

ARTICLES

VENTURE CAPITAL AND THE FUTURE OF CORPORATE FINANCE

GEORGE W. DENT, JR.*

CONTENTS

INTRODUCTION	1030
I. WHAT AND WHY IS VENTURE CAPITAL?	1031
II. HOW VENTURE CAPITALISTS PROTECT THEIR INVESTMENTS	1035
A. <i>Background</i>	1035
B. <i>Protection Without Covenants—Participation in Control, Financial Arrangements, and Their Limitations</i>	1037
C. <i>Protective Covenants</i>	1044
1. <i>A Taxonomy of Venture Capital Covenants</i>	1044
2. <i>Illiquidity and Payouts</i>	1045
3. <i>Managerial Self-Dealing and Compensation; Freezeouts</i>	1052
4. <i>Abuse of Corporate Opportunities and Information; Competition with the Firm</i>	1054
5. <i>Dilution and Restrictions on New Issues of Shares</i> ..	1055
6. <i>Restrictions on Transfers of Shares</i>	1057
7. <i>Disclosure</i>	1058
8. <i>Risk of Loss and Liquidation Preferences</i>	1059
D. <i>Protecting the Company Against Restrictive Covenants</i> ..	1061
III. VENTURE CAPITAL LESSONS FOR CORPORATE LAW	1064
A. <i>Sales of Control for a Premium</i>	1066
B. <i>Unequal Repurchases</i>	1067
C. <i>Dissolution and Mandatory Buyouts</i>	1068
D. <i>Freezeouts</i>	1075
E. <i>Voting Rights and Control</i>	1076

* Professor of Law, Case Western Reserve University School of Law. The author thanks Meredith Brown, Lloyd Cohen, Ron Coffey, Tamar Frankel, Rob Kauer, Bob Refiner, Larry Ribstein, David Schwartz and Robert Thompson for their helpful comments. Kevin Adler rendered able research assistance.

F. *Corporate Opportunities* 1078

IV. VENTURE CAPITAL IN THE FUTURE OF CORPORATE FINANCE 1079

A. *Facilitating Venture Capital* 1079

B. *The Limits of Private Equity Financing* 1083

C. *The Future of Corporate Finance* 1084

INTRODUCTION

The central task of corporate law is to protect minority shareholders. In public corporations, the problem is referred to as the separation of ownership and control. Managers, even those who own little stock, can control public companies for their own benefit rather than striving to maximize shareholder wealth.¹ Despite efforts of legislatures, courts, bar associations, and scholars to reform corporate law, the plight of minority shareholders persists. Managers of public companies remain free to disdain shareholders, as evidenced by the deep discount from intrinsic value at which public stocks trade.² In non-public, or close, corporations the issue is referred to as the oppression of minority shareholders.³ Close corporations have no market for their stock, and they rarely pay dividends. Thus, minority shares are frequently worthless to hold and impossible to sell. These conditions discourage investment and precipitate disruptive disputes in small companies.⁴ This damage is significant because of the crucial economic role of small companies—for example, in the 1980s, small companies accounted for two-thirds of all new employment.⁵

Commentators occasionally predict new market solutions to the minority investor problem. Over twenty years ago the tender offer was hailed as the panacea.⁶ However, tender offers are not made for close corporations or public corporations with concentrated ownership. Even

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

2. See Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891, 892 (1988).

3. See F. HODGE O'NEAL & ROBERT B. THOMPSON, *O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS* (2d ed. 1991 & Supp. 1992).

4. See *id.* §§ 1.03-04.

5. See Don L. Boroughs, *Smart Moves for Small Business*, U.S. NEWS & WORLD REP., June 3, 1991, at 52.

6. See Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

in widely-held companies, tender offers are discouraged by high costs, as well as by the development and legal approval of potent takeover defenses. Michael Jensen proclaimed that the proliferation of leveraged buyouts ("LBOs") would cause the "eclipse of the public corporation."⁷ Jensen considered separation of ownership and control inevitable in public companies; therefore, the problem can be avoided only by public firms "going private" through LBOs. But LBOs, like tender offers, do not affect close corporations, and even in public companies the tide of LBOs has ebbed.⁸ Neither tender offers nor LBOs solved the plight of minority investors.

In the search for solutions, commentators have paid remarkably little attention to venture capital—to date, no law review articles have addressed the topic. A venture capitalist supplies equity financing, but does not assume control of the enterprise. A venture capitalist protects his investment through contracts. This provides a model for protecting minority investors in close corporations. Moreover, a venture capitalist's ability to supply major equity funding revives Jensen's suggestion that private financing could eclipse the public corporation.

After discussing general venture capital principles, this Article analyzes how venture capitalists protect themselves against the managerial opportunism that plagues other passive investors. The Article then shows that venture capital, though not the long-sought panacea for minority shareholders, offers valuable lessons for both close and public corporations. Finally, the Article demonstrates that venture capital confirms Jensen's insight into the strength of private equity financing; thus, venture capital has the potential to transform corporate finance. To fully realize this potential, however, the law must change to better accommodate minority investors.

I. WHAT AND WHY IS VENTURE CAPITAL?

Venture capital is a substantial equity investment in a non-public enterprise that does not involve active control of the firm.⁹ It is often asso-

7. Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.-Oct. 1989, at 61.

8. See Christopher Donnelly, *M&A Loan Volume Drops by 64% in 1990*, INVESTMENT DEALERS' DIG., Jan. 21, 1991, at 3; Aaron Pressman, *Merger Volume is Down, but Bigger Slide is Coming*, INVESTMENT DEALERS' DIG., Oct. 15, 1990, at 21, 22 ("lack of leveraged buyouts").

9. This Article will refer to a corporation in which a venture capitalist has invested (often called a "portfolio company") as the "company" or the "firm."

ciated with the financing of high technology start-up companies, where it has achieved its most spectacular successes. But, many companies financed with venture capital are neither high technology nor start-up companies. Indeed, companies past the start-up stage often raise additional venture capital when they are unable to finance through more conventional sources. These later round financings are often called "second tier," or "mezzanine" financings.¹⁰ Furthermore, once-successful companies that have fallen on hard times may also obtain financing from venture capitalists; these investors are often called "angels."

Entrepreneurs usually seek venture capital when they need capital but are unable to raise it elsewhere. Retained earnings are a manager's favorite source of funding. However, this source of funding is unavailable for start-up companies since they have not yet produced earnings to retain; and even after the start-up, a growing company usually requires more capital than its cash flow provides. Debt is often the managers' second choice for capital. Debt financing is generally preferred over equity because equity investors demand a higher return on their investment than lenders. Moreover, sales of stock dilute managers' equity interest and voting power. However, loans are unavailable to most start-up and growth companies because of the high risk of loss. In theory, lenders can offset increased risk by charging a high interest rate. In practice, however, usury laws, as well as regulations that require institutional lenders (such as banks and insurance companies) to be conservative, preclude such high interest loans. Moreover, few start-up companies generate sufficient cash flow to service high interest charges. For these companies such a loan would rapidly lead to insolvency.¹¹ Even more established firms may need more capital than they can borrow.

Some companies avoid debt financing even when loans are available. The risk of insolvency frightens owner-managers since insolvency will render their stock worthless and eliminate their jobs. Lenders may re-

10. Commentators use various terms for the stages of a corporation's life. One commentator identified the stages as seed, start-up, early development, expansion, profitable but cash poor, rapid growth toward liquidity, mezzanine, and liquidity. See William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473, 479 (1990). This taxonomy is useful, although somewhat artificial. Corporations may need financing several times while in a single stage; a corporation may not need any financing at all in some stages. In addition, many venture capital-financed companies fail before they reach liquidity.

11. A company could structure a debt financing to postpone the payment of interest, but then the loan would in substance be equity. A court would probably classify it as equity in bankruptcy. See *infra* text accompanying notes 128-29.

quire personal loan guarantees, which managers often refuse to give.¹² Furthermore, lenders may demand covenants that restrict managerial control.¹³ Default on these covenants, even while a company is solvent, enables the lender to intrude more deeply into managing the firm. Even if default is avoided, high interest payments may stunt a company's growth.

The third financing alternative is a public sale of company stock. Although stock sales dilute managers' equity interest, their loss of control is limited if the stock is sold publicly. Even if a firm sells a majority of its stock to the public, managers can retain control through the proxy mechanism.¹⁴ Public offerings usually generate a higher stock price than private placements.¹⁵ For most start-up companies, however, a public offering is not an alternative since underwriters and investors will not buy a stock in an unknown company that has no earnings record. Even if a public offering is possible, the costs of the offering and of operating as a public company may be so great¹⁶ that managers prefer a private sale of stock.

In later round financings, venture capitalists with an equity position in a company may value the company's equity higher than public investors based on their superior knowledge of the company. If the two sides have

12. See Richard I. Levin & Virginia R. Travis, *Small Company Finance: What the Books Don't Say*, HARV. BUS. REV., Nov.-Dec. 1987, at 30.

13. See Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979).

14. Managers may prefer a sale of equity for three reasons. First, the sale of equity may restrict managerial discretion less than the restrictive covenants demanded by lenders. Second, a public sale of stock permits managers to sell some of their own stock, because an initial public offering usually leads to the creation of a trading market in which such stock can be sold. Finally, managers may also favor equity financing if they are less optimistic than the market about the company's future, and therefore consider equity cheaper than debt.

15. See William J. Torpey & Jerry A. Viscione, *Mezzanine Money for Smaller Businesses*, HARV. BUS. REV., May-June 1987, at 116-17. "If a company could get a multiple of ten times earnings with an initial public offering (IPO), it might get only six times earnings from a private issue . . ." *Id.* This estimate is somewhat misleading. In a public offering the underwriter investigates the company. The underwriter incorporates this investigation cost into its compensation, which is then deducted from the public selling price; the company receives only the net. If one compares the net proceeds from public offerings (as opposed to the gross selling price) to private offerings, the price differential is considerably reduced. The remaining difference is explained largely by the greater liquidity and diversity that investors in public companies enjoy. See *infra* notes 20-23.

16. See Jeffrey A. Timmons & Dale A. Sander, *Everything You (Don't) Want to Know About Raising Capital*, HARV. BUS. REV., Nov.-Dec. 1989, at 70, 71. According to Timmons and Sander, costs "can run 15% to 20% of a smaller offering and can go as high as 35% in some instances." *Id.* Post-offering expenses "often add up to \$100,000 a year or more." *Id.*

amicable relations, the managers' fear of losing control to the venture capitalist diminishes and may be outweighed by a desire for the lower transaction and maintenance costs and higher stock price of a private equity sale.

Because venture capital financing dilutes managers' equity interest and control, it is often the last choice of financing. When venture capital is the *only* method of raising capital available, however, it is often eagerly sought.¹⁷ Therefore, most companies that seek venture capital are unstable and risky. In fact, one-third of venture capital-financed companies wind up in bankruptcy. Another one-third end up in "limbo" or as "living dead"—limping along, able to pay expenses (including managers' salaries), but unable to go public or pay significant dividends.¹⁸ Only one-third of the companies that use venture capital financing succeed. Venture capitalists demand high returns because the successful one-third of their investments must cover the losses generated by the other two-thirds, as well as the high transactions costs that venture capitalists pay in seeking, monitoring, and evaluating their investments.¹⁹

Venture capitalists also demand high returns because they cannot reduce risks by diversifying. Although modern portfolio theory advises investors not to put all their eggs in one basket,²⁰ venture capitalists are forced to ignore this advice. High transaction costs of choosing, monitoring, and evaluating private equity investments limit the venture capitalist to a few major purchases rather than many small investments. Large venture capital firms may receive over 1,000 proposals each year, but may invest in only a dozen.²¹ Further, the firm-specific expertise needed to enter into, and continually monitor, wise investments limits the investor's range of investment options; therefore, most venture capital firms concentrate their investments in one industry or a set of indus-

17. See GEORGE KOZMETSKY ET AL., FINANCING AND MANAGING FAST-GROWTH COMPANIES: THE VENTURE CAPITAL PROCESS I (1985) (entrepreneurs seek venture capital when they "are unable to raise capital from conventional sources"). Venture capitalists claim that they often provide general management advice and useful business connections to portfolio companies, especially when the company needs further financing or wants to go public. See *id.* at xiv; Sahlman, *supra* note 10, at 509. Commentators question these claims. Although venture capitalists have the skill, connections, and possibly the desire to help portfolio companies, in practice they are too busy to devote sufficient time to be truly helpful.

18. See Sahlman, *supra* note 10, at 483, 511-12.

19. See *Venture Capital in the '90s*, INC., Feb. 1991, at 31.

20. See ROBERT W. HAMILTON, FUNDAMENTALS OF MODERN BUSINESS 459 (1989).

21. See Sahlman, *supra* note 10, at 475; see also KOZMETSKY ET AL., *supra* note 17, at 8 (explaining that about two percent of proposals are funded).

tries.²² The result is a less diverse, and consequently more risky, portfolio.

Illiquidity also requires venture capitalists to demand a higher return on their investment. The inability of venture capitalists to sell their stock at a fair price whenever they choose is a burden for which they must be compensated. Thus, venture capitalists demand higher returns than the yield typically paid on debt or even on other types of equity investments.²³

II. HOW VENTURE CAPITALISTS PROTECT THEIR INVESTMENTS

A. Background

Venture capitalists usually obtain a significant voice in the control of the firm. However, even when this voice includes choosing half or a majority of the board of directors, it does not ensure fair treatment for the venture capitalist, who still must face the problem of agency costs. Venture capitalists demand protective covenants to minimize these costs.

The requisite level of protection influences the choice of security as the investment vehicle.²⁴ In theory, the parties may give a security any features that they desire, regardless of the label they attach to it: "For a draftsman, the security is whatever he chooses to make it."²⁵ However, in practice, each type of security traditionally includes some features and not others.²⁶ Altering a security's traditional features invites confusion,

22. See I MICHAEL J. HALLORAN ET AL., VENTURE CAPITAL AND PUBLIC OFFERING NEGOTIATION 145 (1991) (sample private placement memorandum indicating fund specialization); KOZMETSKY ET AL., *supra* note 17, at 3 (venture capital firms often specify their areas of investment specialization).

23. See *Venture Capital in the '90s*, *supra* note 19, at 31. There may be another reason: the small supply of venture capital. Until recently this contributed to high investment returns. Because of the small supply of venture capital, venture capitalists could choose to invest only in firms that promised high returns. Firms that would not or could not make such promises could not obtain venture capital financing. The growing supply of venture capital has forced down these returns. See Allan Myerson, *Venture Capital Funds on Upswing*, N.Y. TIMES, Mar. 11, 1992, at C1 (influx of venture capital in late 1980s forced down returns).

24. The enterprise must also decide under which business form it will operate—i.e., general partnership, limited partnership, S corporation, or a regular C corporation. Tax considerations largely dictate this decision, not the financial contracting issues which are the focus of this Article. Most firms with substantial venture capital financing choose to incorporate. Accordingly, this Article focuses almost exclusively on the corporate form.

25. WILLIAM L. CARY & MELVIN A. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 1108 (5th ed. unabridged 1980).

26. For example,

both common and preferred [stock] have ownership rights. The preferred normally is lim-

disputes about interpretation, and even accusations of deception. Thus, venture capitalists commonly use traditional securities that contain the desired features rather than creating unconventional securities. Many venture capital securities contain covenants that are common to close corporations. This Article will briefly examine these familiar covenants and will more closely analyze agreements that are distinctive to venture capital.²⁷

Each party to an economic transaction attempts to maximize its wealth; when all parties so behave, the result is an effort to maximize their joint wealth. However, caveats must be noted. A covenant may result from the parties' mistaken belief that it will increase their joint wealth, or from one party's superior bargaining power. In addition, contracts evolve toward greater efficiency; standard contract terms at any given time are imperfect and are continually evolving. Nonetheless, standard terms in any field, including venture capital, "take their current form and have survived because they represent a contractual solution which is efficient."²⁸

Although contracts are quite standardized in many areas,²⁹ the varied business contexts of venture capital discourage uniformity. For example, an investor who has the power to choose a majority of the board of directors, has needs far different from an investor who lacks even a veto power over the board's decisions. The variety of terms in venture capital contracts also mirrors the diverse preferences of the parties involved. Venture capitalists range from pension funds and other huge financial institutions to individual investors of modest means. In addition, managers have varied preferences, such as differing levels of risk aversion. Another factor is the parties' level of sophistication. Unusual terms may reflect either mutual ignorance or overreaching by a more sophisticated party.³⁰ The youth of the venture capital industry is another reason for

ited to a fixed dividend but has prior claim on dividends and, in the event of liquidation, assets. Claims of both common and preferred stockholders are junior to claims of bondholders or other creditors of the company. Common stockholders assume the greater risk, but generally exercise the greater control and may gain the greater reward in the form of dividends and capital appreciation.

