require the cooperation of the founders.[127] The startup's intellectual property may only have value if its creators continue to develop it. Founders could threaten to leave the company, and take their hand-picked team, if the acquisition offer is rejected. They could more subtly signal to the VCs that they are unenthusiastic about remaining independent, raising questions in the VCs' minds about whether the founders are willing to exert the effort needed to reach the next exit opportunity. The VCs' predicament is akin to a contracting party seeking specific performance of a contract that the other party wants to terminate. Faced with that choice, the VCs' estimate of the EV of remaining independent might fall below the value of the acquisition offer, even though the VCs preferred that the startup remain independent before they learned of the founders' position.

3. The Revenge of the One-Shotter

Suppose the VCs decide that the startup will continue to grow without the founders or that the founders are bluffing when they claim they will quit. After all, when founders hold a beach-money-level equity stake in a startup, they also have a lot to lose. In some cases, founders may feel loyalty to the company or to the investors who bet on them before they found success. VCs will likely have more financial and legal resources to bring to the fight. They will also have more experience with founder-VC disputes and a network of colleagues to advise them. In the language of social science, the VCs are the repeat players.[128]

Startup exit disputes may be the exceptional case in which the one-shotter has an advantage over the repeat players. For founders, if they win the battle, they win the war. They will not need to raise VC capital again to fund their life on the beach. This is why, in some Silicon Valley circles, beach money is called "fuck you money"[129]—money that

127. For an account of why tech companies use acquihires as a talent acquisition strategy rather than just poaching individuals, see John F. Coyle & Gregg D. Polsky, *Acqui-hiring*, 63 DUKE L.J. 281, 311–31 (2013).

128. For the classic formulation, see generally Marc Galanter, *Why the "Haves" Come Out Ahead: Speculations on the Limits of Legal Change*, 9 LAW & SOC'Y REV. 95 (1974).

129. Michael Wolfe, *What Is "Fuck You Money"?*, QUORA (Mar. 18, 2014), https://www.quora.com/What-

offers freedom from having to care much about one's reputation. Some successful founders will found other startups. In fact, according to one study, 18% of founders raised capital from investors who had invested in their previous startup.[130] But when a founder receives a beach money payout, it is their choice whether to seek remunerative employment again.

For VCs, the dispute over exit will be just one of many disagreements they have with founders over their careers. If the battle becomes public, other founders and prospective founders might think twice about taking investment from the VCs involved. VC firms do not want to be known for fighting with founders over an arguably successful exit. As Marc Andreessen, of the VC firm Andreesen Horowitz put it: "We make our money on the [startups] that work and we make our reputation on the ones that [do not]."[131] From the perspective of a VC, a startup that only returned 2–5x is a startup that did not fully work out and where leaving with their reputation intact is important.

Multiple participants in the TechGC questionnaire, when asked what surprised them the most about deliberations in which directors disagreed about exit, emphasized how non-confrontational the deliberations were. One lawyer at a VC-backed startup stated: "Each Board I've been involved with has acted based on consensus. Although there have been lively discussions about exits with different perspectives represented, I've never seen it come down to a vote." Another startup lawyer gave a similar account: "My experience over a couple of companies is that it [does not] reach the point of formal disagreement but, rather, healthy dialogue and an ultimate consensus." A third startup lawyer simply stated being surprised at "[h]ow cordial it typically is."

Kate Litvak and her collaborators found that VCs who litigate with entrepreneurs "invest in a smaller number of deals, raise smaller funds, and syndicate with a smaller number of VCs relative to their non-litigated peers."[132] The conventional wisdom in Silicon Valley is consistent with Litvak's evidence. VCs are seen as extremely litigation-averse.

For example, in 2017, Benchmark Capital sued its portfolio company Uber and its former CEO Travis Kalanick in the Delaware Chancery Court.[133] Benchmark alleged that Kalanick had committed fraud, violated fiduciary duties, and breached a contract.[134] At the time of the suit, Benchmark was reported to have owned approximately 13% of Uber's equity.[135] Benchmark reportedly had never sued a portfolio company before.[136] That fact alone is remarkable.

The reaction to the lawsuit is also telling. Commentators were critical of Benchmark for having allowed Kalanick to accumulate so much power, including control of three Uber

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is-fuck-you-money (observing that, derivation of the term notwithstanding, "I find that the kinds of people who do obtain their f—k you money rarely end up telling the world to f—k off and go live on the beach").

130. *See* WASSERMAN, *supra* note 40, at 360.

131. *MiB: Marc Andreessen, Venture Capitalist at A16Z*, MASTERS BUS. (May 20, 2017), http://ritholtz.com/2017/05/mib-marc-andreessen-venture-capitalist-a16z/ (full interview can be found on iTunes, Soundcloud, Overcast, and Bloomberg).

132. Atanasov et al., *supra* note 17, at 2218.

133. Dan Primack, *Scoop: Benchmark Capital Sues Travis Kalanick for Fraud*, AXIOS (Aug. 10, 2017), https://www.axios.com/scoop-benchmark-capital-sues-travis-kalanick-for-fraud-1513304764-18c62fe5-c80e-4fec-ad1b-135ffaafa1ec.html.

134. *Id.*

135. *Id.*

136. Connie Loizos, *What was Benchmark Thinking?*, TECHCRUNCH (Aug. 11, 2017), https://techcrunch.com/2017/08/11/what-was-benchmark-thinking/.

board seats.[137] An institutional investor in Benchmark told *TechCrunch* that Benchmark "[was] riding the gravy train, and now they're sticking it to [Kalanick]. . . . These guys are all billionaires anyway, but this could definitely taint their reputation."[138] *TechCrunch* added that "[a] second institutional investor who also believes Benchmark should shoulder more of the blame, agrees that founders may grow wary of the firm following its recent actions. But he notes that even this worst-case scenario isn't likely to turn off Benchmark's backers," because Benchmark's fund had been so successful.[139] If suing a founder as unsympathetic as Kalanick makes founders wary, one should expect VCs to shy away from lawsuits.

Finally, the court of public opinion may favor the founders. VCs and those who follow the VC industry closely know that a 2–5x return is underwhelming. But to outsiders, a company that triples or quadruples in size looks highly successful. For founders, success buys reputational power. That power can be converted into cash in a forced exit.

IV. THE LIMITS OF CONTRACT

VCs anticipate the risk of beach money exits and try to prevent them by contract. First, before VCs agree to invest, they screen for founders who have ambitions for the business beyond the first beach money offer and a business plan that suits the term of their investment. Then they monitor founders to ensure that they are focused on building value rather than courting acquirers. Second, at the time of investment, VCs usually demand blocking rights—a veto on exits, or exits below a certain value, even in the absence of board control. Third, VCs agree with founders to mutually appoint one or more independent directors who can arbitrate disputes among board members from an impartial perspective. Fourth, when the startup receives an acquisition offer, VCs can facilitate the purchase of some of the founders' equity with secondary capital.

To be sure, preventing beach money exits is not the primary explanation for these practices. VCs manage many risks, and the risk of an underwhelming exit in a successful startup is just one. VCs' main focus in screening founders is to find the potential grand slam. VC monitoring can check many kinds of founder opportunism. Blocking rights can be used to prevent exits forced by other investors, as well as by founders.[140] Independent directors can arbitrate many kinds of disputes, which may not even involve exits. Secondary capital purchases can give founders needed liquidity even in the absence of an acquisition offer.[141] Each of these contractual strategies can reduce the chance of a forced exit, but they are all at best incomplete solutions.

A. VC Screening and Monitoring

VCs vet tens or hundreds of startups for every startup they invest in.[142] In addition to

137. *Id.*

138. *Id.*

139. *Id.*

140. Note, however, that the existence of limited blocking rights that apply only to exits below, for example, a 3x return is strong evidence that VCs are concerned about beach money exits.

141. It is only when founders sell more of their equity on the secondary markets than their personal liquidity needs can explain that one should suspect that VCs are allowing a founder to cash out in exchange for forgoing a beach money exit.

142. *See, e.g.*, Satya Patel, *Homebrew's 1%: The VC Metrics Behind Investing in One of Every 100*

assessing how likely founders and their business plans are to succeed, VCs can assess how founders *define* success, whether it involves a quick acquisition or long-term growth.[143] Three participants in the TechGC questionnaire reported that, in board deliberations they had experienced in which the VCs opposed exit and management supported it, the directors invoked discussions that they had about exit options before the VCs had invested. One participant who reported that pre-investment discussions came up in exit deliberations recalled a VC director expressing disappointment that the founder had "opted to not build a big company."

Of course, at the time of investment, sophisticated founders may tell VCs what they believe VCs want to hear. But VCs can look to costly signals. For example, the startup may be developing a technology that will not bring revenue or other external validation for years. In the case of a serial founder, VCs can ask about her decisions in the face of previous acquisition offers. In these ways, VCs can screen for founders who are less vulnerable to beach money exits. But because VCs need to screen along so many other dimensions, preventing decent but underwhelming acquisitions may not be a priority. VC screening also cannot prevent a founder's definition of success from changing, which a beach money offer may do.

VCs can use board meetings to monitor whether founders are creating long-term value. VC directors will expect updates from the founders on progress towards technological or business milestones oriented to long-term goals. During fundraising periods, VCs can assess how willing founders are to remain independent by observing how vigorously they work to raise the next round and from whom they seek funding. But, again, the information asymmetry in the founders' favor dampens VCs' ability to monitor.[144] By the time VCs become aware that founders are courting acquirers, it may be too late and too costly for the VCs to thwart them from accepting an offer.

B. Blocking Rights

Most VC investment contracts contain blocking rights—provisions enabling VCs to veto a sale, even in the absence of board control.[145] A blocking right can take the form of a class voting rule.[146] For example, an investor or a group of investors representing the majority of the Series A Preferred shareholders might obtain a provision stating that a change of control requires the approval of a majority of each class of shares. With such a provision, the VCs could legally thwart an exit that the founder majority supported.

Securing blocking rights may require VCs to make tradeoffs. VCs will be unlikely to have the bargaining power to demand that *only* their class—e.g., the Series A—will have

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Companies We Meet, VENTURE GENERATED CONTENT (Jan. 9, 2014), https://venturegeneratedcontent.com/2014/01/09/homebrews-1-the-vc-metrics-behind-investing-in-one-of-every-100-companies-we-meet/ (claiming that his VC fund closed 9 investment deals after evaluating 885 opportunities).

143. *See* WASSERMAN, *supra* note 40, at 294 (suggesting that VCs look for signals that founders are "wealth-motivated").

144. *See supra* Part III.B.1.

145. *See, e.g.*, Smith, *supra* note 20, at 346–47 (using negative covenants to force an exit).

146. Note that "California purports to subject 'quasi-California' corporations (corporations doing business in California but incorporated elsewhere) to the requirement of separate class votes" for sales and consequently "many (but not all) Delaware-incorporated companies located in California are advised by lawyers to hold separate class votes." Broughman & Fried, *supra* note 21, at 1345–46.

a veto right. The right for the Series A investors to veto a sale they oppose may come packaged with the right for the Series B investors or the common shareholders to veto a sale the Series A supports. VCs are unlikely to accept a bargain that limits their own liquidity because VCs may want to force an exit on the moderate downside.

Blocking rights provide evidence that VCs are concerned about forced exits. Blocking rights are unidirectional: they only serve to block a sale the VCs oppose rather than force one that the VCs support. This suggests that VCs believe that other shareholders—which, in early-stage startups, largely means founders—may seek exits they oppose. The exits that VCs seek to thwart must be exits that generate *some* return for them, because VCs' liquidation preferences, if set to 1x, already ensure that founders gain nothing from an exit that returns to VCs less than they invested.[147] Four participants in the TechGC questionnaire stated that at least one VC director had raised the issue of their blocking rights in deliberations about an exit that the VC directors opposed.

Some VC contracts include limited blocking rights that allow a set of shareholders to veto a sale below a certain level.[148] For example, the Series A investors in NewCo, who invested $10 million at a post-money valuation of $50 million, could require as a condition of their investment that the NewCo could not agree to a change of control for less than $150 million—a 3x return—unless a majority of each class of shares approved. Note that if a startup has raised multiple rounds of funding, investors' views about what counts as a successful exit could be heterogenous, making it difficult to reach consensus on the level for the veto. Where they are found, blocking rights limited to a specific level are powerful evidence that VCs are concerned about beach money exits.

That most VCs have blocking rights does not mean that they use them. The reputational costs could be significant. An article in *TechCrunch* summarized the conventional wisdom in Silicon Valley:

> Many VCs have rights they can use to try to block an acquisition. But most rarely use them, particularly if a founder makes a good case for a deal as the best possible outcome for a company. VCs do not want to be known as 'not founder friendly,' even if they hate a deal and feel it is unfair. But they'll complain privately.[149]

Do formal blocking rights matter when founders can force exit through informal means? Blocking rights set to a certain level might have persuasive value with founders and especially independent directors. The level at which the blocking right is set has an anchoring effect on what kinds of exits are and are not acceptable. That anchor can be a double-edged sword for VCs because it is so difficult to assess what a startup's EV will be at the time of an acquisition offer. Suppose that AlphaFund persuades Emily and Oscar to give the Series A investors a blocking right for all sales below $150 million, but NewCo's product takes off and it grows faster than expected. If a prospective acquirer offers $250 million, AlphaFund will not have much credibility to argue that the offer is underwhelming given that it far exceeds the anchor that AlphaFund chose.

147. In theory, a blocking right could be designed to prevent future investors with a senior liquidation preference from forcing exit.

148. Bengtsson, *supra* note 23, at 1931.

149. Tomio Geron, *When Founders and Investors Split over an Acquisition Offer*, TECHCRUNCH (Feb. 22, 2014), https://techcrunch.com/2014/02/22/when-founders-and-investors-split-over-an-acquisition-offer/.

C. Independent Directors

VCs may have an ally in persuading founders to resist a beach money exit offer: the startup's independent director. Because independent directors generally only receive "a small share of common stock for their services,"[150] they are free from the strong financial incentives that might bias other directors in exit decisions. But, like other directors, they have access to the board's confidential deliberations and a vote in its decisions.

Broughman argues that founders and VCs deliberately choose a neutral independent director because they anticipate the potential for conflict and expect that the independent director will serve as an arbitrator.[151] In fact, he notes, VCs will sometimes negotiate the name of the independent director as part of their initial investment.[152] In Broughman's account, "[t]he independent director does not need to 'arbitrate' actual conflicts, but rather, primarily serves as a commitment mechanism that forces the entrepreneur and VC to compromise. Provided the independent director is relatively unbiased, competition for the independent director's support limits the threat of opportunism."[153]

To support his theory, Broughman offers evidence suggesting that independent directors are generally appointed by mutual agreement.[154] He emphasizes that independent directors are more than just mediators or advisors, because they are granted voting rights.[155] In fact, he notes that, in Kaplan and Strömberg's dataset of VC-backed startups, independent directors held the tie-breaking vote between founders and VCs in the majority of cases.[156]

The role that independent directors play in Broughman's account resembles in some respects[157] the role that an independent board of directors plays in public companies in Margaret Blair and Lynn Stout's influential "team production theory" of corporations.[158] Blair and Stout argue that "an independent board is what makes a public corporation a public corporation."[159] They describe the board of directors as a "mediating hierarch" for a corporation.[160] According to their theory, the board aims to "balance team members' competing interests in a fashion that keeps everyone happy enough that the productive coalition stays together."[161] In other words, the board serves as an "internal 'court of appeals.'"[162]

Startup boards differ from public company boards in that startup directors are largely

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150. Broughman, *supra* note 83, at 485.

151. *See id.* at 480–86.

152. *See id.* at 493 (finding, based on interviews with entrepreneurs that, "in many cases the identity of the independent director was specifically negotiated as part of the financing, and the name(s) of the independent director(s) were sometimes included directly in the voting agreement").

153. *Id.* at 464.

154. *See id.* at 491–95 (describing evidence on how independent directors are selected).

155. *See* Broughman, *supra* note 83, at 500 (rejecting the idea that independent directors serve merely as advisors, on the ground that they have voting rights).

156. *See id.* at 469.

157. *See id.* at 502 (characterizing the independent directors as arbitrators theory as "a partial extension of Blair and Stout's theory to VC-backed firms").

158. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

159. *Id.* at 251.

160. *Id.* at 276.

161. *Id.* at 281.

162. *Id.* at 276.

not independent.[163] Founders are managers, directors, and large shareholders. VCs are directors and large shareholders. Both founders and VCs are deeply interested in startup board decision-making. Therefore, a startup board does not resolve disputes between other corporate stakeholder groups, like shareholders or managers, as a public company's board would. Instead, as Broughman explains, independent directors on a startup's board arbitrate disputes *among board members*.

When startup board members disagree about a beach money exit offer, independent directors may not be able to resolve the dispute, for three reasons. First, to the extent that an independent director's power is based on her tie-breaking vote, it is unlikely to matter in many exit cases. Founders' informal power to force an exit does not rely on a board majority.[164] VCs usually have contractual blocking rights that render a board majority irrelevant anyway. A founder's credible threat to leave the company and take her key employees, or simply to not work as hard in pursuit of a higher exit later, may suffice to force an exit.

Second, an independent director has much weaker incentives in a beach money exit scenario than either founders or VCs do. For founders, the incentive is a life-changing amount of money. For VCs, the incentive is not quite as strong as it is for founders, but it is at least 20% of the difference in returns between the pending exit offer and the hypothetical future exit offer that the VCs believe has a higher EV. For an independent director, the incentive of the modest equity stake she holds will generally not be significant. The financial outcome for the independent director likely will not be beach money now or later, and she will not be counting on 10x or more returns. An independent director's weak incentives are what make her opinion on the best course for the startup credible. But the same incentives also make her less willing to escalate the conflict.

Third, independent directors may be subject to similar reputational pressures as VCs. Broughman contends that independent directors should be impartial because, "[i]f an independent director develops a bad reputation among the broader community of entrepreneurs or VCs, he is unlikely to be appointed to serve on future boards."[165] But this argument only holds if the reputational pressure to side with founders or VCs is symmetrical. That is likely true in many decisions that a startup board makes. But VCs' reluctance to litigate against founders suggests that opposing the sale of a moderately successful startup may be the riskier move for one's reputation in Silicon Valley.

One implication of this analysis is that the best strategy for VCs in selecting an independent director may not be selecting the most VC-favorable director possible. A better strategy, at least for avoiding beach money exits, may be to choose an independent director who has the respect of, or influence over, the founders, in the hope that she will be able to talk the founders out of an opportunistic decision.

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163. Note, however, that in a later article, Blair stated that "a growing body of evidence suggests that in many private corporations, board structures are being chosen explicitly so that independent directors can carry out a mediating function." Margaret M. Blair, *Boards of Directors as Mediating Hierarchs*, 38 SEATTLE U. L. REV. 297, 335 (2015); *see also* Pollman, *supra* note 100, at 621 (arguing that the "[t]he mediating hierarchy model is reflected in certain private corporations and might in fact find some of its clearest expression in the evolution of startup companies").

164. *See supra* Part III.B.

165. Broughman, *supra* note 83, at 486.

D. Secondary Capital

VCs also have an exit prevention strategy available at the time that a startup receives an acquisition offer. VCs can arrange for some, but not all, of the founders' shares to be cashed out on the secondary capital market.[166] Five participants in the TechGC questionnaire stated that VC directors had raised the possibility of secondary capital sales during deliberations in which founders supported an exit that VC directors opposed. There are two ways that these purchases can work. The company can sell new shares to investors and use the proceeds of those sales to repurchase the founders' shares. Alternatively, the investors can cross-purchase shares directly from the founders. VCs' cooperation may be necessary for secondary capital transactions if the company has a right of first refusal on sales of its shares.[167]

Secondary capital purchasers are usually outside investors.[168] The price of the shares they purchase will usually reflect a discount on the value of the shares to be purchased in the adjacent financing round.[169] The justification for the discount is that secondary market purchasers generally buy common shares, which lack the liquidation preference and other special rights that a new class of preferred shares would have.

Recall that Emily had 10 million shares of NewCo at the time of TechGiant's acquisition offer. TechGiant offered to pay $2 per share, so, after accounting for the redistribution of the unused shares set aside for employee options, Emily stood to gain $24 million from the acquisition. Suppose instead that Al of AlphaFund found outside investors willing to buy 2 million of Emily's shares for $1.50. If she took the deal, she would be left with $3 million in cash and 8 million shares of NewCo. The advantage of secondary capital is that the $3 million can provide Emily with some financial security short of beach money *and* she would still stand to gain an outsize amount from a later acquisition or IPO. From Alpha Fund's perspective, arranging the secondary capital deal could be a strategy to steel Emily to resist TechGiant's offer.

Emily may still prefer the acquisition. The same factors—nondiversifiable risk and diminishing marginal utility of money—that push Emily towards the beach money offer in the first place will push her to reject the secondary capital. The secondary capital alternative—$3 million plus a risky bet on a future payout from the 8 million shares—may be better than rejecting the acquisition offer alone, because it is a risky bet on a future payout from 10 million shares. The secondary capital alternative may, however, not beat $24 million and no risk.

Secondary capital presents a trade-off: the more financial security that founders receive, the more it erodes their strong equity-based incentives to run the business. Whoever buys the secondary capital is effectively betting that the founders will continue to manage the business as they did when their incentives were stronger. In some cases, there may be a happy compromise that gives founders financial security but keeps investors convinced that they have sufficient incentives going forward. In many cases, secondary

166. For an analysis of how secondary capital sales are exempted from securities regulation, see Pollman, *supra* note 26, at 189–91.