BLACK'S LAW DICTIONARY 1416 (6th ed. 1990).

27. For example, arbitration agreements commonly appear in other close corporations as well as in firms with venture capital investors. Because such agreements are not distinctive to venture capital arrangements, this Article will not discuss them.

28. Smith & Warner, *supra* note 13, at 123 (referring to bond covenants).

29. *See id.* at 122-23 (discussing the high level of standardization in bond covenants).

30. Although managers may be experts in production or marketing, they often know much less

the multiformity of contractual terms. Participants learn from experience which contract terms are efficient, but evolution by survival of the fittest takes time. Moreover, due to the diverse uses of venture capital, covenants will not evolve toward perfect uniformity. More likely, the venture capital field will evolve into several categories of deals, with contract terms varying among the categories, but becoming more standardized within each category.

This Article will attempt to explain how venture capital covenants are utilized to maximize the parties' mutual wealth. Economic advantage to just one party does not justify a covenant term. If a term does not maximize the mutual wealth of the parties, a term that would do so should have been used and the benefits of the entire agreement adjusted to make the deal *Pareto superior*.³¹ Nor does superior bargaining power of one party explain a covenant term; it must be determined why a party chooses to exert its superior bargaining power to extract one concession rather than another. Why, for example, does a venture capitalist bargain for a restrictive covenant rather than for a larger share of equity? To answer this question, the Article uses both inductive economic analysis and empirical evidence. This Article initiates an analysis of venture capital and serves as a starting point for future research in the area.

B. Protection Without Covenants—Participation in Control, Financial Arrangements, and their Limitations

Contract covenants are not the only form of protection for venture capitalists. Although they often deny a desire to interfere with the control of a company,³² venture capitalists generally demand a voice in con-

about financial contracting than the venture capitalists. A knowledgeable lawyer can even the balance, but many managers are not even sophisticated enough to retain such lawyers.

31. One situation is *Pareto superior* to another if in the former at least one party is better off and no party is worse off than in the latter. A situation is *Pareto optimal* if there is no other situation in which any of the participants would fare better and no participant would be worse off. See A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 7 n.4 (1983).

32. See KOZMETSKY ET AL., *supra* note 17, at xii; Gilbert Kennedy, *Packaging the Deal, in HOW TO RAISE AND INVEST VENTURE CAPITAL* 85, 94 (Stanley M. Rubel & Edward G. Novotny eds., 1971) ("Generally, a venture capital investor is not looking for a leading role in the operating management. . ."). The venture capitalist's disclaimer of control is conditional. If a company steadily expands and its managers do not harm the company or its investors, the capitalist gladly leaves control to the managers. If the company falters, however, the venture capitalist often becomes more active. If severe problems arise (as they often do—see *infra* note 40), the investors may attempt to liquidate the company or replace its managers. Managers' fear of this possibility is a major reason why they avoid venture capital financing when possible. See Jill Andresky, *I'd Rather Go Bankrupt*, FORBES, June 17, 1985, at 142.

trol. This voice may include the power to elect one-half of the board of directors³³ or a minority of directors sufficient to veto major board actions.³⁴

Despite the protection afforded by controlling one-half or more of a board of directors, investors still need restrictive covenants. First, although by electing one-half of the directors an investor can block unwanted board action, the investor cannot institute action over the opposition of the other half of the board. If a corporation's charter requires a supermajority vote, even an investor majority on the board may lack working control. Second, if the board develops a voting deadlock, compromise between the investor and management is possible, but not inevitable. Since managers control the day-to-day business, board deadlock may leave them free to run the firm³⁵ with their compensation intact. Therefore, the burdens of board deadlock weigh more heavily against investors. To avert deadlock, managers and investors may agree to equal board representation and the joint selection of a neutral director.³⁶ This

33. The power to elect directors entails voting, which is usually tied to ownership of common stock. Venture capitalists often purchase preferred stock that is convertible into common stock and carries votes equal in number to the common shares into which it is convertible. See I HALLORAN ET AL., *supra* note 22, at 354-55. If there are several investors, they may contract to vote as a class to elect directors. *Id.* at 355. Some state statutes permit debt holders to contract for voting rights. See, e.g., DEL. CODE ANN. tit. 8, § 221 (1991). Venture capitalists obtain the power to elect half the board in several ways: (1) management may directly stipulate such power; (2) shareholders may enter into a pooling agreement; or (3) management may give the investors the same number of votes as the managers.

The percentage of the board of directors that investors have the power to elect varies widely in venture capital deals. A study of initial public offerings ("IPOs") by venture capital-financed firms shows that on average venture capitalists held 34.3% of the pre-IPO equity and 33.4% of the board seats. See Christopher B. Barry et al., *The Role of Venture Capital in the Creation of Public Companies*, 27 J. FIN. ECON. 447, 461 (1990). These percentages are undoubtedly higher in other venture capital-financed companies because IPO companies are not start-ups, but have matured to the point of making a public offering. The percentage of board seats held may be especially misleading because underwriters often insist that companies add unaffiliated directors (excluding venture capitalists) to the board before conducting an IPO.

34. See Harold M. Hoffman & James Blakey, *You Can Negotiate With Venture Capitalists*, HARV. BUS. REV., Mar.-Apr. 1987, at 16, 22. A board veto is often arranged by giving the investor a substantial minority (for example, 40%) of the directors and requiring a supermajority vote (for example, 67%) to approve major actions as defined in the charter. Even in public companies, a board veto is sometimes given to major equity investors. See Clifford G. Holderness & Dennis P. Sheehan, *Monitoring an Owner: The Case of Turner Broadcasting*, 30 J. FIN. ECON. 325, 336-38 (1991).

35. See *Gidwitz v. Lanzit Corrugated Box Co.*, 170 N.E.2d 131, 133 (Ill. 1960) (where two factions on the board of directors were equally divided, causing deadlock, the president ran the company unhindered for over 10 years).

36. See, e.g., *Lehrman v. Cohen*, 222 A.2d 800, 803 (Del. 1966) (company controlled by fami-

arrangement, however, may cause the investor to be outvoted, perhaps repeatedly, if the neutral director sides with management.³⁷

If several investors have board representation, none will have a majority on the board. Investors generally cooperate since their interests coincide. But, occasionally their interests may diverge, or they may simply disagree on a course of action. In addition, some investors may conspire with managers to exploit other investors. Even an investor who initially controlled one-half the board may lose his veto power over board actions due to death, illness, disability, or disloyalty of a director. Protective covenants assume importance in each of these situations.

If selecting one-half of the board of directors does not adequately protect investors, why do they resort to protective covenants rather than insisting on even greater board representation? Corporate control carries burdens as well as benefits. For example, "controlling persons" may incur liability to third parties and are subject to strict fiduciary duties to the other shareholders.³⁸ Moreover, certain financial institutions are legally barred from controlling the firms in which they invest.

Investors may be able to select a majority of the board's directors under an "event of election" clause. Yet, these clauses apply only if the corporation defaults on its obligations to the investor or fails to achieve certain goals.³⁹ Logically, a venture capitalist will not invest in a company unless he values the company's managers. If the company performs to the investor's satisfaction, the investor will not interfere with management. If the company fails to perform, however, the investor may assume that management is at fault. Moreover, when a company falters, the balance of risks and burdens between managers and investors shifts. Managers may avoid risk and allow the company to limp along as long as

lies with equal shares of voting stock established a neutral directorship to obviate the risk of deadlock).

37. See *id.* at 804 (neutral director repeatedly sided with one of the two owner families).

38. See HARRY G. HENN & JOHN R. ALEXANDER, *LAW OF CORPORATIONS* 653-56 (3d ed. 1983) (fiduciary duties of controlling shareholders); Mark J. Roe, *Political and Legal Restraints on Ownership and Control of Public Companies*, 27 J. FIN. ECON. 7, 9-21 (1990) (legal restrictions on investments by financial institutions); Securities Act of 1933, § 15, 15 U.S.C. § 77o (1988) (liability of controlling persons for securities law violations by controlled company); Securities Exchange Act of 1934, § 20, 15 U.S.C. § 78t (1988) (same).

39. For example, investors often receive the power to elect a board majority if the corporation misses too many dividend payments on the investors' preferred stock or if it fails to make a public stock offering by a certain date. Such arrangements are called "voting switch provisions," see I HALLORAN ET AL., *supra* note 22, at 359, or "event-of-election" clauses, see Andresky, *supra* note 32.

the firm continues to pay them more than they could earn elsewhere. Investors, though, abhor this state of limbo in which the company is able to pay its bills but cannot pay dividends or go public. Therefore, investors may prefer to take risks that managers would avoid.

On the other hand, if the company is on the verge of insolvency, the views of risk may change.⁴⁰ Investors often have a liquidation preference,⁴¹ so managers risk losing their jobs and their equity interests in case of insolvency. Therefore, managers may decide to usurp firm assets or take desperate actions. They will benefit if their efforts succeed but will not suffer if the risks fail; in effect, they are playing with the investors' money. A venture capitalist may attempt to avoid this problem by reserving the power to seize control of the board when the company encounters financial difficulties.

Even investors who control a board may still want restrictive covenants because replacing managers is difficult and costly. For example, investors may be unable to remove managers because they have employment contracts or because better managers are not affordable or available.⁴²

This discussion also explains why venture capitalists generally secure protective covenants instead of seeking a majority of the company's equity. Investors who control the board could exploit management. The threat of oppression by investors is more serious than the risk of managers oppressing investors because managers have their jobs as well as their own investment money at stake; unlike investors, managers bear the risk of being fired, or having their compensation, perquisites or authority reduced. By allotting managers substantial equity in the firm, investors discourage managerial opportunism and slack. In addition, it encourages diligence on the job because managers have an equity interest in the suc-

40. See Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147 (1977) (a party with a contingent claim on value has an incentive to increase risk).

41. See *infra* note 65.

42. Some corporate actions (such as mergers) require shareholder approval, often by a supermajority, and cannot be taken by the board alone. Some actions, such as selling shares back to the corporation, are forbidden as self-dealing if the investor controls the board and treats itself differently from other shareholders. Consequently, board representation alone may not enable an investor to take certain steps. These actions may be taken only if (or more safely if) the investor has a contractual right to take them.

Although firing managers may be difficult, even when the venture capitalist controls the board, it is sometimes done. See Phyllis Berman, *The Unacceptable Face of Venture Capitalists*, FORBES, June 2, 1986, at 106. Berman's article also demonstrates the strong allure of venture capital; the ousted executive soon started another company which he also financed with venture capital.

cess of the firm. As the managers' share of equity is reduced, the incentive weakens, and the divergence between the managers' interests and the investors' interests grows, as often happens in public companies.⁴³ Thus, it is unwise to give the managers an equal voice on the board if they own a minority of the firm's equity. This would merely increase the managers' power of day-to-day control without aligning the managers' and investors' goals.⁴⁴

Although venture capitalists traditionally rejected minority status on the board, many now accept it⁴⁵ when the company is better established and less risky than a start-up company. In such cases the managers have other sources of capital and do not need to cede half the board to outside investors. Investors must devote special attention to contract terms when they have little voice in control. An investment that contains a debt component may benefit both the investors and management.⁴⁶ The right to interest payments and the general creditor's rights that attach to debt assure investors steady payouts and protect them against freezeouts. To assure additional protection in a debt security, investors can negotiate for the right to seize control if management fails to meet certain financial goals.⁴⁷ These deals usually include an "equity kicker" (the ability to increase the investor's equity position at a reduced price).⁴⁸

Why do companies finance in this manner rather than using straight debt? Though more stable than start-ups, these companies are generally too risky to borrow from banks. Furthermore, without an equity kicker, a lender might charge a higher interest rate than the company's cash flow can cover. By financing primarily with debt, however, managers reduce the equity dilution and the loss of control that they suffer with more

43. See George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881, 889-91 (interests of managers and shareholders in public companies often diverge).

44. Companies also use dual class stock (different classes of stock with disparate voting rights) in other contexts to produce different allocations of voting power and interest in profits. See George W. Dent, Jr., *Dual Class Capitalization: A Reply to Professor Seligman*, 54 GEO. WASH. L. REV. 725 (1986).

45. Increasing competition among venture capitalists has contributed to the new attitude. See Robert A. Mamis, *Cashing In Without Cashing Out*, INC., Sept. 1987, at 113. Moreover, improved protection through covenants has made equal board representation less important. Finally, an investor who accepts minority status on the board may avoid the disadvantages of being a control person. See *supra* note 38.

46. See Mamis, *supra* note 45, at 113; Torpey & Viscione, *supra* note 15, at 117.

47. See Mamis, *supra* note 45, at 113; Torpey & Viscione, *supra* note 15, at 117.

48. "Equity kickers" include warrants to purchase common stock at less than fair market price.

conventional venture capital financing.⁴⁹ A combination of debt with an equity kicker benefits management (lower cost of capital and less equity dilution) while protecting investors (assured interest payments, creditor's rights, and the right to acquire a strong equity position at a low cost).

These transactions illustrate the benefits of convertible debt securities. Some scholars argue that the combination of disparate elements in these securities (i.e., debt and equity) makes no more economic sense than packaging apples and oranges together.⁵⁰ Sometimes, though, convertible debt modulates risk and payouts better than either straight debt or straight equity. As noted, minority shareholders fear that a company will limp cautiously along, paying the managers generous compensation while providing no return to the investors. On the other hand, a creditor faces the opposite risk: if a company approaches insolvency, the managers may engage in reckless behavior at the creditor's expense. Convertible debt addresses both these risks. First, it deters managers from struggling along in limbo by forcing them to make periodic interest payments. Second, it discourages management from taking imprudent risks, because if the effort fails, the security holder will have the priority of a creditor in bankruptcy. Yet, if an effort succeeds, the holder will convert to equity and share the profits.

Similarly, convertible debt may offer a payout policy superior to either straight debt or straight equity. Straight debt financing works well for companies with sufficient cash flow to cover both interest and growth opportunities. If cash flow falters even briefly, however, growth may be stunted or, worse, the company may default on its debt. On the other hand, straight equity financing is attractive to companies that are not prosperous. But, if a firm's fortunes improve, management may find the investors' share of the profits a heavy price to pay for the capital that the investors contributed. For investors, the considerations are the opposite—it is better to hold debt securities when the company languishes and equity is preferred when the company flourishes. Convertible debt may provide a golden means of financing for the two sides by imposing a moderate burden on the managers, in both good and bad times.⁵¹

49. See Torpey & Viscione, *supra* note 15, at 117 (both investor and company profit from these transactions).

50. See William A. Klein, *The Convertible Bond: A Peculiar Package*, 123 U. PA. L. REV. 547, 553 (1975).

51. Similar effects may be achieved by issuing a combination of straight debt and straight equity. With both types of investments outstanding, managers would have less incentive for the opportunism described above. Convertible debt, however, offers certain advantages. First, a convertible

Investors must also consider how future corporate financing will affect their control. A new issuance of stock may reduce or eliminate an investor's board representation.⁵² The investor can avoid this problem through cumulative voting or a pooling agreement that entitles it to elect a portion of the board. Staged financing also helps to protect prior investors. A venture capitalist typically provides capital to sustain a company only for a brief time.⁵³ Long-term financing is not feasible because it is impossible to specify by contract when to abandon the firm and return the unused capital to the investors.⁵⁴ Staged financing also provides the initial investor an advantage when a company needs more money since that investor's knowledge of the company makes it the most logical source of additional financing. Other investors may be wary, reasoning that the company must be in shaky condition if the original investor will not furnish additional capital.

Combining staged financing with restrictive covenants can provide an investor undue power over future financings. With enough board votes, the investor can simply veto stock sales to new investors. Short of a veto,

debt investment requires only one set of negotiations, often with an investor who is familiar with the company, rather than two sets of negotiation, one at least with a stranger to the company. Transaction costs might escalate if the two deals were interdependent and had to be negotiated simultaneously. For example, the interest rate on the debt could depend on the stock issuance, and the terms of the stock sale could depend on how much the company borrows. Second, the high interest rate charged to risky companies could preclude lenders who are required by law to be cautious. *See supra* text preceding note 11. Pursuing other types of lenders would further raise transaction costs. Third, straight borrowing could violate covenants with an existing investor. A company could avoid this problem by negotiating a convertible debt package with the same investor. Fourth, and most importantly, managers can conspire with the other shareholders against the holders of straight debt in ways that they cannot with holders of convertible debt. If a firm's fortunes wane, both managers and outside shareholders would have an incentive to approve high-risk projects. Holders of straight debt would share losses if the projects fail, but, because they have a fixed rate of return, they would not share the gains if projects succeed. If, by contract, straight debt holders could veto such high-risk projects (either through a covenant or voting rights), they could also veto those projects with a positive net present value—projects that a convertible debt holder would have approved. In short, convertible debt better aligns the interests of the managers and the investors.

52. In most states, a simple majority of the shares outstanding can elect the entire board unless the corporate charter permits cumulative voting. *See, e.g.,* DEL. CODE ANN. tit. 8, §§ 212, 216 (1991) The initial investor can maintain its power by purchasing a percentage of shares in the new issue equal to or greater than its current ownership percentage. Even if the initial investor has the right to make such a purchase at a fair price, however, it may waive that right to avoid concentrating its investments in one company.

53. *See* Sahlman, *supra* note 10, at 475.

54. Managers prefer not to liquidate an enterprise as long as capital remains, regardless of a dismal business outlook. Using an independent arbitrator to decide if a company should liquidate is inappropriate and unnecessary: the market will decide. If a firm shows promise, investors will continue to provide financing.

an investor that is entitled to choose a portion of the board can refuse to reduce its representation. The new investors must then either forego representation on the board or take board positions from the managers.⁵⁵ The original investor may also refuse to modify its right to convert to a given percentage of common stock, thus making further financing impractical. The ability to disrupt new financing may enable an initial investor to snap up subsequent stock issuances at bargain prices.

As a result, managers have strong incentives to keep the original investor satisfied.⁵⁶ Venture capitalists and managers have a long-term, relational contract in which the need to cooperate for mutual advantage often restrains parties from fully pressing their contract rights.⁵⁷ Thus, the importance of contract terms in venture capital deals should not be overstated. On the other hand, when a company falters, cooperation may cease and conflict may erupt, causing contract rights to become crucial. Moreover, even in prosperity, contracts often dictate the terms of cooperation. For example, in a successful firm, dividend rights will be observed, or at least provide the basis for renegotiation, rather than be utterly ignored. In summary, the importance of contract terms should not be understated.

C. *Protective Covenants*

1. *A Taxonomy of Venture Capital Covenants*

Covenants in venture capital investments are best classified according to the problems that they are designed to solve. These problems include: (1) illiquidity (holding shares that cannot be sold and receive no payouts); (2) excessive compensation and other self-dealing by managers; (3) dilution of the investor's equity interest resulting from new issues of shares; (4) abuse of corporate opportunities and information and competing with the firm; (5) undesirable transfers of the managers' shares; (6) lack of information; and (7) insolvency. Covenants should also be analyzed for features that minimize undue burdens on the company.

Although the following section is organized according to the preceding

55. The same problem arises if, by a pooling agreement, the managers give the initial investor the power to elect half the board.

56. See Sahlman, *supra* note 10, at 506-07.

57. See generally Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981). Appreciating the need to cooperate, parties may not specify how they will resolve certain problems, but may instead decide to work them out when and if they arise. *Id.* at 1090.

taxonomy, protective devices can also be categorized in other ways. William Klein classified them into rules that directly limit a party's behavior (i.e., restrictive covenants), participation in control, and aligning of investors' and managers' interests.⁵⁸ Rules that permit a party to exit should be added to the list—a party can often deter or escape another's opportunism by withdrawing or threatening to withdraw its capital contribution.⁵⁹ The power to exit is often achieved by requiring the corporation to repurchase the venture capitalist's stock.⁶⁰ This Article previously discussed participation in control and aligning of the parties' interests, so most of the following discussion focuses on direct limits on party action and exit and on the interplay among all four approaches.

2. *Illiquidity and Payouts*

Being "locked in"—having an investment that receives no payouts and cannot be sold—is perhaps the largest problem for minority investors in close corporations. Even when managers act in good faith, close corporations rarely pay dividends because dividends incur double taxation; the company is taxed when it earns the income and investors are taxed when they receive dividends from the residue.⁶¹ Every effort is made to channel income from the firm to the entrepreneurs in ways other than dividends, such as management compensation.⁶² This is effective for manager-investors, but not for investors who are not part of management. Nonmanagement investors can assure payouts by mandating dividend payments whenever the firm meets certain financial tests or by tying dividends to management compensation. Alternatively, investors can acquire debt instruments, which avoid double taxation because interest is deductible by the corporation as a business expense.⁶³ Hence, most private financings of established corporations employ debt instruments.

These measures are not feasible for most companies financed with venture capital because they lack sufficient cash flow or stability to promise

58. William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 *YALE L.J.* 1521, 1556 n.126 (1982).

59. See generally ALBERT O. HIRSCHMANN, *EXIT, VOICE AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS AND STATES* (1981).

60. See *infra* text accompanying notes 72-80.

61. Corporations are taxed once based on their profits. I.R.C. § 11 (1988). Then, shareholders are taxed a second time on dividends received from the corporation. I.R.C. § 61(a)(7) (1988).

62. See HAMILTON, *supra* note 20, at 373.

63. I.R.C. § 163 (1988).

regular dividends or interest payments.⁶⁴ Sometimes, however, preferred stock dividends are cumulative—missed dividends must be paid before further dividends are paid to the common stockholders.⁶⁵ When the investor is a corporation, the double tax burden from paying stock dividends is eased by the exclusion of most dividend income from the corporate investor's taxable income.⁶⁶

Close corporation shares are illiquid since, by definition, no market exists for them. The managers' stock is similarly unmarketable; therefore, managers share the investor's incentive to go public.⁶⁷ Managers are more ambivalent, though, because going public entails substantial costs and disclosure obligations. More importantly, the sale of additional stock may weaken their control.⁶⁸ If hopes for going public fade, the interests of investors and managers further diverge. As long as the managers are paid more than they could earn elsewhere,⁶⁹ they will oppose dissolution. Investors, however, abhor a state of limbo, since they receive no return on their investment. Indeed, investors view limbo, which is a common fate for venture capital financed firms,⁷⁰ as worse than insolvency and dissolution. At least an investor can take a tax loss for stock that becomes worthless; he has no such recourse for stock of companies in limbo.⁷¹

64. See *supra* text accompanying note 11. See also I HALLORAN ET AL., *supra* note 22, at 334 (preferred stock issued by venture capital enterprises is rarely entitled to mandatory dividends because venture capital-financed firms "are rarely in a position to pay dividends").

65. See 2 ROBERT J. HAFT, VENTURE CAPITAL AND SMALL BUSINESS FINANCING 2B-88 to 2B-89 (rev. ed. 1991). Sometimes preferred stock dividends are either not cumulative, or cumulative only if earned—"i.e., to the extent that the profits earned in the relevant fiscal period were sufficient to pay dividends." I HALLORAN ET AL., *supra* note 22, at 335.

66. I.R.C. § 243(a)(1) permits corporations to deduct 70% of the dividends they receive from their taxable income. The deduction increases to 100% if the corporation owns more than 80% of the payor's stock. I.R.C. §§ 243(a)(3), 1504(a) (1988).

67. However, managers and venture capitalists usually do not sell most of their stock in an IPO. Indeed, venture capitalists generally sell none of their stock. See Barry et al., *supra* note 33, at 460. After a company goes public though, the shareholders can more readily sell their stock. Venture capitalists sell an average of 30% of their shares within one year after an IPO. See *id.*

68. Stock exchange rules that require listed companies to include several outside directors on their boards may constrain managerial control. See 2A HAFT, *supra* note 65, at 5A-48.

69. This does not imply that the managers are overpaid. Managers' skills become more firm-specific the longer they work for a firm. See John C. Coffee, Jr., *Shareholders versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 15-23 (1986). Since the managers' value to other firms is lower, due to firm-specific skills, they hesitate to dissolve their current employer.

70. See *supra* note 18.

71. I.R.C. § 165(a) (1988) (permitting deduction for "any loss sustained").

a. Puts or Mandatory Redemptions

To avoid limbo, venture capitalists often obtain a right (dubbed a mandatory redemption, a put, or a buyout) to sell their stock back to the corporation after a specified time lapses, unless the company goes public.⁷² The redemption price is typically the original purchase price plus a reasonable rate of interest. Preferred stock that fails to receive dividend payments, but which contains such a right, resembles a zero coupon bond because interest is paid only when the security matures.

Mandatory redemptions enable investors to sell an investment which is in limbo and which would otherwise be illiquid. They also discipline managers. Although limbo may result from market conditions beyond managerial control, it can also result from managerial misconduct which is hard to detect and which may not violate fiduciary law or protective covenants.⁷³ Managers may be lazy or incompetent—shortcomings that a contract cannot directly prohibit. Investors and managers may also disagree over the appropriate level of risk taking. Because venture capitalists spread risk over several investments, they are risk-neutral: they favor all actions that, discounted for risk, increase the net present value of the firm. Managers, on the other hand, are more risk averse because more of their wealth—both stock and employment—is invested in the firm.⁷⁴ Redemption rights do not address the problems of managerial incompetence or risk-aversion, but they do provide investors the remedy of exit when the problems occur. Thus, redemption rights resemble

72. A corporation may allow each investor to individually decide whether to exercise a mandatory redemption right. See I HALLORAN ET AL., *supra* note 22, at 348 (form of mandatory redemption); Stanley Keller, *Venture Capital Financing Documents*, REPRESENTING THE GROWING TECHNOLOGY COMPANY (I ALI-ABA Course of Study, Dallas, Tex.), Oct. 25-26, 1990, at 307, 347-49 (*semble*); Jack L. Lewis & Thomas C. Dabney, *Certificate of Incorporation for a Delaware Corporation with a Venture Capital Investor Purchasing Preferred Stock*, REPRESENTING THE GROWING TECHNOLOGY COMPANY (I ALI-ABA Course of Study, Washington, D.C.), Oct. 19-20, 1989, at 29, 42-43 (*semble*). Alternatively, a corporation may require the holders of a specified portion of the securities to approve a mandatory redemption, in which case the corporation must redeem all of the securities. See Robert Reffner, *Legal Considerations in Venture Capital Financing*, Speech at Case Western Reserve University School of Law (Apr. 22, 1988) (transcript on file with author) (form of mandatory redemption). The latter approach prevents investors with a small quantity of securities from carrying burdensome special privileges. A company can waive the requirement that it redeem the entire class of securities.

Redemption rights typically expire if the company goes public. See I HALLORAN ET AL., *supra* note 22, at 481-82.

73. See Larry E. Ribstein, *A Statutory Approach to Partner Dissociation*, 65 WASH. U. L.Q. 357, 380-83 (1987) (buyout rights counter managerial exploitation).

74. See Coffee, *supra* note 69, at 15-23.

event-of-election clauses, which give investors the remedy of seizing control when management falters.

Practical considerations, however, limit the value of redemption rights for an investor. In fact, investors almost never exercise them. Yet, they are still useful. First, by not exercising the redemption right the venture capitalist protects his reputation. If the investor is too aggressive with managers, he may lose attractive deals to friendlier investors. Second, if the company is in poor financial condition, the right of redemption cannot be exercised because only current profits or surplus earnings can fund stock redemptions.⁷⁵ Redemption rights are often tied to event-of-election clauses, though, so that if the company cannot redeem, the investors can seize control from the managers. Third, an investor may waive its right to redeem in exchange for additional securities or contract rights. An investor may also accept a lesser payout than the stated redemption price if it cannot realistically enforce the put at its full price. Managers will pay an investor some amount in order to maintain control.

On the other hand, if a firm prospers and the stock's value exceeds the buyout price, an investor should waive its redemption rights.⁷⁶ Furthermore, a company that satisfies the state law on redemptions does not necessarily have cash to effect the redemption. An investor is reluctant to injure itself by exercising a redemption that could trigger a financial crisis or force the company into bankruptcy. Still, even stock in a successful firm has a discounted value if it is illiquid. Furthermore, where redemption might injure the investor, it will most likely harm the managers more severely, so that management cannot ignore the investor's threat to exercise. In short, a right of redemption pressures managers to satisfy investors. For example, if the company has prospered, a public offering may be possible. Ordinarily, managers may resist a public offering even when feasible;⁷⁷ however, the threat of a mandatory redemption makes them more amenable. Alternatively, the obligation may induce

75. See DEL. CODE ANN. tit. 8, §§ 151, 160 (1991). Restrictive covenants in debt instruments may also preclude a company from satisfying a mandatory redemption.

76. See I HALLORAN ET AL., *supra* note 22, at 346-48 (discussion of and form for waiver of redemption right). Some agreements forbid the investor to waive redemption; then, the investor can avoid the redemption only by converting to common stock. Nonwaivable redemptions force investors to surrender the protective covenants and the other privileges that they initially bargained for and to choose between cash redemption and the lesser rights of a common stockholder. If a corporation flourishes, the value of the common stock makes conversion more attractive. A right to waive redemption gives an investor more time to decide whether to convert.

77. See *supra* text preceding note 14 (public offerings dilute managers' equity interest and control).

the managers either to find another investor to fund the buyout or to start paying dividends.⁷⁸

Whether redemption rights are included in a venture capital transaction depends in part on the parties' bargaining skills. Venture capitalists are often better counseled and more sophisticated than managers. Managers are often overly optimistic and may grant redemption rights without appreciating the probability or the magnitude of the trouble they may create. The threat of a cash drain caused by a forced redemption may deter future investors from participating, and thus further tighten the initial investor's grip over later financings.⁷⁹ By exercising a right of redemption, an investor signals dissatisfaction which scares off other potential investors. Another reason why redemption clauses are omitted from some transactions is that they are difficult to draft without inviting opportunism. For example, requiring long notice periods before an investor can exercise his right of redemption not only permits managers to find substitute financing, but it also enables them to loot the company. A redemption right could be made exercisable only if the company fails certain financial tests. However, these tests may be hard to specify, and a company that fails such tests may be legally barred from redeeming stock.

Even sophisticated managers often allow rights of redemption in venture capital arrangements, presumably because they are an efficient solution to some problems. It is unclear, though, why redemption rights may be efficient solutions only in certain cases. Perhaps they are best used for companies that are especially likely to wind up in corporate limbo. It is also probable that, given both their benefits and their costs, a redemption right is a fairly neutral feature which does not materially enhance or impair most deals. The net benefits of a redemption clause may be so slight that parties often forego it as not worth its transaction costs.⁸⁰

b. Facilitating Resales

Some covenants are designed to facilitate the resale of an investor's interest, including the right to have the stock registered with the Securities and Exchange Commission ("SEC") for public sale. The extent of

78. See I HALLORAN ET AL., *supra* note 22, at 345 (a put "pressures the company to find another path to liquidity for the investors").