167. *See* NAT'L VENTURE CAP. ASS'N, NVCA MODEL LEGAL DOCUMENTS: RIGHT OF FIRST REFUSAL AND CO-SALE AGREEMENT (2018), https://nvca.org/resources/model-legal-documents/.

168. *See* Ibrahim, *supra* note 25, at 19–20 (describing potential buyers on the secondary market).

169. *See id.* at 18 (giving examples of discount rates between 5% and 71% on direct secondary capital purchases).

capital will be too little, too late to stop a beach money exit.

Consider the case of Travis VanderZanden, the founder of the electric scooter startup Bird. In just one year of existence, Bird had raised $450 million from investors, including Sequoia Capital.[170] VanderZanden had invested some of his personal wealth in Bird's $4 million seed round.[171] But in June 2018, a securities filing revealed that the percentage of Bird stock that was "'founders preferred stock' ha[d] dropped by one-third, to nearly 7.5 million shares from 11.25 million," which represented a decrease from 7% of the total shares to 4%.[172] It is believed that VanderZanden, as the sole founder of the company, was the likely holder of all of the "founder-preferred stock."[173] The amount that VanderZanden cashed out "would be equivalent to about $44 million if the shares were sold at the same price as the company's most recent fundraising round."[174] Of course, they might not be equivalently-valued if the "founders preferred" carries different rights than the new preferred stock that investors purchased.

The secondary sale raised eyebrows. An article in the Silicon Valley insider publication *The Information* said a stock sale of that size was "highly unusual for the founder of a startup that is only a year old."[175] A reporter in *Vanity Fair* agreed with that assessment and explained that "venture capitalists would typically balk at a founder asking to cash out tens of millions of dollars. Holding on to stock is seen as a way to signal confidence about a company's future, and a way to incentivize founders to keep their noses to the grindstone."[176] In other words, VCs worry that when founders sell large portions of their equity stakes, they erode their forward-going incentives.

So why did Sequoia and Bird's other investors agree to let VanderZanden sell such a large share? In an interview, VanderZanden stated:

> It's not atypical in Silicon Valley. It's not often reported, but it happens frequently. In our case, we were so oversubscribed on our fundraise round, and what's important right now is getting as many strategic investors [as possible]. I did sell some of the [founder-friendly] shares to get some of the strategic investors in the Bird family.[177]

The ostensible rationale VanderZanden offers for the sale—that Bird's fundraising round was oversubscribed—is plausible. Bird's current investors could see value in diversifying the company's shareholder base to bring more external validation for the startup and give more deep-pocketed investors a vested interest in supporting Bird financially if it later struggles. VanderZanden is exaggerating how typical a secondary capital sale this large and this early is. It would not have been considered newsworthy by insider publications if it were typical. VanderZanden's rationale may be pretextual. What we do know is that VanderZanden must have had considerable leverage with the VCs if

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170. *See* Amir Efrati & Alfred Lee, *One Year in, Bird Founder Sells Some Shares*, THE INFORMATION (June 17, 2018), https://www.theinformation.com/articles/one-year-in-bird-founder-sells-some-shares.

171. *See id.*

172. *Id.*

173. *Id.*

174. *Id.*

175. Efrati & Lee, *supra* note 170.

176. Maya Kosoff, *Why Is the Electric-Scooter King Selling His Shares?*, VANITY FAIR (June 18, 2018), https://www.vanityfair.com/news/2018/06/electric-scooter-king-travis-vanderzanden-selling-bird-shares.

177. Cory Weinburg, *Bird CEO Passes on Uber, Takes Aim at Cars*, THE INFORMATION (July 20, 2018), https://www.theinformation.com/articles/bird-ceo-passes-on-uber-takes-aim-at-cars (brackets in original).

they were willing to let him cash out in beach money.

E. Other Contractual Solutions

It is possible that VCs could find other contractual means to steel founders to resist a beach money exit offer. John Coyle and Joseph Green have demonstrated that the structure of VC contracts has evolved over time.[178] The decline of IPOs and the rise of unicorns—privately-held companies with a valuation over $1 billion[179]—may increase pressure for startup equity liquidity and beach money exits. The prestige of a potential IPO may have given founders a non-financial benefit to resist acquisitions and hold out on going public. When the only realistic exit option is an acquisition, founders may be more willing to take a non-EV-maximizing one sooner than an EV-maximizing one later.

We also know that VCs use cash payments to induce agreement in other contexts. Recall Broughman and Fried's evidence that, in a small number of moderate downside exits in which common shareholders receive little or nothing because of the VCs' liquidation preferences, VCs will give a "carve-out" to common shareholders to sweeten the deal.[180] VCs could also facilitate a special dividend payment to common shareholders. In 2011, the Airbnb founders reportedly rewarded common shareholders with a $22.5 million divided, $21 million of which went to the founders personally.[181] The payments from VCs to founders could also come in the form of an increase in their salaries. Alternatively, the VCs could relax their monitoring of the founders' extraction of private benefits from ownership, though this would be a dubious "solution" to the problem.

The beach money exits hypothesis implies that all of these kinds of payments could happen in the aftermath of a founder reluctantly turning down an acquisition offer she wanted to accept. It would be difficult to test empirically whether a deal to turn down an acquisition offer *caused* the payments, because a startup's early success could cause *both* a beach money exit offer and infusions of cash from existing or new investors. The Bird example illustrates the difficulty of isolating the cause, absent access to confidential documents.

All contractual solutions to the beach money exit problem face a version of the same tradeoff that limits the use of secondary capital purchases for that purpose. Any payment, in cash or otherwise, that can compensate founders on the level of beach money, erodes their forward-going incentives to manage the business.

In a sense, all startup equity compensation has an option-like quality.[182] Founders

178. For a case study of one recent development in venture capital investment contracts, the seed note, see John F. Coyle & Joseph M. Green, *Contractual Innovation in Venture Capital*, 66 HASTINGS L.J. 133, 160–70 (2014).

179. For a list of publicly known unicorns, see *The Global Unicorn Club*, CB INSIGHTS, https://www.cbinsights.com/research-unicorn-companies. For an argument that unicorns struggle with corporate governance, see generally Renee M. Jones, *The Unicorn Governance Trap*, 166 U. PA. L. REV. ONLINE 165 (2017).

180. *See* Brian J. Broughman & Jesse M. Fried, *Renegotiation of Cash Flow Rights in the Sale of VC-Backed Firms*, 95 J. FIN. ECON. 384, 385 (2010).

181. Kara Swisher, *Email: Chamath Palihapitiya Decries Airbnb's Recent $112M Funding for Founder Control and Cash-Out*, ALLTHINGSD (Oct. 1, 2011), http://allthingsd.com/20111001/vcs-unite-chamath-palihapitiya-decries-airbnbs-recent-112m-funding-for-excessive-founder-control-and-cashout-in-email/.

182. Gilson, *supra* note 1, at 1080 (explaining that staged financing responds to "the option-like character of the entrepreneur's interest in the portfolio company").

never stand to lose an investment, unless they bootstrapped the business. If the startup fails, their only losses are the forgone salary, the hit to their reputation, and the opportunity cost. But the financial upside of equity is strong motivation. The ubiquity of strong equity incentives in VC contracts—especially the fact that they are consistently demanded by sophisticated, motivated repeat players—suggests that these incentives are critical to the success of startups. Consequently, VCs would be taking a risk that they would not usually take if they gave founders beach money-level payments and expected founders to still be motivated by what was left of their equity incentives.

V. THE LAW OF EXITS

A beach money exit appears to be a breach of the founder-directors' fiduciary duties. A startup, like any Delaware corporation, is managed by its board of directors.[183] Under Delaware law, directors owe a duty of loyalty to the corporation. As the Delaware Court of Chancery explained in *In re Trados*, "the duty of loyalty mandates that directors maximize the value of the corporation over the long term for the benefit of the providers of equity capital."[184] By definition, a beach money exit does not maximize the value of the corporation over the long term, and, except in the unwitting version, founders know this when they advocate for one.

Nonetheless, in most beach money exit cases, VCs likely would not be able to show that founders breached their duty of loyalty under existing doctrine because the source of their disloyalty is difficult to prove: the subjective value founders place on an otherwise legitimate payout. VCs likely would not be able to show that founders breached their duty of care either—even in a world in which Delaware corporations did not routinely waive director liability for breaches of the duty of care—because a punctilious process could still lead to a non-EV-maximizing sale. Finally, VCs would not gain much by exercising their appraisal rights if their argument that a deal is not EV-maximizing assumes exponential growth. The focus of the analysis in this Part is positive rather than normative. However, the positive analysis suggests the difficulty of reforming doctrine in a surgical way to block beach money exits but not raise the cost of desirable transactions.

A. The Duty of Loyalty in Trados

The Court of Chancery analyzed the application of the duty of loyalty to startup exits at length in Vice Chancellor Laster's famous opinion in the 2013 case *Trados*. *Trados* is a classic moderate downside fact pattern—a startup that cannot generate enough growth to escape the weight of its liquidation preferences.[185] It was doomed to face a conflict between preferred and common shareholders in an exit.

Trados was in the business of translation software.[186] It raised several rounds of VC funding, starting in 2000.[187] After its last round of fundraising, the investors collectively

183. DEL. CODE ANN. tit. 8, § 141(a) (2019).

184. *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 37 (Del. Ch. 2013).

185. *See id.* at 77 ("Trados had no realistic chance of growing fast enough to overcome the preferred stock's existing liquidation preference.").

186. *See id.* at 21.

187. *See id.* at 21–24.

held a liquidation preference of $57.9 million.[188] Trados grew slowly. Its VC directors became convinced that the best way to recoup at least some of their investments was to sell the company.[189]

The VC directors faced an incentive problem. Because of their accumulated liquidation preferences, they knew that common shareholders would receive little or nothing in an exit. They needed a strategy to motivate the Trados management team to support an exit. Their answer was the "Management Incentive Plan" (MIP). Under the MIP, three members of the management team would receive a percentage of the proceeds of any exit, before any cash went to preferred or common shareholders.[190] The percentage that MIP participants would receive would increase with the value of the acquisition.[191] The board expected the MIP participants to receive 11% or 13% under realistic exit scenarios.[192]

Trados's board had seven directors at the time of the exit.[193] Three directors represented VC investors and two directors were on the management team and participating in the MIP.[194] The final two directors were nominally independent, but one of them, Joseph Prang, had a close business relationship with Sequoia Capital, one of Trados's VCs, and also held preferred stock in Trados.[195] In 2004, the directors unanimously approved the MIP.[196]

The MIP worked as intended. The management team sought and obtained an offer to buy the company for $60 million.[197] The board approved the merger unanimously.[198] At the time of the deal, the preferred stockholders were entitled to a liquidation preference of $57.9 million.[199] As the Court explained, "[w]ithout the MIP, the common stockholders would have received $2.1 million."[200] But the MIP entitled the participants to 13% of the proceeds of a sale of this size.[201] That 13% was worth approximately $7.8 million.[202] The preferred shareholders took the remaining amount, approximately $52.2 million."[203] The common shareholders got nothing.[204]

A common shareholder in Trados brought a breach of fiduciary duty claim against its directors.[205] After a long and contentious litigation, the Court of Chancery ultimately ruled for the Trados directors, concluding that Trados's "common stock had no economic value before the Merger, making it fair for its holders to receive in the Merger the substantial

188. *See id.* at 33.
189. *See Trados*, 73 A.3d at 26–30.
190. *See id.* at 59.
191. *See id.*
192. *See id.*
193. *See id.* at 45.
194. *See Trados*, 73 A.3d at 45–46.
195. *See id.* at 54–55.
196. *See id.* at 59.
197. *See id.* at 30–31.
198. *Id.* at 33.
199. *See Trados*, 73 A.3d at 33.
200. *Id.* at 20.
201. *See id.* at 32.
202. *See id.*
203. *Id.* at 33.
204. *See Trados*, 73 A.3d at 33.
205. *See id.* at 34.

equivalent of what they had before."[206] But *Trados* is more interesting in its reasoning than its holding. The Court was critical of the VC directors and suggested that similar conduct could lead to a successful suit for breach of fiduciary duty.