79. See *id.* at 346; see also *supra* text accompanying note 55 (initial investor's influence over later financings).

80. See Ribstein, *supra* note 73 (discussing the costs and benefits of buyouts in partnerships).

these rights varies. "Piggy-back" rights entitle the investor to include its stock in the company's public offerings.⁸¹ "Demand" rights go further by allowing an investor to compel the company to register the investor's stock with the SEC, at least if the company meets certain financial tests.⁸² However, even demand rights do not guarantee the investor the opportunity of a public sale. Registering securities with the SEC is so complex that a court will not order specific performance if management balks. Regardless of management's desires, a company cannot make a public offering on acceptable terms if the company is unsuccessful or if market conditions are poor. Thus, even demand rights only pressure managers to register securities.⁸³

The adoption of SEC Rule 144A⁸⁴ in 1990 may be conducive to resales of venture capital securities. The SEC had long conceded that securities can be sold privately without registration; but before 1990, it never specified the conditions for private sales.⁸⁵ The SEC believes that the new rule will create a market where investors can more readily sell restricted securities. Some venture capitalists have responded to Rule 144A by extracting promises from portfolio companies to satisfy the rule's information requirements.⁸⁶

c. "Unlocking" Clauses

An investor in a close corporation can also cash out in a sale of the entire firm. However, because managers have pecuniary and psychological interests in remaining managers, they may veto a sale that investors favor. One solution to this problem, an "unlocking" clause, allows the investor to sell its securities to the company on the same terms that the

81. See 2 HAFT, *supra* note 65, at 2B-73 to 2B-74.

82. See *id.* at 2B-69 to 2B-73. If the company is already publicly traded, the investor may obtain a commitment from the company to maintain disclosure sufficient to satisfy SEC Rule 144 so that investors can sell their shares pursuant to that rule. See Robert L. Frome, *Investment Agreement Covenants*, 200 N.Y. L.J. 3, 4 (1988).

83. High nondeductible dividends paid on the preferred stock that venture capitalists usually hold provide an additional incentive. See 2 HAFT, *supra* note 65, at 1-8.7. Going public encourages investors to convert their preferred stock to common stock, which usually pays lower dividends. See Sahlman, *supra* note 10, at 509.

84. 17 C.F.R. § 230.144A (1992).

85. See THOMAS L. HAZEN, *THE LAW OF SECURITIES REGULATION* 219-24 (2d ed. 1990 & Supp. 1991).

86. See Bruce A. Mann, *Rule 144A and Venture Capital Financing*, *INSIGHTS*, Sept. 1990, at 24, 27.

managers vetoed.⁸⁷ In effect, this permits the managers not a veto but only a right of first refusal over offers to acquire the company. This seems equitable—if the managers deem an offer inadequate, they should readily acquire the investor's securities at the same inadequate price.

Unlocking clauses appear to pose little threat to managers, since presumably investors will not sell at an inadequate price. The burden imposed by unlocking clauses is mitigated by the difficulty that investors face obtaining attractive offers subject to a right of first refusal.⁸⁸ The new investor should be willing to retain the incumbent managers at their fair value. Thus, an acquirer should reduce the managers' pay only if the old investors were overcompensating them. The blocking of acquisitions by managers anxious to preserve their privileges is a notorious problem in public companies,⁸⁹ and one which venture capitalists should address.

Such provisions, however, are unusual for several reasons. First, a manager's central function is planning. New investors usually oust an acquired company's managers not because they are incompetent, but because the acquirer takes over planning.⁹⁰ Managers' skills are often firm-specific and are worth less to other firms than to their old employer. Therefore, a corporate takeover threatens management with diminished pay and status, or possibly unemployment, regardless of whether they are currently overpaid. Second, managers cannot easily finance such a buyout, even at an "inadequate price," or they would have bypassed venture capital initially. Moreover, an unlocking clause may be triggered unexpectedly, without the advance notice provided for in mandatory redemptions. Since unlocking clauses impose undue burdens upon managers, they may refuse to accept such clauses.⁹¹

87. See DAVID J. GLADSTONE, *VENTURE CAPITAL HANDBOOK* 129 (1983).

88. This is especially true when an insider holds an unlocking clause right. If the offeror negotiates an advantageous bargain (low offer), the insider will exercise the right. Thus, the insider will waive the right only if the offeror has offered too much.

89. See Frank H. Easterbrook & Gregg A. Jarrell, *Do Targets Gain from Defeating Tender Offers?*, 59 N.Y.U. L. REV. 277, 278 (1984) (shareholders generally lose when managers defeat takeover attempts).

90. See Kenneth J. Martin & John J. McConnell, *Corporate Performance, Corporate Takeovers, and Management Turnover*, 46 J. FIN. 671 (1991) (CEOs are replaced more often in acquired companies than in others); John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1236 (1984).

91. Could companies handle this situation differently, for example, by giving managers generous severance pay? Perhaps this happens in practice, with managers waiving their veto power in exchange for some form of compensation. Perhaps companies do not agree to such payments in advance because of the difficulty of drafting contract provisions to cover all contingencies.

A venture capitalist can also improve its liquidity by insisting that it be included in any offer to repurchase the managers' stock.⁹² This also protects investors from management self-dealing.

3. *Managerial Self-Dealing and Compensation; Freezeouts*

An investor who can veto corporate transactions that involve managers does not need a covenant against self-dealing. Such covenants are useful, however, when an investor lacks such a veto power.⁹³ Covenants against self-dealing include limits on the sale of stock, payment of dividends, loans to, and repurchases of stock from, insiders.⁹⁴ These transactions are often limited rather than forbidden because, in some cases, they are desirable. For example, stock ownership and stock options motivate managers to perform well. Venture capitalists, therefore, commonly agree to give managers stock purchase rights.⁹⁵ Similarly, a company should pay dividends if it cannot profitably invest its excess cash. However, a venture capitalist often owns preferred stock or debt securities while insiders own the common stock. Accordingly, an investor typically permits dividends on common stock if equal dividends are paid on the investor's stock.⁹⁶

Repurchases of a manager's stock by the corporation may also benefit an investor. First, if a manager resigns, other stakeholders⁹⁷ may want to terminate that manager's voting and financial interest in the firm. Also, by requiring departing managers to sell their stock at a reduced price, investors deter resignations.⁹⁸ Second, a manager who retires, dies or becomes disabled may be "locked-in" with stock that is practically worthless if the firm pays no dividends and is not publicly traded. Thus,

92. See *infra* notes 119-22 and accompanying text.

93. See *supra* text accompanying notes 31-55 (discussing the shortcomings of control).

94. See generally I HALLORAN ET AL., *supra* note 22, at 430-31 (form of limitation on interested transactions).

95. See *id.*, at 434.15 (form of employee stock purchase agreement). See also *id.* at 266 (discussing these agreements).

96. See *id.* at 336-39 (form of charter provision limiting dividends on common stock).

97. See *infra* note 127 (defining stakeholder).

98. For example, the repurchase agreement may set the price at book value or at the price that the manager originally paid for the stock. See I HALLORAN ET AL., *supra* note 22, at 379-80 (form of repurchase agreement). See also 2A HAFT, *supra* note 65, at F 10.2-1 to F 10.2-5 (corporation's option to repurchase at the price the manager originally paid); Jack L. Lewis & Arthur E. Cirulnick, *Stockholders' Agreements - Part 2*, 10 ALI-ABA COURSE MATERIALS J. 81, 96-106 (1985); Jack L. Lewis & Arthur E. Cirulnick, *Stockholders' Agreements - Part 3*, 10 ALI-ABA COURSE MATERIALS J. 107, 107-19 (1985).

managers may also prefer to be cashed out even at a reduced price. Accordingly, disabled or retiring managers, or the estate of a deceased manager, may be obliged to sell their stock back to the company. Since this type of sale functions as a reward to motivate managers while they work, investors may set the redemption price (often appraised value) higher than in those cases where the manager departs for another job.⁹⁹

Managerial compensation is self-dealing that cannot be avoided. If the investor lacks a general veto over board action, it can negotiate a specific veto over executive compensation.¹⁰⁰ Investors oppose excessive management compensation, but they want a compensation package that will motivate the managers. High salaries may distort managerial incentives since they encourage executives to be cautious and avoid risks that may damage the firm's ability to continue paying that salary.¹⁰¹ Although excessive managerial caution does not breach a fiduciary duty, it can injure the investors as much as managerial self-dealing. This problem is addressed by designing a compensation package that combines more modest salaries with significant stock ownership and stock options.¹⁰² This helps align the manager's interests to those of investors. It does not, however, align their interests perfectly, because managers still have an interest in compensation and perquisites that the investors do not share. This gap is further bridged by signing the managers to employment contracts when the venture capitalist initially invests, thereby alleviating the concerns of both sides over compensation and perquisites.

Minority shareholders in close corporations are in danger of majority attempts to freeze them out—unilaterally seize their equity interest in the firm.¹⁰³ Although most states review the price paid in freezeouts for fair-

99. See Jack L. Lewis & Arthur E. Cirulnick, *Stockholders' Agreements—Part 3*, 10 ALI-ABA COURSE MATERIALS J. 107, 107-19 (1985).

100. Investors can accomplish this by requiring a supermajority board vote on executive compensation levels or by requiring a board committee, on which the investor has a veto power, to decide executive compensation levels.

101. See Dent, *supra* note 43, at 889-91 (explaining that managers' and investors' interests diverge over the appropriate level of risk).

102. See Hoffman & Blakey, *supra* note 34, at 18. Managers of new firms seeking venture capital usually accept lower salaries than they had with their previous employers. See Sahlman, *supra* note 10, at 508. Giving investors preferred stock rather than common stock helps the managers. It allows them to take advantage of more favorable tax treatment when they acquire common stock at low prices. See *id.* at 510.

103. See ROBERT C. CLARK, CORPORATE LAW 499-504 (1986). Majority shareholders achieve this by forcing the company to merge into a new firm that is owned entirely by the majority and by giving the minority shareholders cash or debentures instead of stock in the new firm. The majority has other ways to freeze out the minority shareholders, such as a reverse stock split. *Id.*

ness, the minority shareholders may not like the result.¹⁰⁴ Venture capitalists who lack a board veto power can avoid freezeouts in two ways. First, they can purchase securities that explicitly forbid transactions that materially affect their rights, unless approved by the holders of a majority of that class of security.¹⁰⁵ With this option, some minority investors can still be cashed out against their will if a majority of the security holders approve. Second, they may obtain a "take-me-along clause" which forbids managers to exchange their stock unless investors are offered the same terms.¹⁰⁶ This type of clause is effective since freezeouts are usually accomplished by merging the firm into a specially created dummy corporation which issues the managers stock in the new corporation while issuing investors cash or debt securities. A take-me-along clause forces managers to give investors the same terms that the managers receive. This prevents transactions in which managers receive stock while the investors receive cash or debt securities.

4. *Abuse of Corporate Opportunities and Information; Competition with the Firm*

Managerial disloyalty may not entail company contracts; therefore, investors cannot protect themselves completely with a veto power on the board. Such disloyalty includes use of corporate information for personal benefit. This encompasses not only trade secrets as ordinarily defined, but also broader information, such as knowledge of and even personal acquaintances with customers. Investors may address this problem with non-competition agreements, which forbid employees from working for competing firms. Such agreements are unreliable, though, because courts limit their temporal, geographical and industry scope.¹⁰⁷ Employment agreements are helpful but imperfect.¹⁰⁸ Therefore, it is common also to expressly forbid personal use of proprietary informa-

104. See *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (freezeout subject to strict scrutiny for fairness); see generally CLARK, *supra* note 103, at 518-30.

105. See O'NEAL & THOMPSON, *supra* note 3, § 9.13; Hoffman & Blakey, *supra* note 34, at 22.

106. See *infra* notes 119-22 and accompanying text.

107. See HENN & ALEXANDER, *supra* note 38, at 630-31.

108. Courts do not specifically enforce employment agreements because forcing an employee to fulfill his obligation to work would constitute involuntary servitude and because a court could not supervise the employee's compliance with such an order. To enjoin an employee from working for another employer, the original employer must demonstrate that the employee's services are "unique or extraordinary." E. ALLEN FARNSWORTH, *CONTRACTS* 856 (2d ed. 1990). Employers can recover damages, but the amount of damages is often difficult to prove.

tion.¹⁰⁹ By itself this prohibition is also inadequate because it is often difficult to prove the use of proprietary information. The strengths of each agreement, however, help to offset the weaknesses of the others. Employment agreements may also forbid managers from “moonlighting”—working outside the company while still employed by the company. This type of agreement bars employees from working part-time for other ventures, whether or not they compete with the company.

These types of covenants also discourage managers from usurping corporate opportunities—opportunities that belong to the firm. Corporate opportunities that managers of venture-capital financed firms may be tempted to take normally require the manager to work for another firm, and thus, are also limited by buy-sell agreements.¹¹⁰ Both employment and non-competition agreements would also forbid this. Seizures of corporate opportunities (including those that do not require the manager to work for another firm) are also curbed by the law of fiduciary duties and by buy-sell agreements.¹¹¹

5. *Dilution and Restrictions on New Issues of Shares*

Statutory and contractual preemptive rights can prevent controlling shareholders from purchasing stock at a low price. Preemptive rights entitle shareholders to subscribe to new issues of stock in the same proportion as they currently own. This right may not go far enough to protect investors, as when minority shareholders cannot afford the new stock, even at a bargain price, and the issuance would shift the control of the firm. Accordingly, a venture capitalist may forbid all new issues of stock unless the issuance is approved by all or some supermajority of the shareholders.¹¹²

Even a veto power over new stock issuances may not adequately protect investors. Although a venture capitalist may object to losing control through the entry of a new investor, it may feel morally and legally

109. See I HALLORAN ET AL., *supra* note 22, at 434.41 (form of agreement relating to proprietary information and agreements).

110. Opportunities that require a substantial investment of money, such as purchasing another company, will generally exceed the means of managers who had to seek venture capital financing. Buy-sell agreements often require officers to sell their stock back to the firm at a low price if they resign. See *supra* notes 98-99 and accompanying text. This both discourages officers from resigning in order to exploit corporate opportunities and information and affords the firm relief when an officer does resign.

111. See CLARK, *supra* note 103, at 223-62.

112. See O'NEAL & THOMPSON, *supra* note 3, § 3.20, at 201.

obliged not to veto a stock sale that is needed to raise money. Therefore, investors often obtain a first option or right of first refusal over new issues of stock.¹¹³ These rights go beyond preemptive rights by allowing an investor to purchase more than its pro rata share—and occasionally 100%—of a new issue. Giving these rights to investors is often costly for the company because investors exercise first options only if the firm's stock value exceeds the option price, and because obtaining third party offers to buy stock is difficult when the sale is subject to a right of first refusal.¹¹⁴ These rights may also dilute managers' equity interest, and thus motivate them to avoid private stock sales, conserve cash and make a public offering instead. The effect of the investor's rights over new stock issues is magnified by the use of staged financing, which assures that the investor's rights come into play quickly and frequently.¹¹⁵

Venture capitalists usually acquire preferred stock or debt securities that are convertible into common stock. Conversion rights are both a sword to promote the venturer's interests and a shield from exploitation by the managers. First, conversion ratios are often tied to the firm's success; the better the firm's performance, the higher the conversion price. This protects investors against depreciation of their conversion rights when the company falters. It also spurs managers to succeed; the better the firm performs, the fewer shares the investors receive on conversion, and the larger the share of equity that the managers will retain.¹¹⁶

Investors also fear equity dilution, which is depreciation of the common stock (and thus of conversion rights) by the issue of cheap stock or by payouts on already outstanding common stock. Stock dividends, stock splits, and cash dividends, *inter alia*, cause equity dilution. Even an investor who has the power to veto these actions may feel constrained by fiduciary duties not to do so because they may benefit the company.¹¹⁷ Covenants that require the company to adjust the conversion ratios in

113. A right of first refusal permits its holder to intervene and purchase by matching the highest bid by a third party. A first option permits its holder to purchase on specified terms before the seller offers the opportunity to third parties. See CLARK, *supra* note 103, at 765. These restrictions may apply to new stock issues or to sales by shareholders. See I HALLORAN ET AL., *supra* note 22, at 422 (form of right of first refusal applicable to new issues).