As the Court explained in *Trados*, in duty of loyalty cases, Delaware courts separately apply a standard of conduct and a standard of review.[207] The standard of conduct requires that directors "promote the value of the corporation for the benefit of its stockholders."[208] The standard of review controls how closely Delaware courts scrutinize director conduct. There are three standards: the business judgment rule, enhanced scrutiny, and entire fairness review.[209] The default standard is the deferential business judgment rule.[210] It entitles directors to a presumption that they "acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[211]

When the Delaware courts review a director's decision to approve a sale, they generally apply enhanced scrutiny.[212] In the famous *Revlon* case, the Delaware Supreme Court explained that, in the context of a sale, "a board's primary duty becomes that of an auctioneer responsible for selling the company to the highest bidder."[213] The doctrine is "rooted in a concern that the board might harbor personal motivations in the sale context that differ from what is best for the corporation and its stockholders."[214] For example, "there is the danger that top corporate managers will resist a sale that might cost them their managerial posts, or prefer a sale to one industry rival rather than another for reasons having more to do with personal ego than with what is best for stockholders."[215] Therefore, "[t]he court must take a nuanced and realistic look at the possibility that personal interests short of pure self-dealing have influenced the board."[216] To survive enhanced scrutiny, directors "show that they acted reasonably to obtain for their beneficiaries the best value reasonably available under the circumstances, which may be no transaction at all."[217]

When directors have an actual conflict of interest, the Delaware courts apply the most demanding standard of review, entire fairness.[218] Specifically, the standard applies if the plaintiff proves "that there were not enough independent and disinterested individuals among the directors making the challenged decision to comprise a board majority."[219] Under the entire fairness standard, defendants must prove that "the transaction was the product of both fair dealing *and* fair price."[220] In other words, "the transaction itself must be objectively fair, independent of the board's beliefs."[221] In *Trados*, the Court held that six of the seven board members—the VC directors, the management directors subject to

206. *Id.* at 20.
207. *See id.* at 35.
208. eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 34 (Del. Ch. 2010).
209. *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 43 (Del. Ch. 2013).
210. *See id.*
211. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).
212. *See Trados*, 73 A.3d at 43–44.
213. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 184 (Del. 1986).
214. *In re* Dollar Thrifty S'holder Litig., 14 A.3d 573, 597 (Del. Ch. 2010).
215. *Id.*
216. *Id.* at 598.
217. *Trados*, 73 A.3d at 44.
218. *See id.*
219. *Id.*
220. Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1163 (Del. 1995).
221. Gesoff v. IIC Indus., Inc., 902 A.2d 1130, 1145 (Del. Ch. 2006).

the MIP, and Prang, the independent shareholder who held preferred stock—were interested in the transaction.[222] Accordingly, the Court applied the entire fairness standard.[223]

Turning from the standard of review to the standard of conduct, the Court held that directors owe their duty of loyalty to the common shareholders, rather than to all shareholders.[224] Vice Chancellor Laster was sympathetic to the Plaintiff's argument that the directors did not engage in fair dealing with the common shareholders. He emphasized that the Trados directors did not ensure that the interests of the common shareholders were represented or even consider their interests in deliberations.[225]

Ultimately, though, the Court concluded that the price of the merger was fair because "Trados did not have a reasonable prospect of generating value for the common stock."[226] The Court recognized that "[a]s a practical matter no outside VC firm would invest [in Trados] without participation from the Company's existing backers."[227] Therefore, the Court held, the directors "breached no duty to the common stock by agreeing to a Merger in which the common stock received nothing. The common stock had no economic value before the Merger, and the common stockholders received in the Merger the substantial equivalent in value of what they had before."[228]

B. The Elusiveness of Beach Money Disloyalty

The reasoning of *Trados* suggests that fiduciary duty lawsuit brought against founder-directors for pursuing a beach money exit likely would not succeed. First, unlike in traditional self-dealing cases, founder-directors would not receive any identifiable benefit outside the deal consideration. Second, unlike in *Trados*, preferred shareholders in a beach money exit case would receive the same payout per share as common shareholders. Third, VC plaintiffs would struggle to show that remaining independent is the highest EV option for a startup if it required the continued cooperation of the founders, which courts will not compel.

1. No Benefit Outside Deal Consideration

A beach money exit does not resemble a typical case of breach of the duty of loyalty. The Court of Chancery has explained that the "[t]he classic example that implicates the duty of loyalty is when a fiduciary either appears on both sides of a transaction or receives

222. *See Trados*, 73 A.3d at 45–55.

223. *See id.* at 55–78.

224. *Id.* at 41. Before *Trados*, it was unclear, even as a matter of positive law, to whom directors of a startup board owed a duty of loyalty. Fried and Ganor argued—seemingly persuasively—that a series of Delaware cases had created a "control-contingent" duty of loyalty. *See* Fried & Ganor, *supra* note 5, at 992–93. Under their interpretation of the caselaw, "a preferred-controlled board c[ould] make business decisions that serve the preferred at the expense of common, as long as those decisions can be defended as in the best interests of the corporation." *Id.* at 993. In *Trados*, Vice Chancellor Laster explicitly acknowledged the Fried and Ganor article and disagreed. *See Trados*, 73 A.3d at 42 n.16. The Court made it clear that startup directors owe a duty of loyalty to the common shareholders, regardless of board control. *See id.* at 38–42.

225. *See Trados*, 73 A.3d at 62–65.

226. *Id.* at 76.

227. *Id.* at 77.

228. *Id.* at 78.

a personal benefit not shared by all the shareholders."[229] A founder-director in a beach money exit need not have any ties to the acquirer. She receives consideration only in her position as a shareholder and no consideration outside the deal. She simply subjectively values the deal consideration differently than the VCs do because of nondiversifiable risk and diminishing marginal utility.

One could imagine a classic disloyalty fact pattern in a startup exit. For example, suppose a startup received an acquisition offer from Acquirer A and slightly lower offer from Acquirer B. Suppose further that Acquirer B promised the founder-director that she would receive above-market compensation in her first year as an employee of Acquirer B. From the perspective of Acquirer B, the side deal extracts more value out of the combined sum it spends on the acquisition *and* post-exit compensation, because the post-exit compensation will help to retain the founder. Putting the post-exit compensation into the acquisition price would require giving some of the founder's share to the VCs, which would have no retentive value.[230] From the perspective of the founder, Acquirer B's side deal gives her more net income. The investor shareholders, and any employee shareholders not part of the post-exit compensation agreement, would be worse off. In such a case, if the founder-director voted for Acquirer B's offer over Acquirer A's because of the post-exit compensation promise, she would have breached her duty of loyalty. The above-market post-acquisition compensation is the identifiable illicit benefit.

The management team in *Trados* received a similarly suspect benefit—the MIP.[231] Although it was the acquisition that triggered their payments under the MIP, the payments were not in consideration for their Trados stock. The management team held common stock, which was worth nothing. In fact, the VC directors created the MIP to motivate the management team precisely because they anticipated that the common stock would be worth little or nothing in the deal. The *Trados* Court pointed to the MIP to explain why the management team directors were not disinterested and did not deal fairly with the common shareholders.[232]

By contrast, a plaintiff in a beach money exit suit would not be able to identify an MIP-like benefit that the founders received, because all of their payout is from the deal consideration. To be sure, the Delaware courts can consider "personal interests short of

229. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 751 (Del. Ch. 2005).

230. In an analogous recent case, the Court of Chancery implied that a controlling shareholder could breach the duty of loyalty by agreeing to vote for a merger in exchange for consideration from the acquiror in the form of revenue from contracts with the surviving company after the merger. *See In re* Delphi Fin. Grp. S'holder Litig., No. 7144-VCG, 2012 WL 729232, at *17 (Del. Ch. Mar. 6, 2012) (rejecting plaintiff's argument that the controlling shareholder would receive disparate consideration through contracts after the merger on the ground that the surviving corporation could terminate the contracts on 30 days' notice).

231. Consider an executive in a public company who pushes for an acquisition that will trigger her departure from the company and a golden parachute payment, because she values the golden parachute over the EV of her future compensation package, discounted by the labor she would have to provide to receive it. As in *Trados*, the executive in this example would be motivated by a benefit that would not accrue to all shareholders. In practice, though, the case against the executive might be harder to prove than the case against the *Trados* management directors. The MIP in *Trados* was intentionally designed to motivate the management team to support a deal. The golden parachute payment could be a routine component of executive compensation. Courts may be less willing to base a holding that a director violated her fiduciary duties on her subjective motivation, rather than on an objectively identifiable benefit she received.

232. *See In re* Trados Inc. S'Holder Litig., 73 A.3d 17, 45–46 (Del. Ch. 2013) (reviewing the management directors' compensation from the deal and concluding they were interested in the transaction because of, inter alia, the MIP).

pure self-dealing."[233] But the only personal interest that would be relevant is the founder's subjective valuation of the payout to which she is entitled as a shareholder.

2. No Divergence in Price Per Share

A beach money exit involves a conflict between the interests of VC shareholders opposing an acquisition and the interests of founder shareholders supporting it. Likewise, on the moderate downside, there may be a conflict between the interests of VC shareholders *supporting* an exit and the interests of founder shareholders *opposing* it. One difference between these two kinds of conflicts is that, in a moderate downside exit, the VCs will receive a higher payout per share due to their liquidation preference as preferred shareholders. The founders will receive a lower payout per share as common shareholders. In a beach money exit, VCs will convert, or be paid out as if converted, to common. Therefore, the VCs and the founders will receive the same price per share.

Put differently, the conflict in a beach money case is not a conflict *among* classes of shareholders.[234] It is a conflict *within* the class of common shareholders, with the VCs joining that class, or being treated as if a member, by operation of law in the acquisition. There is no doctrine that precludes a holding that directors were disloyal to other members of their class. But such a holding would require the courts to go beyond the formal cash flow rights to the individual directors' subjective valuation of those rights.[235] The *Trados* Court did analyze VC financial incentives in detail. The Court explained that VCs "operate under a business model that causes them to seek outsized returns and to liquidate (typically via a sale) even profitable ventures . . . which otherwise would require investments of time and resources that could be devoted to more promising ventures."[236] But the Court framed the unfair dealing as preferred shareholders and MIP-beneficiary shareholders as a class mistreating common shareholders as a class.[237]

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233. *In re* Dollar Thrifty S'holder Litig., 14 A.3d 573, 598 (Del. Ch. 2010).

234. After *Trados*, corporate law scholars have debated whether the directors' obligations should be to maximize the value of common shareholders or of the enterprise as a whole. One argument against using common shareholder value as the maximand is that it may lead to pursuing a highly risky strategy that is negative EV for the business on the downside or near the "zone of insolvency." William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815, 1885–87 (2013). One counterargument is that preferred shareholders are protected by contract law, whereas common shareholders are at the mercy of corporate law for protection. Leo E. Strine, Jr., *Poor Pitiful or Potently Powerful Preferred?*, 161 U. PA. L. REV. 2025, 2039–40 (2013).

235. The Delaware Supreme Court rejected an analogous argument in the context of a dividend payment to a subsidiary's shareholders that was allegedly timed to benefit the cash flow needs of the parent at the expense of minority shareholders. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 721–22 (Del. 1971). The Court gave this example:

> [S]uppose a parent dominates a subsidiary and its board of directors. The subsidiary has outstanding two classes of stock, X and Y. Class X is owned by the parent and Class Y is owned by minority stockholders of the subsidiary. If the subsidiary, at the direction of the parent, declares a dividend on its Class X stock only, this might well be self-dealing by the parent.

Id. at 721. The Court found the case before it distinguishable from its example and concluded that because, "a proportionate share of this money was received by the minority shareholders . . . these dividends were not self-dealing." *Id.* at 721–22. The *Sinclair* Court was not persuaded by the plaintiff's argument that the dividends "resulted from an improper motive—[the parent company's] need for cash." *Id.* at 721.

236. *Trados*, 73 A.3d at 48.

237. *See, e.g.*, *id.* at 56 (finding that the plaintiff had the strong argument on fair dealing because "there was no contemporaneous evidence suggesting that the directors set out to deal with the common stockholders in a

The conceptual commonality between the conflict in *Trados* and the conflict in a beach money exit case is what Abraham Cable calls an "opportunity cost conflict."[238] For the VCs in *Trados*, the opportunity cost of keeping their money in the company was that they could not invest it in more promising startups.[239] For the founders in a beach money exit case, the opportunity cost of remaining independent would be forgoing the chance to diversify risk and lock in a beach money net worth. Cable argues that the courts should recognize a limited doctrine of opportunity cost conflict, but he concedes that it ought only to be invoked in "exceptional cases," in which, for example, the court is presented with clear evidence of illicit motivation.[240] That is likely what it would take to convince a Delaware court that a founder-director breached the duty of loyalty in a beach money exit case: clear evidence that the founder-director believed that the acquisition was not in the interest of common shareholders. That evidence is unlikely to be present in all but the most egregious cases, because founders have a strong incentive to try to persuade their fellow directors that the acquisition is in the interest of shareholders generally.

3. No Higher EV Alternative Without Founders

Even if a VC plaintiff persuaded a Delaware court to find a breach of loyalty in a case in which the disloyal founder-director received no compensation outside of the deal and the same payout per share as VC directors, the plaintiff would still need to prove that remaining independent had a higher EV for shareholders. Recall from *Trados* that the review under the entire fairness standard—and, given how interested startup boards are, entire fairness is the standard which would generally apply—is a holistic test that includes both unfair dealing *and* an unfair price.[241] Accordingly, the plaintiff will generally need to establish that the startup would continue to grow enough that it would have a significant chance of a higher-value exit in the future. In most early-stage startups, continued growth would require the continued services of the founders and their team.[242] If the founders are not willing to cooperate, the EV of remaining independent might be below the value of the acquisition.

It may seem perverse that the founder-directors can defend their own opportunism by not being willing to continue to run the business. But consider an analogy to the VCs in *Trados*. Vice Chancellor Laster, in explaining why Trados had little hope for growth if it remained independent, observed that Trados's current VCs would not increase their investment going forward and "[a]s a practical matter no outside VC firm would invest [in Trados] without participation from the Company's existing backers."[243] Implicitly, the Court suggested that the VCs'—financially reasonable but self-serving—decisions not to invest more were not disloyal. Similarly, a court might reason that a founder-director was not being disloyal by deciding not to continue to manage her startup. This reasoning could

procedurally fair manner").

238. *See* Cable, *supra* note 93, at 53 ("An opportunity-cost conflict arises when corporate fiduciaries operate under strong incentives to withdraw human and financial capital for redeployment into new investment opportunities.").

239. *See id.* at 75.

240. *Id.* at 90.

241. *See Trados*, 73 A.3d at 56 (explaining that, in the context of entire fairness review, the "[c]oncept of fairness has two basic aspects: fair dealing and fair price" and that both aspects "must be examined as a whole").

242. *See supra* Part III.B.2.

243. *Trados*, 73 A.3d at 77.

lead the court to conclude that taking the acquisition actually had a higher EV than remaining independent, given the decline in EV the founders' expected departure would create.

Although the *Trados* Court does not quite articulate it, there is a strong moral and economic intuition behind its blessing of the VCs' decision not to reinvest. Directors' actions in their non-director capacities—as managers or investors—should not become subject to their fiduciary obligations. If VCs believed that their routine decisions about whether to invest in other startups would be exposed to fiduciary liability because they served as a director,[244] they might be less willing to invest or to serve on their portfolio companies' boards. Similarly, founders might avoid taking a board seat if they knew their future decision to leave the company could be part of a claim that they violated a fiduciary duty.

For these reasons, a lawsuit alleging that founder-directors breached their duty of loyalty in pursuing a beach money exit is unlikely to succeed, even though the directors are acting on their private financial interest at the expense of the interest of shareholders.

C. The Duty of Care Revisited

Could founder-directors still breach their fiduciary duty in the absence of a showing of disloyalty? At least until the mid-1980s, directors owed a duty of care to the corporation under Delaware. In the 1985 case *Smith v. Van Gorkom*, the Delaware Supreme Court found that directors had breached the duty of care by their actions in connection with a merger.[245] The *Van Gorkom* Court made it clear that directors could breach their duty of care even in cases with "no allegations of fraud, bad faith, or self-dealing."[246] Shortly after *Van Gorkom*, though, the Delaware legislature amended the Delaware General Corporation Law to allow corporations to adopt a charter provision waiving liability for directors in most cases that do not involve disloyalty, bad faith, or intentional misconduct.[247] Delaware corporations "eagerly adopted" these provisions—commonly called 102(b)(7) waivers for the subsection that authorizes them.[248]

Even though *Van Gorkom* is largely a relic today, it shows how courts might police director decisions in the context of a transaction with no evidence of disloyalty. The case involved claims against the former directors of Trans Union Corporation, who had approved the merger of that company with a subsidiary of Marmon Group, a holding company controlled by the Pritzker family.[249] Jerome Van Gorkom, Trans Union's CEO, had privately negotiated the merger with Jay Pritzker and presented the deal the two had struck to the Trans Union board in a hastily scheduled special meeting.[250] The Board

244. Of course, there are hypothetical cases in which a VC's decision to invest in another startup would and should be considered a breach of the duty of loyalty. One easy example would be a VC's investment in the startup's competitor. But that example specifically and this category of hypothetical cases generally should not arise because VCs stand to lose financially by investing in companies that could damage a startup in which they have already invested.

245. Smith v. Van Gorkom, 488 A.2d 858, 893 (Del. 1985).

246. *Id.* at 873.

247. DEL. CODE ANN. tit. 8, § 102(b)(7).

248. Holger Spamann, *Monetary Liability for Breach of the Duty of Care?*, 8 J. LEGAL ANALYSIS 337, 338 n.2 (2016).

249. *Van Gorkom*, 488 A.2d at 869–70.

250. *Id.* at 866–68.

approved the merger in that meeting, without conducting a deeper investigation.[251]

The Delaware Supreme Court held that the defendants did not reach an "informed business judgment" in approving the merger because, in part, they "were uninformed as to the intrinsic value of the Company" and "were grossly negligent in approving the 'sale' of the Company upon two hours' consideration, without prior notice, and without the exigency of a crisis or emergency."[252] The Court rejected the defendants' argument that their approval of the merger was conditioned on, and justified by, a "market test" to take place in the 90 days after their vote.[253] The Court suggested that the market test was not meaningful because the merger agreement "barred Trans Union from actively soliciting [competing] offers and from furnishing to interested parties any information about the Company other than that already in the public domain."[254]

The reaction to *Van Gorkom* was highly critical.[255] But it demonstrates one model of how courts might police director behavior in transactions in the absence of disloyalty or bad faith. They could demand strict adherence to procedural formality. They could ask whether a board actively solicited other bidders, whether it retained an investment banker to shop the company,[256] and whether it gave other prospective bidders sufficient time to submit a competing bid. Insisting on a thorough sale process could be particularly useful in the context of a startup, because fewer investors and journalists are motivated to learn about bids to acquire startups than they are to learn about potential publicly company M&A.

But even exacting judicial scrutiny of the sale process would deter only the most egregious beach money exits, in which the founders were so smitten with beach money that they did not see if another acquirer would offer a higher price at the same time. The loss in EV in a beach money exit is incurred because the startup sold at *the wrong time*, not to the wrong bidder. A startup could run an impeccable process, receive multiple bids, and the highest bid still might be worth less than the EV of remaining independent. Even if Delaware did not allow corporations to waive the duty of care, it would not be much use in deterring beach money exits.

D. Appraisal Rights

Separately from fiduciary liability, the Delaware General Corporation Law provides that shareholders who dissent from a merger have the right to seek an appraisal of the "fair value" of their shares. Unlike a plaintiff claiming that a director has breached fiduciary duties, a dissenting shareholder exercising appraisal rights need not prove any wrongdoing. Instead, the dissenting shareholder simply needs to prove that the shares are worth more than she will receive in the transaction. The Plaintiff in *Trados* had also brought a claim

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251. *Id.* at 869.

252. *Id.* at 874.

253. *Id.* at 878–80.

254. *Van Gorkom*, 488 A.2d at 878.

255. For example, Daniel Fischel called it "one of the worst decisions in the history of corporate law." Daniel R. Fischel, *The Business Judgment Rule and the* Trans Union *Case*, 40 BUS. L. 1437, 1455 (1985); for a contrasting account, arguing that *Van Gorkom* is best understood as a takeover case, see generally Jonathan R. Macey & Geoffrey P. Miller, Trans Union *Reconsidered*, 98 YALE L.J. 127, 128 (1988).