114. See *supra* note 88 and accompanying text.

115. See *supra* text accompanying note 52.

116. See Sahlman, *supra* note 10, at 510. Adjustable conversion rates also encourage managers to formulate realistic earnings projections at the outset because failure to meet these projections will entitle the investor to a larger portion of the equity on conversion. See *id.*

117. Some courts hold that shareholders have a fiduciary duty not to use a veto power unreasonably to the company's detriment. See *Smith v. Atlantic Props., Inc.*, 422 N.E.2d 798 (Mass. 1981)

such cases will protect the interests of both the investor and the company itself.

New issues of stock are more problematic. If the sale price is high, the investor will be satisfied with preemptive rights in the new issue. But what if the offering price is at market, but lower than the investor's conversion price? A new sale of stock at a fair price does not cheapen existing common or conversion rights. Adjusting the conversion price in this situation cannot be warranted as a defense against management opportunism. However, it would be justified by a "most favored investor" theory that the original investors should be able to convert at the same price offered to new investors.

Is this adjustment provision wealth-increasing? The loss to the managers from a lower sale price for the new issue appears to offset any benefit to the initial investor.¹¹⁸ Perhaps antidilution clauses increase firm wealth by adjusting risk. Selling new stock at a price below the old investor's conversion price demonstrates that the company's fortunes have declined. Although the value of the managers' stock will have also declined, their compensation usually does not. Lowering the conversion price partially reallocates the firm's falling fortunes from investors to managers. Thus, antidilution clauses further motivate managers to sustain the firm's fortunes and further align the managers' interests to the investors'.

6. *Restrictions on Transfers of Shares*

A shareholder may receive an offer to sell his stock without other shareholders receiving the same offer. Control blocks of stock usually fetch a premium price. Even a block of stock that does not command control, but that does carry a board veto power, may merit a premium. This is especially true if a purchaser wants to deal with the firm and could profit by blocking alternative deals. A board veto may also give a purchaser day-to-day control of the business if the other shareholders, like venture capitalists, lack the skill to manage the firm, or the pur-

(holding that minority shareholder breached fiduciary duty by vetoing payment of dividends, which caused the corporation to incur tax penalties).

118. Conversion rights dilute the value of outstanding common shares; the lower the conversion price, the greater the dilution. Accordingly, reducing a conversion ratio in turn lowers the price a subsequent investor will pay for common stock. The diminution would affect all existing shareholders except that an antidilution provision protects the venture capitalist. Each reduction in the price of common stock to outside investors also reduces the venture capitalist's conversion price. Thus, only the managers suffer from the antidilution clause.

chaser can veto any other candidate to manage. A sale of stock by a venture capitalist poses lesser, but still substantial, dangers to the managers. Corporate law, however, generally permits a shareholder (including one in control of the firm) to sell his shares for a premium without extending the same offer to the minority shareholders.¹¹⁹ To avoid such sales, parties often agree on a co-sale clause (also called a tag-along, take-me-along or include-me-in covenant) which prohibits a sale of stock unless the purchaser makes the same offer for all shares.¹²⁰ Even if the purchase price does not include a premium, the opportunity to liquidate an otherwise illiquid investment may be desirable. The co-sale clause prevents a manager or investor from exploiting such an opportunity while excluding the other shareholder.

In addition, shareholders in venture capital-financed firms and other close corporations often agree not to sell their shares without first offering them to the other shareholders or to the corporation.¹²¹ The ability to exclude unwanted investors is important, even when the shares for sale do not carry control, because share ownership confers a right to inspect the company books and records.¹²² This right is especially significant in a company with valuable proprietary information. Agreements to first offer stock to other shareholders or the corporation do not obviate the co-sale covenant, however, because exercise of the former requires the other shareholders to increase their investment in the firm, rather than cashing it in. Such agreements may further require the other shareholders to pay a higher price than they can or want to pay.

7. Disclosure

The shareholder's statutory right to inspect firm books and records

119. See CLARK, *supra* note 103, at 478.

120. See 2A HAFI, *supra* note 65, at F 11.1 to F 11.3 (form of co-sale agreement); I HALLORAN ET AL., *supra* note 22, at 434.3 to 434.14 (*semble*); Jack L. Lewis & Arthur E. Cirulnick, *A Stockholders' Agreement*, REPRESENTING THE GROWING TECHNOLOGY COMPANY (I ALI-ABA Course of Study Materials), 1987, at 235-37 (*semble*).

121. For a general discussion of stock transfer restrictions, see I WILLIAM H. PAINTER, CLOSE CORPORATIONS § 3.1 (3d ed. 1991). The covenant may permit the other shareholders to purchase at the same price offered by the outsider ("right of first refusal") or at a stipulated price ("first option"). See *id.* § 3.1.2; I HALLORAN ET AL., *supra* note 22, at 434.4 (form of right of first refusal); Lewis & Cirulnick, *supra* note 120, at 235-37 (combined right of first refusal and take-me-along clauses).

122. State corporation laws typically provide every shareholder "the right . . . to inspect for any proper purpose the corporation's stock ledger, a list of its stockholders, and its other books and records." DEL. CODE ANN. tit. 8, § 220(b) (1991). See CLARK, *supra* note 103, at 96-105.

may not satisfy a venture capitalist,¹²³ who may hold his investment in the form of debt securities and thus would not be a stockholder entitled to inspect. Furthermore, the proper purpose condition to inspection rights may demand more than a general desire to keep informed. In addition, the inspection right encompasses only papers such as general accounts, and not more specific papers, such as corporate contracts, even when they are important. Finally, the statutory right only permits a stockholder to inspect the records that the company maintains; it does not require the company to keep particular records.

To obtain better disclosure, venture capitalists contract for the company to maintain and provide specific records.¹²⁴ Although disclosure does not by itself benefit investors, it does help them to ascertain whether the managers are complying with the law and restrictive covenants and to sue when they do not. Disclosure is also prophylactic since it helps deter illegal conduct by managers.¹²⁵ Additionally, disclosure helps investors participate in corporate control and intelligently exercise rights, such as the right to purchase new shares and the right to have their shares redeemed by the firm.

Venture capitalists who do not hold directorships often secure "observer rights" to attend board meetings.¹²⁶ An observer has no right to vote or even, in theory, to speak, at board meetings. However, observer rights do provide valuable information and, in practice, enable investors to have their views heard and weighed.

8. *Risk of Loss and Liquidation Preferences*

All corporate stakeholders share in the risk of loss from the firm's failure.¹²⁷ Venture capitalists typically contract for a status superior to the managers' but inferior to the creditors' in case the firm becomes insol-

123. Federal securities laws exempt most firms financed with venture capital from the broader disclosure obligations since they only apply to firms with over 500 shareholders and \$5,000,000 in assets. Securities Exchange Act of 1934, § 12(g)(1), 15 U.S.C. § 78j(g)(1) (1988); SEC Rule 12g-1, 17 C.F.R. § 240.12g-1 (1992).

124. See I HALLORAN ET AL., *supra* note 22, at 418-22.

125. In the famous words of Justice Brandeis, "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." LOUIS D. BRANDEIS, *OTHER PEOPLE'S MONEY* 92 (1932).

126. See I HALLORAN ET AL., *supra* note 22, at 343.

127. "Stakeholder" includes not only holders of debt and equity securities, but also trade creditors and employees because they also suffer if the firm folds.

vent. Why do they bargain for this degree of preference, but no more, and how do they accomplish their objective?

In bankruptcy, creditors are favored and secured creditors are preferred over unsecured creditors. Both business and legal motivations encourage venture capitalists to partly or completely avoid creditor status. The principal legal reason is that bankruptcy courts would probably deny venture capitalists creditor status, even if they hold instruments labeled as debt. The doctrine of equitable subordination permits bankruptcy courts to defer a creditor's claim when fairness requires, as, for example, when a claim labeled as debt is in substance equity.¹²⁸ Because a venture capitalist holds a substantial equity interest,¹²⁹ the bankruptcy court would subordinate any claims that it makes as a creditor to the other creditors' claims.

Yet, the threat of subordination alone would not deter venture capitalists from taking debt securities because subordination only reduces the claimant to the status of a common stockholder; it leaves the claimant no worse off than it would have been if it had bought common stock in the first place. However, using debt can also create business problems. First, it can hamper the company in obtaining additional credit elsewhere; lenders and suppliers may deny credit when a company is already heavily in debt. By contrast, equity investments facilitate borrowing because the equity provides the creditors with a cushion. Second, interest payments on debt drain badly needed cash from the company.¹³⁰ Third, debt securities usually do not carry voting rights, which the investor wants for control.

Common stock is not, however, the only alternative to debt securities. Venture capitalists usually purchase preferred stock with cumulative dividends and a liquidation preference over common stock.¹³¹ A separate class of common stock could include these features. Yet, because they are not typical features of common stock, drafting would be somewhat

128. 11 U.S.C. § 510(c) (1988). See generally CLARK, *supra* note 103, at 52-71.

129. By definition, a venture capitalist holds equity investments. See *supra* text accompanying note 9.

130. See *supra* note 11. A venture capitalist could bargain for debt securities that defer interest payments. Yet, this would make it clearer that in substance the capitalist holds an equity investment.

131. See *supra* note 65 (discussing cumulative dividends); 2 HAFT, *supra* note 65, at 1-16.3 (discussing liquidation preferences). Preferred stock's liquidation preference over common stock usually equals the preferred stock's purchase price plus all accrued dividends.

difficult.¹³² A preferred shareholder's claim is subordinate to creditors' claims but senior to managers (who own common stock) if the firm dissolves. Thus a venture capitalist is better situated holding preferred stock than it would be with debt securities that a bankruptcy court would reduce to the priority level of common stock.

Why do managers concede this preference? While managers enjoy compensation and perquisites from the firm, venture capitalists do not. Managers may attempt to delay liquidation in order to retain these benefits at the expense of other common stockholders. In effect, the managers are inclined to spend other people's money to fund their paychecks. The liquidation preference that favors outsiders forces managers to bear more of these costs and thus helps deter such opportunism.¹³³ However, this solution is imperfect. If a company's losses destroy all of the firm's equity, the managers will still have an incentive to delay liquidation; they have nothing to lose. But a liquidation preference does reduce the venture capitalist's risk of loss.

Some of the covenants discussed earlier also reduce the venture capitalist's risk of loss. For example, mandatory redemption provisions not only allow investors to cash out an otherwise illiquid investment, but also discourage the same managerial opportunism. In addition, if a right of redemption becomes exercisable when a firm is in trouble, investors can use it to compel corporate liquidation, rather than watching helplessly as executive compensation erodes the firm's assets. Similarly, business problems may trigger an event-of-election clause that will stop managers' opportunism by allowing the investor to take control of the firm away from the managers.

D. Protecting the Company from Restrictive Covenants

The costs of restrictive covenants to a company may exceed their benefits to investors. To avoid this, contracts often provide the company an egress. First, venture capitalists' restrictive covenants usually end by their own terms after several years or when the firm goes public.¹³⁴ Termination, viewed in light of the investor's exit clauses, such as conversion and mandatory redemption clauses, permits an investor either to cash

132. See I HALLORAN ET AL., *supra* note 22, at 253-54.

133. See *id.*, at 259, 339-44 (discussing the purposes of liquidation preferences). Another common feature of preferred stock is that it is "participating," which allows its holders to share any gain on the sale of the corporation with the common stock shareholders. See *id.* at 340.

134. See *id.* at 482.

out or continue its investment in the firm. Yet, in the case of conversion, the investor must surrender its special securities for common stock. If a company is so successful that the venture capitalist wants to retain its investment, then it should willingly surrender these protections.

Automatic termination of restrictive covenants when a company goes public is interesting in light of criticisms that managers of public companies can and often do exploit their shareholders.¹³⁵ Perhaps venture capitalists discredit these complaints. More likely, going public brings the investor such great returns that it does not dwell upon future exploitation. Moreover, contracts are ineffective to curb exploitation in public companies, especially since companies usually go public, if at all, only several years after initial financing. Because such problems are almost never handled by contract, there are few models to follow. In addition, some restrictive covenants, if kept in effect, would hamper a public offering.¹³⁶ In short, even if venture capitalists are concerned about exploitation after going public, the costs of contracting around the problem at the time of the initial investment would exceed the benefits.¹³⁷

Some companies negotiate an option to redeem (or "call") the investors' securities in order to eliminate the restrictive covenants.¹³⁸ A pending call forces the investors to choose between conversion and liquidation of their investment. The investors' reasons for accepting this option depend on the circumstances. Securities subject to call¹³⁹ are, like most venture capital securities, hybrids—preferred stock or convertible debt with some of the features of common stock. Managers generally prefer to finance with debt; they sell equity only if a company is too risky to borrow.¹⁴⁰ Thus, more stable companies issue securities that more resemble debt while less secure companies issue securities that are more akin to common stock.

135. See, e.g., Dent, *supra* note 43, at 884-92.

136. For example, venture capital covenants often stipulate the composition of the company's board of directors. See I HALLORAN ET AL., *supra* note 22, at 429. When a company goes public, these covenants could give the venture capitalist a disproportionate power over the board and deprive the other shareholders of fair representation.

137. Furthermore, when a company goes public the venture capitalist typically retains sufficient common stock to effectively resist managerial exploitation.

138. See 2 HAFT, *supra* note 65, at F1.1-3 to F1.1-4 (form of optional redemption).

139. This Article takes the company's perspective: labeling redemption at the company's option as "optional" redemption clauses, while labeling redemption at the investor's option as "mandatory" redemption clauses. From the investor's perspective, these labels would be reversed.

140. See *supra* text accompanying notes 11-13.

Debt securities are usually redeemable¹⁴¹ by the corporation because of its fear that interest rates will fall after a loan is made, thus forcing the company to pay higher interest rates than its competitors. A call option permits a company to refinance its debt at a lower interest rate. Without this option, a lender could profit from a decline in interest rates, but in return for this opportunity it would have to accept a lower rate of return on the debt securities. In effect, the lender would then be betting that interest rates will decline. Since both lenders and borrowers tend to be risk averse, however, they avoid this gamble by agreeing to a corporate redemption provision.¹⁴²

Venture capital securities are often redeemable when they resemble debt more than equity—that is, when the company is fairly stable, though not solid enough to obtain a straight loan. Call provisions in venture capital arrangements differ from other redemption clauses. In venture capital, call provisions reflect concern more about the company's solvency than about interest rates. Management, in effect, gambles that the company's fortunes will improve so that it can redeem, refinance at a lower cost, and escape the restrictive covenants.¹⁴³ It is misleading, however, to assume that the investor gambles that the company's fortune will not improve, because if the company's fortune does improve, the investor's conversion right appreciates. Consequently, in venture capital deals, the corporation's option to redeem works primarily to force an investor conversion that will relieve the company of the burdens of interest (or dividend) payments and restrictive covenants.

Two common venture capital provisions particularly trouble managers: (1) mandatory redemptions, because they often impose an impossible financial burden on the company; and (2) event-of-election clauses, because they often result in the ouster of the managers who founded and nurtured the company. This Article has noted various justifications for these clauses. Because of the dynamics of the negotiation process, it is difficult for managers to resist these terms. Managers who seek venture capital offer projections of sales and earnings. Interested investors then demand that the managers demonstrate faith in their own projections by

141. See Smith & Warner, *supra* note 13, at 142-43 (describing bond redemption provisions and the rationale underlying them).

142. Curiously, traditional lenders rarely insist on protection against a sharp rise in interest rates.

143. If an investor converts its investment to common stock, the company will escape its obligation to pay interest or preferred stock dividends. The investor surrenders the restrictive covenants because the company has reached the stage where the investor no longer needs such protection.

agreeing to redeem the investor's securities or to allow the investors to seize control if management fails to meet those projections. Managers cannot reject these demands without appearing to repudiate their projections. Nonetheless, managers are likely to feel exploited by the investors if the projections are not met because of circumstances beyond the managers' control.