256. The *Van Gorkom* majority noted that Trans Union's investment banker was not invited to the initial meeting. *Van Gorkom*, 488 A.2d at 867. The dissent noted that Trans Union's investment banker was retained later in the process. *Id.* at 896 (McNeilly, J., dissenting).

under the appraisal statute. The Court of Chancery rejected it, reasoning that, because "Trados had no realistic chance of growing fast enough to overcome the preferred stock's existing liquidation preference," the fair value of the common stock under the statute was zero.[257]

A VC's threat to exercise appraisal rights is unlikely to be credible in most cases, for a practical reason. A dissenting shareholder seeking an appraisal must forgo merger proceeds and will not receive payment until after a trial or settlement, which can take years.[258] This is a particularly daunting obstacle to VC lawsuits, because of VCs' obligations to distribute funds to their LPs.

Additionally, recent Delaware Supreme Court appraisal decisions have "encourage[d] greater deference to the deal price."[259] Early-stage startups are especially difficult to value in the absence of a deal price because they lack the standard metrics—earnings, revenue, etc.—used to value established companies. Trados, a later-stage venture, would have been easier to value than most startups because it had a clearly defined market and user base and had been generating cash flows for years. The argument that a startup acquisition price is below-EV would likely rely on a steep growth curve. Exponential growth is the lifeblood of the VC industry, but Delaware courts are not accustomed to blessing valuations based on hockey stick growth projections. Consequently, it would be difficult for VCs to prove that the deal price was too low with high certainty.

The information asymmetry between founders and VCs also creates an obstacle to a successful appraisal suit.[260] In early-stage startups, founders will be better armed with private information to show that the deal price is fair, given the risks the business faces if it remains independent. It is difficult to imagine VCs calling the only other witnesses with some access to that private information—rank-and-file employees—to testify against their management team about the prospects of the business. For these reasons, VCs are not likely to gain much by exercising their appraisal rights in a beach money exit case.

Note that this pessimistic account of VCs' chances of prevailing in a lawsuit based on a claim for breach of fiduciary duty or an appraisal is consistent with VCs' observed behavior. Both legal and reputational considerations deter VCs from contesting beach money exits in court. This allows startups to transact below their EV.

VI. HOW ACQUIRERS CAN DESTROY VALUE

Why should we care about beach money exits? Are they just transfer payments from one set of sophisticated, wealthy parties to another?[261] Beach money exits matter because

257. *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 78 (Del. Ch. 2013).

258. Audra Boone et al., *Merger Negotiations in the Shadow of Judicial Appraisal* 7 (Ind. Legal Stud. Res. Paper No. 381, 2019), https://ssrn.com/abstract=3039040.

259. *Id.* at 9.

260. *See supra* Part III.B.1 (arguing that the information asymmetry between founders and VCs would create an obstacle to VCs prevailing in an appraisal case).

261. One could argue that reducing expected VC returns, by forcing them exit at a 2–5x return when VCs want to hold out for 10x or more, makes VC a less attractive asset class for prospective LPs. But that effect is at least partially counterbalanced by making founding a startup more attractive to entrepreneurs. The cost of a beach money exit may be more precisely reflected in VC firms' privately shared performance data than the cost of a *thwarted* beach money exit would be in the back-of-the-envelope calculations that lead people to quit their jobs and found a startup. But it is plausible that changes in the frequency with which founders receive beach money filters back through the social networks at tech companies and universities that inform would-be entrepreneurs.

they do not just transfer money. They transfer *control of assets*—technology and, most importantly, people with specialized knowledge of how to develop that technology and how to work with each other to develop it. Beach money exits destroy value if the new owners of the assets are unable or not motivated to extract as much value out of those assets than the old owners would have been. The inefficiency of a beach money exit is the opportunity cost of what the startup might have become had it remained independent.

Economic theory suggests that we should *presume* that the acquirer in a beach money exit case will extract less value out of the startup's assets because the price it offered—the acquirer's willingness to pay—reflects a lower estimate of the startup's EV than the board's estimate. To make this point concrete, consider *Revlon*'s auction analogy.[262] If multiple prospective acquirers submit bids for the company, the analogy is straightforward. Each bid represents the bidders' estimate of the EV that it can extract from the assets. The doctrinal rationale for why the highest bidder should win out is that the directors owe a fiduciary duty to maximize value for the company's shareholders.[263] But the economic logic behind the doctrine is that the bidder that submits the highest bid is the bidder that has the greatest chance to extract value out of the assets.[264] The highest bid in the auction should represent the most informed parties' best guess of the most efficient use of capital.

In a beach money exit case, there is only one apparent bidder, the prospective acquirer. But the startup board's estimate of the startup's EV serves as an implicit counterbid. A beach money exit transfers control of the startup's assets to a bidder who submitted a lower bid—the acquirer—and likely has a lower estimate of the EV it can extract from the assets.

One could object that the acquisition price in a beach money exit may not reflect the acquirer's actual estimate of the startup's EV because the founders had insufficient incentive to negotiate beyond a price that would give them beach money. On this view, the acquirer may actually value the startup as highly or more highly than the startup board does—the acquirer just found a lucky opportunity to buy the startup cheaply. In practice, it is unlikely that the startup will be such a weak negotiating partner. Even if the founders are leading the sale process, they are negotiating on behalf of the board. The VC directors will, by definition, be reluctant to accept a beach money exit. Therefore, the founders have a powerful incentive to negotiate the highest price they can; reducing risk that the VCs will block the acquisition. If the founders can credibly signal to the VCs and the independent director that they fought for the best deal with the acquirer, they will have a stronger position in internal board deliberations about whether to accept the offer.

Of course, either party could be wrong in their EV assessments. The startup board might be overconfident about the company's chances.[265] The acquirer might later discover

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262. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 184 (Del. 1986).

263. *See id.* at 182 ("[C]oncern for non-stockholder interests is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder.").

264. *See, e.g.*, Yedidia Z. Stern, *A General Model for Corporate Acquisition Law*, 26 J. CORP. L. 675, 678 (2001) ("The main policy goal which acquisition law should attain is economic efficiency. . . . Placing resources in the hands of those most efficient in their use maximizes aggregate welfare.").

265. There is considerable empirical evidence that *founders* are overconfident about their startup's chances. *See* Åstebro, *supra* note 78, at 61 (reviewing the literature on entrepreneur overconfidence and concluding that "some evidence suggests overconfidence in the form of optimism, overestimation, and overplacement could help explain entrepreneurial entry"). But founder overconfidence likely would not explain why a startup board made an overly high EV assessment in a deliberation in which founders are strongly motivated to cast doubt on the startup's prospects, thereby making the acquisition alternative appear more attractive. There is also, however,

unanticipated ways to extract value from the assets. But the preferences revealed in the price the acquirer offers and the price the VCs wanted the board to hold out for—not the price the board ultimately accepted over the VCs' reluctance—are the best information we have about the EV of the two courses of action.

How might acquirers destroy value after acquiring a startup, relative to the value that could have been created had the startup remained independent? First, the acquirer may weaken the startup's management's incentives prematurely. Second, the acquirer may use the startup's assets to serve their existing customers and existing markets, rather than potentially larger new markets. Third, the acquirer may not plan to use the startup's assets at all—the acquisition may be anticompetitive.

To be sure, some startup acquisitions yield efficiency gains.[266] A startup may be able to grow more quickly by accessing capital inside a firm at a lower transaction cost than it would raising capital from VCs. An acquirer might have professional managers who could improve on the performance of the founders. For example, an acquirer's managers might be more adept than a startup's founders at converting a technology from a prototype to a product. An acquirer might also have access to materials, data, customers, or markets that a startup could not acquire by contract. There may be synergies between an acquirer's core business and a startup's. Remaining independent may exacerbate the "notorious focus of inventors on continuing R&D rather than on developing products for commercial production . . . ."[267]

Not all startup acquisitions are inefficient, and not all beach money exits *ultimately* destroy value.[268] But the best available evidence about whether a beach money exit will create of destroy value is the EV estimates of informed and motivated parties. The acquirer's bid reflects a lower estimate of the EV it could extract from the startup's assets than the board's estimate does. It is plausible that both parties are right about the differential value they could extract because the board and the acquirer's management team have different incentives, abilities, information, and opportunities. The rest of this Part offers practical reasons for why the acquirer's lower EV estimate may reflect an actual inability or lack of motivation to use a startup's assets as productively as they could have been used if the startup had remained independent.

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some evidence that VCs are overconfident about their investments. *See, e.g.*, Samuel B. Graves & Jeffrey Ringuest, *Overconfidence and Disappointment in Venture Capital Decision Making: An Empirical Examination*, 39 MANAGERIAL & DECISION ECON. 592, 592 (2018) (discussing overconfidence in VC decision making).

266. There is evidence that acquisitions are associated with increased innovative activity of acquirers. One study of corporate acquisitions, though not limited to startup acquisitions, found "a strong positive relation between the volume of M&A transactions of a firm and the number of the new patents the firm obtains subsequent to its M&A activity" and a "positive relation between the M&A volume of a firm and the novelty of the firm's patents obtained following its M&A activity where the novelty of the patents is measured by the number of future citations the patents generate." Merih Sevilir & Xuan Tian, *Acquiring Innovation* (AFA 2012 Chicago Meetings Paper, 2012), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1731722. But, of course, this kind of evidence addresses the relative inability of large corporations to innovate before and after an acquisition. The question this Part is addressing is the relative amount of innovation or productivity that would occur if a startup is acquired versus if it remains independent.

267. Raghuram G. Rajan & Luigi Zingales, *Power in a Theory of the Firm*, 113 Q.J. ECON. 387, 423 (1998).

268. The idea that acquisitions can destroy value is not novel. *See, e.g.*, Randall Morck et al., *Do Managerial Objectives Drive Bad Acquisitions?*, 45 J. FIN. 31, 31 (1990) ("There is now considerable evidence that making acquisitions is a mixed blessing for shareholders of acquiring companies. Average returns to bidding shareholders from making acquisitions are at best slightly positive, and significantly negative in some studies.").

A. Weakening Incentives Prematurely

The near universality of equity incentives in startups is strong evidence of their efficiency. As we have seen, the strong equity incentives address the information asymmetries and agency cost or moral hazard problems that startups encounter.[269] Of course, these problems are at least partially inherent in any organized effort to commercialize novel technologies, regardless of whether it occurs in a large corporation or a small startup. For example, engineers in a corporate research and development (R&D) unit developing a novel technology will have asymmetric information about the technology, its potential business value, and their progress, relative to the information that the corporation's management team has. If it will take years for the technology to become a commercial product, the corporation's management team will face an agency cost or moral hazard problem. They will be unable to observe the progress towards commercialization directly and will run the risk that the corporate R&D unit will use the budget they receive to extract private benefits.

There is empirical evidence that large corporations are not as good at developing innovative technologies as startups. One study concluded that one dollar of venture capital was three times more likely to result in a patent then one dollar of corporate R&D.[270] There is also evidence that these patents represent meaningful innovation—"'venture-backed firms' patents are more frequently cited by other patents and are more aggressively litigated."[271] It could be that the reason large corporations are less innovative is that they are not able or willing to use the strong equity incentives that startups use, even though using those incentives would allow corporate R&D units to innovate while minimizing the information asymmetry and agency cost or moral hazard problems.

But large corporations generally do not use such strongly incentive-based compensation. Professionals often receive bonuses, but those bonuses do not usually have the *unlimited upside* of startup equity. This may be because it is difficult to create a market that would accurately value what a corporate R&D unit created. A large, public corporation's stock price will be affected by too many factors to clearly isolate the contribution of a corporate R&D unit.

Recently, however, some large corporations have attempted to maintain R&D-focused business units as separate entities with their own equity or phantom equity, in part to create more startup-like incentives for employees. For example, General Motors keeps its autonomous driving unit, Cruise, in a separate entity, and recently sold 19.6% of the entity's equity to outside investor Softbank for $2.25 billion.[272] The CEO of Cruise promoted the incentive effects of the separate entity: "Equity is a really attractive element of working at Cruise and will really help us in the war to acquire the best talent in the space."[273] But it remains to be seen whether both the current and future employees of corporate R&D units in an entity with separate equity will believe that there is a meaningful market for that special equity, given the parent corporation's control. Employees need to

269. *See supra* Part II.B.

270. *See* GOMPERS & LERNER, *supra* note 1, at 274.

271. *Id.* at 275.

272. Carolyn Said, *Cruise CEO Says GM, SoftBank Billions Will Help Recruit Robot-Car Engineers*, S.F. CHRON. (May 31, 2018, 6:49 PM), https://www.sfchronicle.com/business/article/SF-s-Cruise-gets-3-35-billion-from-GM-12956818.php.

273. *Id.*

believe the unlimited upside is real for the incentives to work.

Another more common way of attempting to preserve startup-like incentives in a startup after an acquisition is to structure the deal with an earnout. In an acquisition with an earnout, the shareholders receive an upfront payment that represents the bulk of the purchase price and then "additional future payments that are contingent upon some observable measure of performance."[274] The economics literature offers two compatible, but distinct explanations for earnouts. One account is that earnouts make deals possible by resolving disagreements about price. The theory is that "[b]y tying the target's consideration in the acquisition to future performance, the earnout can bridge a valuation gap between the target and the acquirer that is caused by disagreements about the target's expected future performance."[275] Another account is that earnouts are a solution to the moral hazard problem, that is, "when the net benefits of the acquisition depend on the unobservable efforts of the target managers."[276] In other words, earnouts are designed in part to solve the same problems that equity incentives inside startups are designed to solve.

But earnouts are inferior to equity incentives. They have a capped upside—the maximum deal consideration—which makes them more like a traditional performance-based bonus than a startup-style equity stake with unlimited upside. Earnouts also generally pay out all shareholders, including the VCs, even though they have no forward-going incentive effect for the VCs. This makes earnouts less attractive to acquirers, who gain nothing from the additional payments to VCs. Additionally, earnouts face the same problem of measuring performance that phantom equity does. They must be tied to negotiated metrics, because there is no market in which shares in an earnout can be traded.

It is possible that there are structural reasons for why corporations do not use equity incentives. Gilson and Joseph Bankman argue that if large corporations had a policy of rewarding innovation, employees would seek to establish internal "property rights" to those ideas in costly ways, in part by hoarding information.[277] Therefore, they contend, large corporations are not willing to set the reward for innovation as high as VC markets would.[278] Creating equity or phantom equity in a separate business unit may partially solve the hoarding problem by assigning property rights in the unit's innovation to the unit itself and thus to the employees who hold equity in the business unit. But employees would need to believe that the corporation would protect the dividing line between the separate business unit and the rest of the business, despite holding a controlling stake in the separate business unit.

Eventually, however, all startups exit. The incentives of the people working in former startups after exit change. After an acquisition or an IPO, the management team of a former startup will generally receive higher salaries and weaker incentive-based compensation. The critical question is *how to time* the change in incentives. Economic theory suggests that the best time to change the incentives should be when the information asymmetry and agency cost or moral hazard problems no longer apply. When a startup or former startup's product is being used by customers, drawing revenue, and capturing a meaningful share of

274. Matthew D. Cain et al., *Earnouts: A Study of Financial Contracting in Acquisition Agreements*, 51 J. ACCT. & ECON. 151, 152 (2011).

275. *Id.*

276. *Id.* at 165.

277. Joseph Bankman & Ronald J. Gilson, *Why Start-ups?*, 51 STAN. L. REV. 289, 302–05 (1999).

278. *See id.* at 307 (concluding that "[e]mployers will rarely find it worthwhile to set the payoff amount high enough to retain all valuable employees" with innovative ideas).

the market, the management team can be efficiently monitored by more conventional metrics. One should expect then that many startups are acquired around the time of this commercial transition. In that case, the change in incentive structure would not destroy value.

A beach money exit may destroy value because the acquirer buys the startup before the commercial transition but is unable or unwilling to preserve strong equity incentives. In such a case, the information asymmetry and agency cost or moral hazard problems may still be intense, and strong equity incentives may still be necessary. By weakening the equity incentives prematurely, the acquirer may destroy value.

This possibility may explain the difference in the acquirer's estimate of the EV of the startup and the board's estimate in a beach money exit. The board may believe that it can extract more EV from the startup by maintaining strong equity incentives to motivate the management team to continue to develop the startup's technology. The acquirer, lacking equity incentives, may not be willing or able to manage continued development and may rush to commercialization of a less valuable product. Of course, an acquisition that is not a beach money exit may also be timed badly and result in an acquirer weakening incentives early. The divergence in EV estimates in a beach money exit, however, suggests that a badly timed incentive weakening is especially likely.

It might appear that there is a contradiction in this argument. Part III argued that, in a beach money exit, the founders may tell the board that they are not willing to continue to manage the startup as an independent business. One could argue then that value is destroyed either way—either because the founders quit the startup or the board takes the acquisition and the acquirer weakens the founders' incentives prematurely. But if the founders were not able to take the beach money exit—if, for example, the startup never received the offer—the founders might have continued to develop the technology and created more value. In other words, the founders' expressed unwillingness to continue to manage the business may be a product of their desire to take the beach money offer, not burnout. Once the startup receives a beach money exit offer, the founders have a financial incentive to foreclose the possibility that they will continue to manage the company, even if they would be otherwise willing to do so.

B. Directing Assets Towards Exiting Customers

An acquirer may also destroy value by using the startup's assets to serve its existing customers and markets, rather than the potentially larger market that a startup could have captured, had it remained independent. Again, this kind of inefficient use of assets could happen in any startup acquisition. The divergence in EV estimates between the acquirer and the startup board in a beach money exit just suggests that misuse of assets is particularly likely.

Why would a corporation use a startup's assets so inefficiently? Clayton Christensen argues that incumbent corporations systematically fail to innovate because they focus on existing markets and customers and neglect potential alternative markets.[279] He claims, based on historical examples, that in internal resource allocation decisions, "[s]ustaining

279. *See* CLAYTON M. CHRISTENSEN, THE INNOVATOR'S DILEMMA 18–19 (2016) (developing this argument within the disk drive industry). For a critique of some of Christensen's arguments, see generally Jill Lepore, *The Disruption Machine: What the Gospel of Innovation Gets Wrong*, NEW YORKER (June 23, 2014), http://www.newyorker.com/magazine/2014/06/23/the-disruption-machine.

projects addressing the needs of the firms' most powerful customers . . . almost always preempted resources from disruptive technologies with small markets and poorly defined customer needs."[280] By contrast, in his account, successful startups target new, often downscale, markets and then move upmarket later to challenge incumbent firms and ultimately capture a larger market.[281]

Christensen also offers the related argument that information about innovative technologies that the company's engineers have or could develop does not filter up to the relevant decisionmakers. He notes that "[m]iddle managers aren't punished for *all* failures," especially not projects that fail because the engineers could not deliver.[282] It is "[p]rojects that fail because the market wasn't there that have far more serious implications for mangers' careers."[283] Therefore, he explains:

> [M]iddle managers—acting both in their own and the company's interest—tend to back projects for which market demand seems most assured. They then work to package the proposals for their chosen projects in ways geared to win senior management approval. As such, while senior managers may *think* they're making resource allocation decisions, many of the really critical resource allocation decisions have actually been made long before senior management got involved.[284]

Thus, even if senior managers were willing to gamble on new customers or new markets, they might not even become aware of those opportunities.

Christensen did not articulate these arguments in the context of analyzing startup acquisitions. It could be, for example, that the acquisition of a startup presents a fresh opportunity for an established corporation's management team to reconsider potential new markets. The management team could allow the newly acquired startup to serve new customers while existing business units continue to serve existing customers.

But there are two reasons to expect that the inefficient use of resources that Christensen describes might apply in a startup acquisition generally and is especially likely to apply in a beach money exit. First, the decision to offer to acquire the startup may have been subject to the pressures that Christensen identifies. That is, the acquisition may have been justified internally as a means to deliver incremental improvements to the established corporation's existing customers. The corporate M&A director may be Christensen's middle manager, unwilling to take the risk to acquire a startup that could serve markets that are only just emerging. The price that the acquirer was willing to pay may reflect that thinking. The acquirer may have only seen the potential to extract value from the startup's assets in the acquirer's existing markets.

Second, once the former startup is inside the acquirer, the former founders may be subject to pressure to deliver value to existing customers. The acquirer's management team may anticipate this eventuality, and their expectation may be reflected in their estimate of the EV of the startup, even if its assets could in principle be deployed to new markets.

Many early-stage startups fail because they never find a market for their products or services. But the other side of that risk is that startups have the luxury of having no

280. CHRISTENSEN, *supra* note 279, at 43.
281. *See id.* at 45–47.
282. *Id.* at 82.
283. *Id.*
284. *Id.*

longstanding customers or markets that they feel that they must serve. They must innovate by necessity. It is common for a startup's value to increase sharply when it establishes a foothold in a new market and proves to investors or potential acquirers that it has a chance to grow that market and capture a significant market share. The divergence between an acquirer and a startup's board estimate of the startup's EV in a beach money exit may reflect differing expectations of whether that sharp increase in value will happen. That difference in expectations, in turn, may reflect the acquirer's plan to only use the startup's assets to serve existing customers and markets and never reach that inflection point.