III. VENTURE CAPITAL LESSONS FOR CORPORATE LAW

Much literature on the law of economic transactions, including corporate finance, now focuses on the hypothetical bargaining model. This literature analyzes default rules (also called residual, gap-filler, or background rules), which are the rules that will govern the parties unless they agree otherwise. The model argues that default rules should be the rules that most people would agree to if they were able to negotiate without transaction costs.¹⁴⁴ This presumes that people are economically rational and that they would draft contract terms which are efficient in maximizing the parties' total wealth.¹⁴⁵

The problem with using the model is determining which rules maximize the parties' total wealth. In corporate transactions, maximizing wealth consists primarily in minimizing agency costs. These costs include an agent's opportunism, shirking and incompetence, and the principal's costs in attempting to reduce these problems. These agency costs cannot be measured precisely by induction.¹⁴⁶ Empirical evidence may help in calculating the costs; however, it frequently does not exist because in neither public nor close corporations do passive (or outside) investors generally negotiate for protections against managerial opportunism.

Venture capital offers a rare paradigm because the outside investors do

144. See, e.g., RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 369-72 (3d ed. 1986); Frank H. Easterbrook, Jr. & Daniel R. Fischel, *Corporate Control Transactions*, 91 *YALE L.J.* 698, 700-03 (1982).

145. This may, however, create wealth distribution problems. For example, the wealth maximizing solution may make Investor *X* \$20 better off, but leave Investor *Y* \$10 worse off. The Coase theorem solves this problem (transactions costs aside) by positing that the parties can negotiate a transfer payment that results in a sharing of the benefit of the chosen alternative. See Ronald H. Coase, *The Problem of Social Cost*, 3 *J.L. & ECON.* 1 (1960); see also *infra* note 185. Both investors in the hypothetical benefit if they choose the wealth maximizing solution and have Investor *X* transfer to Investor *Y* any amount from \$10 to \$20.

146. For example, commentators disagree about the efficiency of antitakeover statutes and charter amendments. See Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 *UCLA L. REV.* 896, 910-13 (1992).

negotiate with management, but this paradigm must be analyzed with care. Some scholars believe that “[s]hareholder expectations [in close corporations] are remarkably uniform, and the situations in which they vary are quite well defined.”¹⁴⁷ Venture capital belies this view since deals vary so widely that typical terms do not exist.¹⁴⁸ This diversity of terms may even argue against a search for a hypothetical optimal bargain. Analogies to firms financed with venture capital are also problematic because these firms are growing and not fully developed, unlike most other close corporations. A company that has achieved its desired size and a stable stream of profits can reject contract terms that venture capitalists often demand, because it can instead borrow from banks or simply forego additional financing. Further, unlike many minority shareholders in close corporations, venture capitalists do not expect or desire to be officers of the firm or to participate in its day-to-day control.¹⁴⁹ The interests of active corporate participants differ significantly from those of passive investors such as venture capitalists.

Perhaps venture capitalists are too sophisticated and potent bargainers to serve as a model for other minority investors. As repeat players with experienced counsel, venture capitalists can often outmaneuver managers, who are generally unschooled in corporate finance and who often retain inexperienced lawyers or, in crucial early negotiations, no attorney at all. The managers' desperation often aggravates their plight; venture capital is usually their only source of capital.¹⁵⁰ On the other hand, venture capitalists can afford to accept less protection than investors in other close corporations because venturers recognize that the company will need additional rounds of financing and that the company will need their cooperation for these financings. Thus, although venture capital covenants are sometimes more favorable than those that investors could expect to procure in other types of minority investments, they are not so one-sided as to make venture capital useless as a model.

Defining the hypothetical optimal bargain in order to establish default rules is difficult. Yet, when contracting parties overlook a contingency, the law *must* supply a term. Ideally, courts treat each case individually

147 John A.C. Hetherington, *Defining the Scope of Controlling Shareholders' Fiduciary Responsibilities*, 22 WAKE FOREST L. REV. 9, 21 (1987).

148. See *supra* text accompanying notes 29-30.

149. See MELVIN A. EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* 12-17 (1976) (discussing distinction between active participants and passive investors).

150. See *supra* note 17 and accompanying text.

and shape the remedy on the expectations and needs of the particular parties. Personalized justice is far too expensive for both the parties involved and the justice system, however; thus, courts must fashion general rules. The question, then, is not whether venture capital arrangements form a perfect model for close corporations; clearly they do not. Rather the question is whether venture capital arrangements better replicate what most parties in close corporations would agree to than do the default rules now fixed by corporate law. In many respects, the answer to this question is yes.

A. *Sales of Control for a Premium*

A perennial issue in corporate law is whether to allow controlling shareholders to sell their stock at a premium from which other shareholders are excluded. With some ill-defined exceptions, courts now permit these sales.¹⁵¹ Venture capitalists, though, usually obtain take-me-along (or tag along) clauses that forbid such sales. Thus, the venturers enable themselves to participate in the unusual opportunity to cash out an illiquid investment and protect themselves from a potential purchaser of control who could exploit them.¹⁵² However, giving minority investors an equal right to sell can create problems. First, tag-along rights inhibit transfers of control that would benefit all parties. For example, a controlling shareholder/manager who has passed his prime may refuse to sell his stock except at a premium price that no purchaser would agree to pay for all of the firm's shares.¹⁵³ Second, a controlling shareholder either creates or pays for control; minority shareholders do not. Therefore, fairness would dictate letting a controlling shareholder sell his control-block of stock for a premium price.

The argument for including minority shareholders in control sales is at its weakest when applied to public corporations. Since a public firm's stock is openly traded on the market, the control sale does not represent a unique opportunity to sell an illiquid investment. Further, in a close corporation, it is quite feasible to obtain waivers from a minority shareholder of a tag-along right if the purchaser is not objectionable and if the sale will benefit all parties. In a public company, though, obtaining waiv-

151. See CLARK, *supra* note 103, at 478-98.

152. See *supra* text accompanying notes 119-20.

153. Since control carries a distinct value, and since purchasing minority shares does not enhance that value, purchasers will generally pay less per share if they must purchase more shares than the minimum necessary to obtain control.

ers is impossible. Thus, a rule that bars the sale of control for a premium should not apply to public corporations.

The argument that controlling shareholders create or pay for control (while the minority do not) is somewhat circular. Minority investors pay a control premium if they expect to obtain a share in corporate control. Take-me-along covenants are fair because investors pay for them. This suggests that any changes in the default rule should only operate prospectively, and therefore, a court should find a take-me-along right only if the seller knew that he was selling such a right. If courts bar premiums for the sale of control, then when investors purchase control they will not have to pay a premium and therefore should not complain when they too are barred from later selling for a premium. A firm's founders will also be prohibited from selling their control for a premium, but this fact is unlikely to deter entrepreneurs from starting new enterprises.

In summary, the use of take-me-along rights in venture capital arrangements strongly suggests that the law should extend such a right. However, this right should apply only prospectively and only to shareholders of close corporations. Furthermore, since the right should operate only prospectively, it should be instituted by statute, not by case law.

B. *Unequal Repurchases*

In *Donahue v. Rodd Electrotype, Inc.*,¹⁵⁴ the Supreme Judicial Court of Massachusetts prohibited a company from purchasing stock from a controlling shareholder without offering the same opportunity to the minority shareholders. Although several courts have followed *Donahue*, a few courts have rejected it.¹⁵⁵

Many venture capital contracts forbid unequal stock repurchases, confirming the general wisdom of *Donahue*. However, these contracts include important exceptions. An agreement may permit or even require a company to repurchase stock owned by an officer who resigns.¹⁵⁶ These terms are intended to benefit the company, not the officer; the agreement sets the purchase price so low that other shareholders would not sell at

154. 328 N.E.2d 505 (Mass. 1975).

155. See *Comolli v. Comolli*, 246 S.E.2d 278 (Ga. 1978) (following *Donahue*); *Toner v. Baltimore Envelope Co.*, 498 A.2d 642 (Md. 1985); *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657 (Mass. 1976) (extending *Donahue* to discharge of employee-shareholder); *Zidell v. Zidell, Inc.*, 560 P.2d 1086 (Or. 1977) (rejecting *Donahue*; to prevail, minority shareholders must show majority shareholder acted in bad faith); see also Frank H. Easterbrook, Jr. & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 293-96 (1986) (criticizing *Donahue*).

156. See *supra* notes 98-99 and accompanying text.

the same price. In cases of death, disability, or retirement, however, the price is usually higher, so that other shareholders might want to have their shares repurchased at the same price, especially when the stock is illiquid. This shows that unequal repurchases are not always unfair.¹⁵⁷

In addition, venture capitalists often have the right to have their stock redeemed under certain conditions.¹⁵⁸ The inequality of shareholder treatment is even sharper with these redemption clauses than it is for repurchases on death, disability or retirement. Anyone may become disabled, and everyone will retire and die, albeit at different times. Redemption clauses, however, benefit only the venture capitalist. This also demonstrates that parties often do agree to unequal repurchases; consequently, the rule of *Donahue* is too broad. At a minimum, courts should uphold agreements for unequal repurchases unless they are manifestly unreasonable.

C. *Dissolution and Mandatory Buyouts*

Minority shares in close corporations are illiquid and rarely pay dividends, so the stock is often worthless unless the shareholder is an employee who is receiving a salary.¹⁵⁹ To address this problem Professors Hetherington and Dooley ("H & D") propose that shareholders of close corporations should be allowed to liquidate their shares at any time through either a forced buyout by the other shareholders or a dissolution of the company.¹⁶⁰ They would permit any shareholder who owns fifty percent or less of a close corporation's stock to demand that the other shareholders buy his stock at an agreed upon price, or at a price fixed by a court if the parties cannot agree on price. If the other shareholders cannot or will not make the purchase, the shareholder may force the corporation to dissolve. This proposal would radically change the law of close corporations. Their approach resembles partnership law, under which any partner can liquidate his interest at any time, by demanding dissolution of the partnership.¹⁶¹

That venture capitalists often obtain mandatory redemption agree-

157. *Donahue* itself concerned a repurchase from a disabled controlling shareholder. 328 N.E.2d at 510. Thus, while the general rule of the case is wise, its application in that case is questionable.

158. These provisions are discussed more fully in part II, *supra*.

159. See O'NEAL & THOMPSON, *supra* note 3, § 1.03, at 1-5 to 1-6 (citing examples).

160. John A.C. Hetherington & Michael P. Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1 (1977).

161. See *infra* note 180.

ments¹⁶² demonstrates that sophisticated investors fear illiquidity and will contract to avoid it. However, mandatory redemption agreements are narrower than the right which H & D propose. First, the redemption right usually ripens only after a few years have passed. Second, the agreed price for a redemption right is typically the original purchase price plus interest, rather than the appraised value at the time of the buyout.¹⁶³ Third, rights of redemption generally extend only to the venture capitalist—an outsider—and not to the managers. While agreements that mirror the H & D proposal by extending the right to force a buyout to all shareholders—dubbed “Russian roulette” provisions—do exist, they are rare.¹⁶⁴

The restrictions on venture capital redemption rights suggest that H & D's proposal is too broad. Permitting redemption only after several years have passed enables the managers to get the firm started and, if necessary, to seek substitute capital. Without this delay, managers could face a quick and unexpected need to refinance. Refinancing may be difficult because managers do not seek venture capital at the outset when financing is easy. Moreover, without a time delay, a venture capitalist could trigger dissolution in order to seize the company on liquidation at a bargain price.¹⁶⁵ This threat could hobble a company seeking long-term purchase or sale contracts or other long-term commitments.¹⁶⁶ At a minimum, courts should distinguish growth companies from stable, developed companies. The latter generally have a positive cash flow and can refinance more easily than growth companies.¹⁶⁷ Problems of refinancing should caution courts against dissolving growth companies.

162. See *supra* notes 72-80 and accompanying text.

163. See *supra* note 72 and accompanying text.

164. See Lewis & Cirulnick, *supra* note 98, at 49, 117-18.

165. See *id.* at 118 (“Russian roulette” provisions that are similar to the H & D proposal may favor the deep pocket or be “abused by trigger-happy or hot-tempered principals in a corporation”). The H & D proposal may also provide the party receiving a buyout demand time because it can litigate over issues such as price. Such delay creates uncertainty in the firm, however, because customers, employees, and suppliers can only speculate about the firm's future. This confusion compounds the already difficult task of raising new capital to finance the buyout. See *supra* text accompanying notes 77-78. Outside investors may refrain from such opportunism because they are unable to run the company. In some cases, however, other managers (perhaps incumbent lower level officers) may be available to operate the firm. Moreover, investors could use a threat of corporate dissolution as leverage to gain more favorable terms from the managers.

166. See Klein, *supra* note 58, at 1547 n.87.

167. The H & D proposal would avoid a “sudden cash drain” by “authorizing the court, upon a showing of good cause, to provide for installment payments of the purchase price for a period of time not exceeding five years.” Hetherington & Dooley, *supra* note 160, at 51. This provision assists

The H & D proposal requires a court to determine a fair buyout price.¹⁶⁸ A contractually stipulated redemption price, however, reduces investors' uncertainty about whether to demand redemption and eliminates the high costs of an appraisal proceeding. A stipulated price also removes the advantage that managers enjoy in appraisal proceedings due to their control over the company and its books. Without a contractually fixed redemption price, investors must investigate and challenge perceived distortions of the company's value.

The pricing of venture capital redemption rights at their original purchase price plus interest reveals their limited purpose. If a company falters, corporate law will bar redemptions.¹⁶⁹ This would also be true under the H & D proposal. If the company prospers, the stock's value will exceed the redemption price and the shareholder will probably waive the redemption right.¹⁷⁰ Thus, mandatory redemption only allows investors to get their money back with a modest return when the company has stalled. Unlike the H & D proposal, mandatory redemption is not intended to resolve disputes in successful companies.¹⁷¹

Managers are generally excluded from mandatory redemptions for several reasons. First, the exclusion motivates them to succeed. If the company stumbles, outsiders can bail out, but the managers cannot. Like passengers on a sinking ship, investors can head for the lifeboats; like the captain, the managers must stay with the ship and therefore have a strong motive to keep it afloat. Second, the exclusion of managers reduces the problem of information asymmetry. Enjoying superior company information, managers could opportunistically insist "buy me out

firms with sufficient cash flow to make the installment payments, but is useless to growth companies that constantly need more capital.

168. The H & D theory would require judicial appraisal only if the parties failed to agree on a buyout price. Hetherington & Dooley, *supra* note 160, at 51. The ability of either party to demand a judicial determination of the buyout price, however, means that the parties' estimate of the judicial appraisal will guide their bargaining.

169. *See supra* note 75.

170. For a discussion of this point and an important qualification, see *supra* notes 76-77 and accompanying text.

171. Mandatory redemption typically attaches only to preferred stock or debentures. Venture capitalists lose their mandatory redemption right when they convert such investments to common stock. This further demonstrates that mandatory redemption rights are not intended for successful companies since investors typically convert to common stock when a company succeeds. However, conversion to common stock often occurs when a company goes public since investors no longer need the mandatory right of redemption to avoid illiquidity.

or I'll buy you out," and the non-manager investors would lack the information necessary to respond intelligently.

Third, and most importantly, the managers' control of the business would allow them to demand unfair buyouts. Suppose that managers could demand a buyout whenever they could obtain new financing with better terms. In theory, the investors could respond to the buyout demand by purchasing the managers' shares, but in practice, this response is unlikely because the investors generally cannot run the company or find substitute managers.¹⁷² Therefore, if managers held a right of redemption they could demand a buyout, confident that the investors could not operate the firm themselves or hire new managers. Thus, the investors would have no choice but to allow the managers to buy them out, perhaps at an inadequate price.