C. Buying Off Competition

In 1998, Bill Gates quipped that he worried more about "someone in a garage" than his established competitors.[285] In the same year, Stanford grad students Larry Page and Sergey Brin were raising angel funding for their garage-based startup, Google.[286] They would later raise funds from leading Silicon Valley VCs, take the company public, and turn it into Alphabet. In 2014, then-Google Chairman Eric Schmidt, in a speech responding to calls for his company to face more antitrust scrutiny, used a similar line, saying: "Someone, somewhere in a garage is gunning for us."[287]

Startups only pose a threat to the market dominance of tech giants if they do not succumb to beach money exits. Page and Brin, for example, offered to sell Google to Excite in 1999 for $1 million, and were talked down to $750,000, but Excite still passed.[288] Since they could not get their $750,000, Page and Brin continued to grow the company until its IPO in 2004, at a market cap of approximately $23 billion.[289] If Excite had been willing to pay a little more, the tech giants of the 2000s might have faced significantly less competition from Google. We do not know how many would-be Alphabets never became serious competitors because they sold cheap.

One final reason why an acquirer's estimate of the EV of a startup might be lower than the startup's board's estimate of remaining independent is that the acquirer does not even have a plan to use the assets of the startup productively at all. Instead, the acquirer may have a plan to prevent the startup from using the assets to compete with the acquirer. In that case, the price that the acquirer is willing to offer will reflect its estimate of the expected cost of new competition and nothing more.

One might predict that an acquirer would be willing to pay *more* for a startup that it

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285. Ho Nam, *What Did Bill Gates Worry About? Lean or Fat?*, ALTOS VENTURES (Mar. 23, 2010), https://altos.vc/2010/03/what-did-bill-gates-worry-about-lean-or-fat/.

286. *See* Kara Swisher, *New Yorker: Bezos' Initial Google Investment Was $250K in 1998 Because "I Just Fell in Love With Larry and Sergey*," ALLTHINGSD (Oct. 5, 2009), http://allthingsd.com/20091005/new-yorker-bezos-initial-google-investment-was-250000-in-1998-because-i-just-fell-in-love-with-larry-and-sergey/ (discussing Google's angel investors which included a billionaire, entrepreneur, and a computer science professor).

287. *Google: Amazon is Biggest Search Rival*, BBC (Oct. 14, 2014), http://www.bbc.com/news/technology/29609472.

288. *See* M.G. Siegler, *When Google Wanted to Sell to Excite for Under $1 Million—And They Passed*, TECHCRUNCH (Sept. 29, 2010, 2:50 PM), https://techcrunch.com/2010/09/29/google-excite/ (discussing Google founders' early attempt to sell the search engine).

289. *See* Google Inc., Final Prospectus (Aug. 18, 2004), https://www.sec.gov/Archives/edgar/data/1288776/000119312504143377/d424b4.htm (SEC document providing specific information on Google's 2004 IPO).

sought to acquire for anticompetitive reasons. In theory, the acquirer could extract both productive value from the startup's assets *and* extract monopoly rents—value from an asset greater than its value in a competitive market. Indeed, there may be an implicit anticompetitive premium in some startup acquisitions. That would be a socially costly outcome from a startup acquisition, but it is unlikely to be a beach money exit.

For example, Steven Davidoff Solomon argues that Facebook has used startup acquisitions for anticompetitive purposes.[290] He recounts that Mark Zuckerberg reportedly "saw that there were two companies with 'hockey stick' growth that matched Facebook's own: Instagram and WhatsApp. Both were amassing users at an amazing rate and both were an existential threat to Facebook."[291] Solomon asks, "Did Mr. Zuckerberg rev up the Facebook machine to try to outcompete them? No. Instead, he bought Instagram for about $1 billion and WhatsApp for an astounding $21.8 billion."[292]

In the cases of Instagram and WhatsApp, Facebook has continued to grow the products and expand their user base. Instagram, for example, had 30 million users at the time of the acquisition and over 600 million in 2017.[293] Still, it is difficult to know what innovations Instagram—and Facebook—could have delivered had they been forced to compete for users. It is also hard to know if Facebook paid a price that reflected Instagram's EV. The $1 billion price tag was "considered a massive price, especially for a company that didn't make any money" at the time, though in hindsight, it was an excellent EV decision—*for Facebook*, not for Instagram's shareholders.[294]

In some cases, the anticompetitive acquirer may not have a plan to develop the potentially competing product or use the startup's assets at all. For example, one recent study of startup acquisitions in the pharmaceutical industry finds evidence of "killer acquisitions," in which an incumbent firm "acquire[s] an innovative target and terminate[s] development of the target's innovations to pre-empt future competition."[295] Specifically, the researchers find that drug "projects that are acquired by an incumbent with an overlapping drug are 22.35% less likely to be continued in the development process compared to drugs that are acquired by other firms."[296]

Startup acquisitions undergo some antitrust scrutiny. The Hart-Scott-Rodino Antitrust Improvements Act of 1976 (HSR) requires M&A deals in excess of a certain threshold to be reported to the FTC.[297] In 2018, the threshold was $84.4 million.[298] But for startups,

290. *See* Steven Davidoff Solomon, *Tech Giants Gobble Start-Ups in an Antitrust Blind Spot*, N.Y. TIMES (Aug. 16, 2016), https://www.nytimes.com/2016/08/17/business/dealbook/expect-little-antitrust-challenge-to-walmarts-bid-for-jet-com.html.

291. *Id.*

292. *Id.*

293. *See* Kurt Wagner, *Here's Why Facebook's $1 Billion Instagram Acquisition Was Such a Great Deal*, VOX (Apr. 9, 2017, 3:16 PM), https://www.vox.com/2017/4/9/15235940/facebook-instagram-acquisition-anniversary.

294. *Id.*

295. COLLEEN M. CUNNINGHAM ET AL., KILLER ACQUISITIONS 1, https://www.colleenmcunningham.com/assets/killeracquisitions.pdf.

296. *Id.* at 3. The authors note that acquisitions "are becoming even more popular as an exit strategy over time" and speculate that "a significant driver fueling this trend may be killer acquisitions." *Id.* at 34. I am skeptical of their claim, given other persuasive explanations for why IPOs are declining and recent uncertainty about whether IPOs are even declining at all.

297. Hart–Scott–Rodino Antitrust Improvements Act of 1976, 15 U.S.C. § 18a (2012).

298. Premerger Notification for Office Staff, *HSR Threshold Adjustments and Reportability for 2018*, FED.

HSR review is widely considered to be a formality. At the time of an acquisition, startups usually do not have a market share large enough for regulators to conclude that an acquisition will harm consumer welfare. A startup's relevance to competition is what it could have become years later, had it remained independent.

Solomon argues that antitrust regulators are too focused on "how the data will be used rather than the accumulation of users."[299] He notes that "[b]oth United States and European Union regulators examined the WhatsApp deal, but it passed muster because WhatsApp was viewed as a messenger service, something where there was alternative competition."[300] He argues instead that "domination is all about users and views. Those companies with users and page views can dominate, and accumulating those users is everything, something only an infinitesimally small number of companies can find the key to doing."[301]

While it is conceivable that antitrust law could develop along the lines Solomon suggests, we cannot expect antitrust regulators to predict the growth curves of startups with confidence. After all, in the Instagram case, it was not 30 million users at the time of the acquisition that made the company an attractive target to Zuckerberg—it was the "hockey stick" growth rate.[302] Antitrust regulation of early- to mid-stage startup acquisitions might face issues of uncertainty in valuation similar to what a Delaware court would face in determining whether shareholders received a fair price for their shares.[303]

Perhaps instead we should think more broadly about how the private law that governs startup acquisitions can have downstream effects on competition, even if those effects are outside the traditional focus of antitrust. One helpful analogue might be intellectual property law, an area of law in which scholars have long analyzed its interaction with antitrust and effects on competition.[304] It may be that if startup boards could only accept offers that were EV-maximizing, more startups would grow to compete with established technology companies. Of course, though, as we have seen, private law does not offer a complete solution to the problem of beach money exits.

VII. CONCLUSION

Beach money exits are inefficient transactions, knowingly entered into by a corporation's board of directors. As such, the existence of beach money exits might appear to contradict the conventional economic analysis of corporate law.

Frank Easterbrook and Daniel Fischel, for example, famously argued that businesses should be organized efficiently because there is a market for corporate forms.[305] They

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TRADE COMM'N (Feb. 8, 2018, 4:01 PM), https://www.ftc.gov/news-events/blogs/competition-matters/2018/02/hsr-threshold-adjustments-reportability-2018.

299. Solomon, *supra* note 290.

300. *Id.*

301. *Id.*

302. *Id.*

303. *See supra* Part V.C (explaining the complications that arise when determining valuations of early- to mid-range startups).

304. *See, e.g.*, Michael A. Carrier, *Unraveling the Patent-Antitrust Paradox*, 150 U. PA. L. REV. 761, 763 (2002) (explaining that "[c]ourts and commentators have struggled with" the paradox of a patent law's protecting the right to exclude competitors and antitrust law's condemnation of excluding competitors "for generations").

305. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 7 (1991).

reasoned that, since corporate law imposes few constraints on how businesses are organized and allows for contracting around default rules, the most efficient business form for the purpose should be selected.[306] Over time, they contend, the most efficient form of organizing a given type of business should outcompete less efficient forms.[307] In fact, Easterbrook and Fischel claim that the "[t]he history of corporations has been that firms failing to adapt their governance structures are ground under by competition."[308]

How can we reconcile the optimism of law and economics scholars about the efficiency of corporate forms with the persistence of inefficient exits? The start of an answer is that even the most enthusiastic proponents of law and economics recognize that business forms cannot eliminate all inefficiencies. In a less frequently cited passage, Easterbrook and Fischel observe:

> Corporate managers have much of their wealth tied up in the firms they manage, and this lack of diversification reduces the agency costs of management. These managers, as investors, will be risk-averse and interested in the allocation of gains and losses. This is not a reason to treat corporate law as if it ought to care about these allocations, however; managers' risk aversion is *a regrettable cost of the corporate form*, not a reason to select a rule other than the wealth-maximizing one.[309]

Substitute "founders" for "managers" and you have the outline of the beach money exit problem. Founders have much of their wealth tied up in the firms they manage—in fact, a far greater percentage of their wealth than a manager of a publicly-traded corporation would. Founders' lack of diversification reduces the agency costs of management. This is just another way of saying that founders have strong equity incentives to manage the business in a way that maximizes shareholder value. But, in their role as investors, founders are risk-averse, and that risk-aversion may affect their decisions.

The law, economics, and social norms that structure contemporary venture-backed startups enable risk-averse founders to push those startups into inefficient transactions. The inefficiency can have real social costs. Our economy relies on startups to develop the fruits of science and engineering into innovative products and services and, ultimately, deliver them to consumers. Beach money exits are, in Easterbrook and Fischel's words, a "regrettable cost of the corporate form."[310]

306. *Id.* at 2–3.

307. *Id.* at 4–8.

308. *Id.* at 13 (citing OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985)).

309. *Id.* at 29–30 (emphasis added). Easterbrook and Fischel are concerned with risk-aversion in management decisions, rather than M&A decisions, but the reasoning is analogous.

310. EASTERBROOK & FISCHEL, *supra* note 305, at 30.