By contrast, the problems that investors would face in operating the company themselves and in settling the managers' employment contracts deter them from wielding a buyout right opportunistically. A venture capitalist worries about its reputation; if it squeezes out managers at a low price, other managers will not bring it attractive deals. Also, as previously noted, venture capital buyouts require advance notice and pay only a limited price. Therefore, a venture capitalist will ordinarily exercise a buyout only when the company is in financial trouble.

Managers are not only excluded from mandatory redemptions, but are also locked into the company more tightly by various covenants. Sales of their shares to outsiders can be restricted. They also can be forbidden from selling their shares at a premium without including the investors in the sale.¹⁷³ In addition, employment contracts can prohibit managers from competing with the company if they resign.¹⁷⁴ Buyout agreements can force them to sell their shares back to the company at a low price if they voluntarily leave the firm.¹⁷⁵ Further, venture capitalists typically have a liquidation preference¹⁷⁶ in bankruptcy that may entitle them to most of the company's assets if the firm liquidates. These factors deter managers from, for example, seeking dissolution when they disagree with the venture capitalist.

172. Moreover, the H & D proposal does not allow investors who demand a buyout to abandon the managers' employment contracts. Thus, the investors may have to pay the old managers' salaries even if they hire new managers.

173. See *supra* notes 120-22 and accompanying text.

174. See *supra* notes 107-11 and accompanying text.

175. See *supra* note 98.

176. See *supra* notes 127-33 and accompanying text.

Managers are excluded from redemption clauses and locked in by restrictions on their employment and sales of shares because of their more active and central role in the company. While managers receive corporate payouts through salaries, investors do not. Investors in close corporations can hold their shares indefinitely without receiving any payouts. Managers initiate the business, run the day-to-day operations, and obtain capital from investors by projecting certain results. Investors should be able to exit more easily than the managers if the investors are not receiving corporate payouts and the managers fail to produce the results that they predicted.

An investor who has a board veto could unreasonably create deadlocks on board decisions from which the managers might seek escape. For reasons previously discussed, however, a venture capitalist is unlikely to act so inappropriately. Moreover, if a board deadlock does occur, managers have remedies. They can demand arbitration if the parties' arrangement so provides, or they can petition a court for dissolution or other relief.¹⁷⁷ Although the investors' liquidation preference in bankruptcy, the problems of refinancing, and the costs of litigation all discourage dissolution, it is available in extreme circumstances.¹⁷⁸ Finally, disgruntled managers have the option of simply quitting. Courts will not order specific performance of their employment contracts. Investors can sue for damages and for enforcement of a noncompetition agreement, but a court is unlikely to grant significant relief to an investor who has acted inequitably. Thus, managers generally do not need a right to dissolve or redeem in order to protect themselves.

Nonetheless, the disparate treatment of venture capitalists and managers may not always be fair. Managers often resist inclusion of mandatory buyout clauses, sometimes with success.¹⁷⁹ When the parties agree to

177. See Robert B. Thompson, *Corporate Dissolution and Shareholders' Reasonable Expectations*, 66 WASH. U. L.Q. 193, 228-36 (1988) (discussing alternative remedies to dissolution).

178. The liquidation preference does not necessarily make dissolution unattractive to managers. The preference generally assures that investors will receive a minimum return on their investment before the managers receive anything in liquidation. See *supra* note 131. Thus, the liquidation preference discourages managers from dissolving the firm and purchasing its assets on liquidation for a bargain price because the venture capitalist, who is unable to run the company, cannot make a serious bid. If the company prospers, however, the venture capitalist's liquidation preference will not exceed the fair value of its securities, and therefore will not deter the managers from seeking dissolution in case of legitimate dissatisfaction.

179. See I HALLORAN ET AL., *supra* note 22, at 346 ("Mandatory redemptions tend to be the exception rather than the rule in venture capital financings.").

such terms, it may reflect the investor's superior bargaining power rather than efficiency. But the prevalence of these terms, and the absence of covenants facilitating exit by managers, strongly suggests that the law need not expand the exit opportunities for managers.

Corporate dissolution can be made too easy, as demonstrated by the problem of opportunistic dissolutions in partnerships. In general, any partner may dissolve a partnership at any time.¹⁸⁰ Courts have invoked common law fiduciary duties to curb partners who exploit this right by dissolving a partnership in order to purchase its assets at a bargain price.¹⁸¹ H & D's proposal would extend the same right and the same problem to close corporations.

Although venture capital arrangements suggest that the H & D proposal goes too far, they also suggest that some critics of judicial dissolution are misguided. Judge Easterbrook and Professor Fischel argue that parties who form close corporations reject broad buyout rights because buyouts can trigger a liquidity crisis for the other investors.¹⁸² Many venture capital deals not only confer such a right, but impose the buyout obligation on the least liquid party, the managers. Although buyouts can create an illiquidity problem for the managers, avoiding that problem is not always the highest priority. Indeed, buyouts benefit investors since they can redress the investors' illiquidity problem and can also protect them from exploitation. Mandatory redemption clauses show that the latter concerns often override the firm's illiquidity concerns.

Should courts require a redemption where the parties have not agreed to it? Arguably not, because even venture capital deals often omit buyout rights. This does not prove, however, that courts should limit involuntary buyouts and dissolution, as Easterbrook and Fischel argue, to cases of oppression and deadlock.¹⁸³ Venture capitalists have many protections other than mandatory redemptions, but other investors often

180. Uniform Partnership Act ("U.P.A.") §§ 31(1)(b) and 31(2) provide that "the express will of any partner" may cause partnership dissolution. U.P.A. §§ 31(1)(b), 31(2) (1914 & Supp. 1992). If dissolution does not violate the partnership agreement, the U.P.A. imposes no sanctions against the partner that caused dissolution, even if it is grossly unfair. *Cf.* U.P.A. §§ 37-38.

181. *See* Page v. Page, 359 P.2d 41 (Cal. 1961) (holding that dissolution of a partnership for purpose of seizing its assets at less than fair value violates partner's fiduciary duty); *see generally* II ALAN R. BROMBERG & LARRY E. RIBSTEIN, PARTNERSHIP § 7.02(c) (1988). Recognizing this problem, the drafters of the revisions to the Uniform Partnership Act propose to restrict partnership dissolutions. *See* Donald J. Weidner, *Three Policy Decisions Animate Revision of the Uniform Partnership Act*, 46 BUS. LAW. 427, 435-53 (1991).

182. Easterbrook & Fischel, *supra* note 155, at 289.

183. *Id.* at 286-90.

fail to obtain these protections. Reasonable investors do not intend to forego payouts indefinitely while the managers reap handsome compensation. If the parties anticipate such a situation, they will probably agree, as most venture capitalists do, that the passive investor could then redeem his shares.

Easterbrook and Fischel complain that a buyout often necessitates a corporate liquidation that in turn dissipates much of a firm's value.¹⁸⁴ That result is possible, but not inevitable. If a firm is successful, its managers may be able to finance a buyout, especially if the agreement permits installment payments. If managers cannot finance the buyout, they know their industry and can find a buyer more easily than outside investors can. If a company has no chance of ever making a profit, there is probably little going concern value to be lost in a sale. If corporate dissolution is likely to dissipate going concern value, the investors will probably settle with the managers, especially since the alternative is lengthy, costly litigation.¹⁸⁵ If the current managers are important to a firm's success, a buyer will want to retain them.¹⁸⁶ This possibility both eases the managers' employment problem and helps to salvage the company's going concern value. These factors do not eliminate all the problems of mandatory buyouts, but no option will be ideal for all parties. The alternative to a buyout is rather a situation in which the managers draw compensation while the outside investors receive no return on their investment. Between the two alternatives, a mandatory buyout of the investor, while imperfect, is preferable.

The example of venture capital suggests that passive investors should be able to demand a buyout by managers, but that the reverse should not be allowed absent a destructive deadlock.¹⁸⁷ Courts should allow investors to demand a buyout only if they give managers a long notice period

184. *Id.* at 289-90.

185. As Easterbrook & Fischel noted, under the Coase theorem "[o]rdinarily, if the number of contracting parties is small enough and property rights are well specified, the parties will dicker to the optimal solution no matter what the legal rule may be." *Id.* at 287 (citing Coase, *supra* note 145).

186. Managers who are critical to the firm's success may even be able to secure a disproportionate share of the sale's proceeds, in the form of side payments, from the new investors. They can also threaten to resign if an undesirable bidder succeeds in purchasing the firm. Since they control their own labor, such threats are entirely fair. They can also play favorites in the bidding process by leaking inside information to a competing bidder in exchange for promises of favorable employment arrangements.

187. When all shareholders actively participate in the business, the H & D proposal to permit holders of 50% or fewer of the shares to demand a buyout seems wise.

to permit a search for substitute financing. Managers should not be allowed to refuse a buyout and then demand corporate dissolution unless they are barred from bidding for the firm's assets upon dissolution.¹⁸⁸ Because the interests and goals of shareholders vary, courts should uphold agreements that modify the default rules if they are not manifestly unfair.

D. Freezeouts

Venture capitalists usually obtain some protection against freezeouts, but this protection is often just a right to vote as a class on a freezeout proposal.¹⁸⁹ The protection is limited because freezeouts can benefit investors. Managers, alone or with others, may offer to buy the outside investors' stock at an attractive price, but condition the offer on participation of all outside investors.¹⁹⁰ By limiting their protection to a majority class vote, venture capitalists make sure that a small minority cannot veto an attractive conditional purchase offer.

Corporate law is still struggling with the issue of freezeouts. Some states prohibit them, yet most permit freezeouts and subject them to strict scrutiny for fairness.¹⁹¹ In the leading case, *Weinberger v. UOP, Inc.*,¹⁹² the Delaware Supreme Court held that approval by an informed majority of the minority shareholders is strong evidence of fairness and shifts the burden of proof on fairness from the defendant (majority shareholders) to the plaintiffs (minority shareholders).¹⁹³ The practice of venture capitalists suggests that the *Weinberger* approach is more appropriate than a flat prohibition. Sophisticated investors accept the possibility of freezeouts if they are approved by a majority of the outside investors. Corporate law default rules should do the same.

188. Frequently the managers are crucial to the continued success of a business. In such cases they can purchase the firm for far less than its value to them because the firm is worth far less to other investors who cannot guarantee that these critical managers will stay with the firm. A bargain purchase by the managers gives outside investors less than their fair share of the going concern value. See *In re Radom & Neidorff*, 119 N.E.2d 563 (N.Y. 1954) (denying dissolution where it would permit manager to seize the going concern value at an inadequate price). This result can be avoided by prohibiting managers from bidding or by allowing only fair price bids. In practice, the latter solution closely resembles a buyout.

189. See *supra* note 33.

190. Managers may need this condition to eliminate restrictive covenants or to achieve a proper balance of power with a new investor on the board of directors.

191. See *supra* notes 103-04.

192. 457 A.2d 701 (Del. 1983).

193. *Id.* at 703.

E. *Voting Rights and Control*

Statutes that govern voting and control of small businesses impose remarkably dissimilar rules for legal entities that are functionally similar. Subject to modification by the parties' agreement, the default rule in partnerships is one partner, one vote. Ordinary business is decided by a majority vote, but extraordinary changes require a unanimous vote.¹⁹⁴ In most corporate statutes, however, the general rule is that the board of directors manages the firm and is elected by a simple majority of shareholders. Therefore, even a large minority of shareholders voting alone cannot elect a single director, but a shareholder with fifty-one percent of the outstanding stock can elect the entire board.¹⁹⁵ Cumulative voting is an intermediate position which is the corporate default rule in some states and an option by charter provision in other states. Cumulative voting produces roughly proportional representation on corporate boards—it generally enables minority shareholders to elect a proportion of directors roughly equal to the proportion of the stock they own.¹⁹⁶

Which rule of governance would parties elect in most small businesses? Venture capital agreements vary too much to offer a simple explanation. Indeed, they demonstrate that none of the governing forms is appropriate for all small businesses. However, two generalizations can be asserted. First, minority shareholders frequently obtain board seats that the usual majority-take-all rule would deny.¹⁹⁷ Rarely do venture capitalists receive less board representation than they would have received under cumulative voting. Second, venture capitalists frequently obtain board representation even when they invest through preferred stock or debt, especially when the firm has missed dividends or interest payments.¹⁹⁸

These patterns suggest that cumulative voting should be the default

194. U.P.A. §§ 18(e), 18(h); see II BROMBERG & RIBSTEIN, *supra* note 181, § 6.03.

195. See, e.g., DEL. CODE ANN. tit. 8, § 216(3) (1991).

196. See, e.g., CAL. CORP. CODE § 708 (West 1991) (general rule of cumulative voting). With straight, or non-cumulative voting, shareholders may cast one vote for each share that they own for one candidate for each open board seat. Under cumulative voting, a shareholder casts the same number of votes, but may "accumulate" his votes and cast them for a single candidate. Board representation under cumulative voting is only roughly proportional, especially when the board is small. For example, if a board has only three directors, cumulative voting does not assure that a minority investor can elect a director unless he holds over 25% of the voting shares. See generally CLARK, *supra* note 103, at 361-66.

197. See *supra* notes 33-34.

198. See *supra* note 39.

rule (probably the minimum default rule)¹⁹⁹ for close corporations. The usual argument against cumulative voting—that it can lead to a divided and ineffective board—is unconvincing in practice. To ensure that substantial equity investors are not denied board representation due to a firm's having a small board, an investor (or several investors voting together) who holds more than a specified share of the equity—for example, fifteen percent—should have a right to a board seat. Although a single board seat carries no veto over board actions, it provides substantial equity holders a valuable window on firm activities. It may also make the majority more accountable because the minority can monitor potential breaches of fiduciary duties²⁰⁰ and can argue views that the majority may not otherwise consider.

Similarly, holders of preferred stock and debt securities should have a statutory right to elect directors when the company fails to make required dividends or interest payments. In such cases, either the firm is in financial trouble or is abusing its non-equity investors. In either case, the non-equity investors are at risk and need board representation to the same extent as minority common stockholders. Board representation for preferred shareholders whose dividends are in arrears is not a novel idea and will not unduly burden firms. The New York Stock Exchange requires such rights as a condition for listing preferred stock, and the rule has caused no problems.²⁰¹

Holders of debt securities are represented in bankruptcy.²⁰² Giving lenders board seats in cases of serious default may reduce corporate opportunism and enable debt holders to postpone forcing firms into bankruptcy; thus, all parties will save money.²⁰³ A right to elect directors

199. Corporate law should allow minority shareholders to contract for greater board representation than cumulative voting would provide.

200. See CLARK, *supra* note 103, at 363.

201. N.Y.S.E. Listed Company Manual (CCH) ¶ 313.00(E) (1989) (explaining that a company must allow preferred shareholders to elect at least two directors if dividends have gone unpaid for longer than six quarters). The SEC requires companies subject to § 6 and § 7 of the Public Utility Holding Company Act of 1935 to allow preferred shareholders to elect a majority of the board when dividends have gone unpaid for a full year. Public Utility Holding Company Act Release No. 13,106, 3 Fed. Sec. L. Rep. (CCH) ¶ 36,691 (Feb. 16, 1956).

202. See I DANIEL R. COWANS, *BANKRUPTCY LAW AND PRACTICE* § 2.16 (1989) (discussing creditors' committees).

203. See THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 203-05, 215-24 (1986). See also VICTOR BRUDNEY & MARVIN A. CHIRELSTEIN, *CASES AND MATERIALS ON CORPORATE FINANCE* 241 n.k (2d ed. 1979) ("The creation of voting power for bondholders, with attendant control of the enterprise, may be a more substantial means for enforcing protective covenants, than the right to seek judicial assistance.").

upon serious default should extend only to holders of debt securities—lenders—and not to trade creditors because a lender's interest is usually financially greater and longer temporally. Reflecting the distinction between lenders and trade creditors, lenders often bargain for board representation while trade creditors rarely bargain for it.²⁰⁴

Although a venture capitalist who elects a board minority cannot block action on most matters, it is common to give such investors a veto power over major business decisions, such as mergers and sales of substantially all assets. This veto power is implemented by requiring a supermajority board vote for such decisions.²⁰⁵ Many state statutes achieve a similar result by requiring a supermajority *shareholder* vote in such cases.²⁰⁶ The practice of venture capitalists confirms the wisdom of these statutes for close corporations. Apparently the benefit to the minority of a veto power over major decisions outweighs the costs of that veto to the majority.

F. Corporate Opportunities

State laws on corporate opportunities vary widely. Some states permit fiduciaries to seize an opportunity unless the company has an "interest or expectancy" in it or the opportunity is "essential" to the firm. Other states apply different tests, such as whether the opportunity is in the same "line of business."²⁰⁷ Venture capital contracts broadly prohibit managers from taking corporate opportunities. Employment, non-competition and buyout agreements discourage, and largely forbid, managers to affiliate with another company in the firm's industry.²⁰⁸ Presumably such agreements are efficient. Courts should lean toward broad rules that prohibit managers from taking corporate opportunities. However, courts should also honor reasonable contractual exceptions. Furthermore, courts should create exceptions when a broad prohibition would be too harsh.

As previously noted, the practice of venture capitalists in this area

204. Trade creditors could, however, still obtain such rights by contract, and lenders could waive such rights.

205. See *supra* note 34.

206. See, e.g., OHIO REV. CODE ANN. § 1701.78(F) (Anderson 1985 & Supp. 1991) (vote of holders of two-thirds of shares required to approve merger).

207. See generally CLARK, *supra* note 103, at 223-62; Ronald J. Coffey, *Firm Opportunities: Property Right Assignments, Firm Detriment, and the Agent's Performance Obligation*, 13 CAN.-U.S. L.J. 155 (1988).

208. See *supra* notes 98, 107-10 and accompanying text.

demonstrates another problem with H & D's proposal.²⁰⁹ Buyouts are often priced to deter managers from voluntarily leaving a company. A low buyout price discourages management abuses of corporate opportunities that are otherwise difficult to prohibit.²¹⁰ Courts should consider this when corporate officers seek judicial dissolution.

IV. VENTURE CAPITAL IN THE FUTURE OF CORPORATE FINANCE

A. *Facilitating Venture Capital*

Although venture capital investments currently total several billion dollars, they remain only a small fraction of all corporate financing.²¹¹ Venture capital does not even supply equity for most close corporations. Instead, friends and relatives provide such funds.²¹² These sources are appropriate for small enterprises, but inadequate for larger companies, especially those capable of rapid growth. For larger companies, either venture capital or public financing is necessary. Not only is public financing unavailable to many growing companies, it is also, according to Michael Jensen, inherently inefficient and doomed to be eclipsed.²¹³ Is venture capital, then, the financial wave of the future for growing companies?

Jensen made his prediction for public financing when many major companies were going private in highly publicized LBOs. Now, however, the LBO wave has crested, principally for two reasons. First, high-yield bonds ("junk bonds") that financed many LBOs have fallen into disrepute.²¹⁴ Second, many LBOs were triggered by the fear of hostile takeovers. This fear has now subsided. State courts upheld poison pills and other defenses that made hostile takeovers difficult or impossible,

209. See *supra* note 172.

210. The difficulties in prohibiting abuses of corporate opportunities include: (1) defining corporate opportunities; (2) proving abuse of proprietary information; (3) proving the amount of monetary damages, and (4) the limited enforcement of non-competition agreements. See *supra* notes 107-10 and accompanying text.

211. Nonfinancial, nonfarm capital expenditures totaled \$380 billion in 1988; new venture capital investment averages about three billion dollars per year. See Sahlman, *supra* note 10, at 475, 482.

212. The principal sources of close corporation financing are sometimes called the three F's—family, friends and fools.

213. Jensen, *supra* note 7.

214. See Roger Lowenstein, *Junk Gets Junkier, and that May Explain Bonds' Current Ills*, WALL ST. J., Nov. 3, 1989, at C1. More recently the junk bond market has revived somewhat. See William Goodwin, *Junk Bond Rebirth May Spur Buyouts, Some Experts Say*, AM. BANKER., Apr. 6, 1992, at 16.

and state legislatures enacted further obstacles to tender offers.²¹⁵ Although the tide of LBOs has ebbed,²¹⁶ Jensen's insight remains persuasive. Public equity financing has many flaws which are best articulated by the phrase "separation of ownership and control."²¹⁷ The decline of LBOs stems from a hostile economic and legal climate; it does not indicate the superiority of public equity financing.

Why, then, is venture capital not more common? One reason is the high transaction costs, which render small venture capital investments impractical.²¹⁸ Investments that are large enough to overcome high transaction costs can be made only by wealthy individuals or by institutions that pool capital from many people. In the latter case, this pooling further increases the transaction costs of venture capital arrangements. These costs put venture capital out of reach for firms needing smaller sums of money. Even firms that could raise venture capital are forced to examine other sources of financing²¹⁹ or forego financing more often than they would if the transaction costs of venture capital were lower. The hypothetical bargaining model²²⁰ suggests how to lower these costs and thus facilitate venture capital financings—the law could provide default rules which most parties would adopt if they were able to negotiate without any costs. Terms that are typical in venture capital financings could be used to satisfy this model and could be applied unless the parties otherwise agreed. This would reduce the costs of negotiating individual financing arrangements.

Some objections to this approach can be anticipated. First, venture capital covenants vary so that determining the default rule is difficult. This objection, though valid, should not preclude the effort. Corporate law already supplies default rules for investors. The only question is whether better default rules can be designed. A more serious problem is that terms that are typical in venture capital arrangements are not always appropriate in other contexts. A good example is the common venture

215. See Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 550-51, 556-58 (1990).

216. See *supra* note 8.

217. See Dent, *supra* note 43, at 881.

218. One publication suggested \$500,000 as the minimum practical venture capital investment. KOZMETSKY ET AL., *supra* note 17, at 3. See also Hetherington & Dooley, *supra* note 160, at 38 n.121.

219. Although venture capital generally represents the owner-managers' last choice for raising capital, there are exceptions. See *supra* text accompanying note 16.

220. See *supra* notes 144-45 and accompanying text.

capital provision that allows the investor to elect half of the company's directors. This provision makes sense when an investor supplies substantial capital and receives a significant portion of the equity. It is not feasible when an investor receives only a small part of the company's equity.

One response to this objection is that only default rules are at issue; parties could still freely negotiate their own terms, customizing them to fit their situation and preferences. For example, a small shareholder could agree to elect only a minority (or none) of the directors. By requiring the small shareholder's consent, the new default rules would strengthen the bargaining position of minority investors, who often fail to appreciate how powerless and vulnerable they will be. However, if typical venture capital terms diverge even more than the current default rules do from what most parties want, adopting such terms as the new default rules would be a step backward. If more divergent default rules were adopted then most parties would incur higher transaction costs to adopt the rules they wanted. This would inhibit rather than promote the financing of small businesses.

Perhaps a prudent compromise would be to establish a set of typical venture capital terms which entrepreneurs could adopt or reject *in toto*. For example, a special statute could apply to each close corporation unless it opted out.²²¹ Unless otherwise agreed, traditional corporate law default rules would govern those close corporations opting out of the special statute. Under this compromise approach, the parties would not have to contract separately out of each venture capital term; they could avoid them all at once. Alternatively, the special statute could be designed as an opt-in type, applying only to companies that expressly elected it.²²² However, this approach requires that an investor (or his counsel) be sophisticated enough to make the necessary election. Many states already have opt-in codes for close corporations, but they are seldom used because either investors have unsophisticated counsel (or no counsel at all) or their counsel does not consider these codes advantageous.²²³

Legislatures have addressed the issue of venture capital in an attempt

221. There are many examples of opt-out statutes. For instance, Delaware corporations may opt out of that state's antitakeover statute. DEL. CODE ANN. tit. 8, § 102(b)(3) (1991). To avoid unfair surprise to minority shareholders, states could require disclosure as a condition to opting out.

222. There are many examples. For instance, Delaware has a special close corporation subchapter that applies only to those companies that elect to be governed by it. DEL. CODE ANN. tit. 8, § 342 (1991).

223. See I F. HODGE O'NEAL & ROBERT B. THOMPSON, CLOSE CORPORATIONS: LAW AND

to make such financing less burdensome. For example, the Investment Company Act of 1940 was amended in 1980²²⁴ to ease its burden on venture capital firms. However, further legislative reform is desirable.²²⁵

Legal change is not limited to legislation; courts can also help protect investors. Most investors know little about corporate law. Yet, justly fearing exploitation, they shun investments in close corporations. In recent years courts have provided minority investors more protection from exploitation;²²⁶ this trend should continue. Judicial protection of investors is inherently limited, though. It requires litigation, which is unpredictable and is too expensive unless the minority's investment is substantial and the defendants' behavior truly egregious.

The bar can also help protect minority investors. The problems of high transaction costs and unsatisfactory results occur most often when uninformed lawyers draft financing agreements from scratch. When, as often happens, one lawyer is experienced and the other is not, the latter's client is likely to get a bad bargain.²²⁷ As in other areas of the law, the bar can assist by educating potential clients about the importance of retaining effective counsel and by identifying experienced counsel.

Beyond this, the bar could publish model or standard form investment contracts. The bar has prepared model forms for other corporate transactions, such as the American Bar Association's Model Trust Indenture.²²⁸ A model contract has some of the limitations of an opt-in statute—it is useful only when lawyers have the knowledge to use it. Even then, it helps only if it is appropriate for the deal. Because deals vary widely, standard form contracts often need modifications. However, this problem is inevitable—the law always provides default rules.

PRACTICE § 1.18 (3d ed. 1986); Dennis S. Karjala, *A Second Look at Special Close Corporation Legislation*, 58 TEX. L. REV. 1207, 1266 n.236 (1981).

224. 15 U.S.C. §§ 80a-53 to 80a-64 (1976), as amended by Small Business Investment Company Act of 1980, Pub. L. 96-477, 94 Stat. 2275.

225. See IV TAMAR FRANKEL, *THE REGULATION OF MONEY MANAGERS* 263-64 (1980) (discussing the Small Business Investment Company Act's conflicting goals).

226. See *Smith v. Atlantic Props., Inc.*, 422 N.E.2d 798 (Mass. 1981) (ordering payment of dividends); *In re Kemp & Beatley, Inc.*, 473 N.E.2d 1173 (N.Y. 1984) (holding that judicial dissolutions are always subject to a party's right to buy out the other party on court approved terms). See also *supra* note 155.

227. Venture capitalists generally retain better lawyers than managers because, as repeat players, they better appreciate the importance of good counsel and know better whom to retain. In other types of equity investments in close corporations, however, the managers are generally more sophisticated and better represented than the investors.

228. See MODEL DEBENTURE INDENTURE PROVISIONS (Am. Bar Found. 1965).

The question is not whether a model contract will fit all cases—clearly it cannot—but whether it can improve existing law for a broad range of transactions.

A model contract would have advantages over a statute. Drafters can more easily amend a model contract in light of experience. The model contract could also more easily offer the parties alternative clauses and comments explaining how different terms should be used and judicially interpreted. The bar could also educate lawyers about a model contract's existence and uses.

B. The Limits of Private Equity Financing

Although legal changes can facilitate venture capital and other minority equity investments in close corporations, this form of financing has some limits. Better default rules may lower the cost of negotiating investment contracts, but the need for customized terms will often restrict the savings. Moreover, many costs of investing arise not from negotiating terms, but from the investor's investigation of the company's business prospects and the company's need to cooperate by supplying information to the potential investor. Legal changes will not reduce these costs.

Venture capital financing is also restricted by liquidity problems. Ironically, although venture capital is an alternative to public financing, venture capitalists typically invest only in companies that they expect will eventually go public—so that they can cash in their investment. Venture capitalists would, therefore, approve measures that would make it easier to go public. However, such measures would eventually make venture capital financing less common because companies would bypass venture capital financing altogether and go straight to public financing.

Easing restrictions on private sales of shares in close corporations would also relieve the liquidity problem. Toward that end, the SEC adopted Rule 144A.²²⁹ Yet, the prospect of further relief is doubtful. A market for private resales will significantly help investors in close corporations only if it approaches the liquidity of a public trading market. The SEC, however, allows companies to be publicly traded only if they regularly disclose full financial information.²³⁰ This requirement is needed to protect investors, but it prohibits companies from publicly trading their stock (and thereby solving their shareholders' liquidity problem) without

229. See *supra* notes 84-86 and accompanying text.

230. 17 C.F.R. § 240.15c2-11 (1992).

incurring the high costs of regular public disclosure.²³¹

The liquidity problem also confines the field of potential investors in close corporations. Investors expect to eventually sell their shares. Although institutional investors can often wait many years to sell, few individuals will commit to such a long wait. Unexpected events in their lives often compel individuals to quickly sell their investments. The possibility of such exigencies may preclude many individuals from investing in a close corporation. Nonetheless, many individuals will make long-term investments, especially if they will not soon need the amount they invested and if a market exists for the investment in case of the need to sell.

Although illiquidity is the immediate problem of investors, it also indirectly harms managers. One drawback of venture capital financing is that venturers demand higher rates of return than public investors.²³² Illiquidity is one reason for this demand.²³³ Hence, if the law can enhance liquidity of investments in close corporations, it will also decrease the cost (and increase the appeal) of private financing. Another reason why venture capitalists demand higher returns on their investments is their lack of diversity.²³⁴ Because they are undiversified, venture capitalists' portfolios are riskier. To compensate, they demand higher investment returns: Unlike the liquidity issue, the law can do little to ameliorate this problem.

In sum, the law can take some steps to facilitate private equity financing, but most of the problems of such financing are partly or entirely immune to legal correction.

C. *The Future of Corporate Finance*

Despite the limitations of venture capital financing, Michael Jensen's prediction that in the future private equity financing will grow at the expense of public financing is correct.²³⁵ The forces that have curbed LBOs are not permanent; LBOs could revive and the obstacles to unsolicited takeovers could erode or be circumvented by raiders. Moreover,

231. See *supra* note 16 (discussing these costs).

232. See *supra* notes 15, 23.

233. See *supra* note 23.

234. See *supra* text accompanying notes 21-22.

235. See Bevis Longstreth, *Takeovers, Corporate Governance, and Stock Ownership: Some Disquieting Trends*, J. PORTFOLIO MGMT. 54, 58 (Spring 1990) ("Institutional investors are increasingly turning to non-public investments.").

LBOs are not always junk-bond financed and designed to forestall hostile takeovers. LBOs persist because of certain disadvantages of public financing—in particular, the tendency of stock markets to undervalue public companies²³⁶ and the disclosure and other costs associated with public company status.

Further, private equity financing is not used only for LBOs—i.e., taking public companies private. It is principally used to finance companies that never have been public and that cannot or prefer not to seek immediate public financing. Private equity financing is also used by public companies.²³⁷ Although the equity in LBOs in some ways resembles venture capital, most venture capital financing is not highly leveraged. It does not depend on simultaneous debt financing, and thus was not injured by the crash of the junk bond market. In addition, because venture capital financing is not a vehicle to avoid hostile takeovers, it has not suffered from the decline of hostile takeovers.

The central question, then, is which form of financing is superior. Public and private financing both have advantages and disadvantages that cannot be weighed precisely. It is difficult to determine the extent of private financing under an ideal legal system—even describing such a system is difficult. Moreover, the appeal of private financing depends on the flaws of public financing. Those flaws may grow or diminish in the future. Private financing will never supplant, and perhaps never surpass, public financing. Yet, private financing may well expand in future decades, especially if its treatment by the legal system improves. Such a development would profit both entrepreneurs who seek capital and investors, and thus the entire economy.

236. This phenomenon reflects the separation of ownership and control. See Kraakman, *supra* note 2. Thus, underpricing creates an incentive for an LBO and may also induce an unsolicited tender offer, which further sharpens the incentive for an LBO.

237. See, e.g., Holderness & Sheehan, *supra* note 34 (discussing a major equity investment in Turner Broadcasting by a consortium of cable television companies).

