
ESSAY

THE UNICORN GOVERNANCE TRAP

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INTRODUCTION

On June 20, 2017, Travis Kalanick resigned as Uber's CEO. The announcement came after six months of brutal press coverage for the one-time darling of Silicon Valley.¹ Kalanick's resignation was precipitated more immediately by a damning report on Uber's culture by former-U.S. Attorney General Eric Holder.² Holder's report focused on sexual harassment and other misconduct by senior Uber managers.³ When Uber released the

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¹ See, e.g., Johana Bhuiyan, *For Some People Looking to Dump Uber, the #deleteUber Campaign Simply Sealed the Deal*, RECODE (Jan. 30, 2017), <https://www.recode.net/2017/1/30/14445122/delete-uber-trump-protest-immigration-ban> [<https://perma.cc/D3D8-39U6>] (reporting on the consumer boycott of Uber prompted by Kalanick's perceived alliance with President Trump's harsh immigration policies); Mike Isaac, *Inside Uber's Aggressive, Unrestrained Workplace Culture*, N.Y. TIMES (Feb. 22, 2017), <https://www.nytimes.com/2017/02/22/technology/uber-workplace-culture.html> [<https://perma.cc/V7FD-5CRE>] (describing interviews with Uber current and former employees that "paint a picture of an often unrestrained workplace culture"); Mike Isaac & Daisuke Wakabayashi, *Uber Fires Former Google Engineer at Heart of Self-Driving Dispute*, N.Y. TIMES (May 30, 2017), <https://www.nytimes.com/2017/05/30/technology/uber-anthony-levandowski.html> [<https://perma.cc/G4YR-XSCW>] (reporting on the firing of Uber engineer for failing to comply with a court order to produce information pertaining to the Waymo law suit); Eric Newcomer, *In Video, Uber CEO Argues With Driver Over Falling Fares*, BLOOMBERG (Feb. 28, 2017), <https://www.bloomberg.com/news/articles/2017-02-28/in-video-uber-ceo-argues-with-driver-over-falling-fares> [<https://perma.cc/7TRE-MBZP>] (describing Kalanick's verbal altercation with an Uber Driver on Super Bowl Sunday).

² Liane Hornsey, Chief HR Officer, *Statement on Covington Recommendations*, UBER NEWSROOM (June 13, 2017), <https://www.uber.com/newsroom/covington-recommendations/> [<https://perma.cc/QU86-3R2V>] [hereinafter Covington Recommendations].

³ See *id.* ("Covington interviewed individuals with knowledge of Ms. Fowler's allegations, employees who reported workplace environment-related complaints, employee representatives of Uber's affinity and diversity groups, and current and former members of the Senior Executive Team.").

recommendations from Holder's report, it was already grappling with a host of other serious legal controversies. Its problems ranged from a messy lawsuit alleging complicity in the theft of intellectual property from a Google-affiliated company, to a criminal investigation for using software to elude detection by local regulators, as Uber commenced unauthorized operations in their cities.⁴

Despite the explosive nature of the allegations that sparked his investigation, Holder's recommendations were surprisingly mundane. For example, Holder recommended that Uber "[u]se [c]ompensation to [h]old [s]enior [l]eaders [a]ccountable," require personnel to "submit receipts as a condition to receiving reimbursement" for expenses, and "train Human Resources personnel on the effective handling of complaints."⁵ Holder also recommended that Uber "[e]nforce [c]lear [g]uidelines on [a]lcohol [c]onsumption and the [u]se of [c]ontrolle[d] [s]ubstances" and prohibit the use of controlled substances during work hours.⁶

Uber reportedly has 14,000 employees around the world, an estimated market valuation of \$70 billion and has raised nearly \$12 billion from outside investors.⁷ Holder's report therefore raises questions about how Uber grew so large and influential without instituting a basic system for human resources management.

Part of the explanation behind Uber's unwieldy operations may lie in changes to the traditional venture capital (VC) structure for financing start-up companies and expanded opportunities for liquidity for start-up investors. These changes in the norms of start-up financing can be traced, in turn, to a series of Securities Exchange Commission (SEC) reforms instituted in recent decades. Together these reforms allow corporations to linger for protracted periods in a corporate Neverland, shielded from what had once been looming pressure to demonstrate to the world that they were ready to grow up and become publicly traded companies.⁸ Like Uber, several other private companies have stumbled seriously due to founder misconduct or fraud. Theranos was devastated in the fall of 2015 when investigations revealed that

⁴ See Mike Isaac, *Uber Weighs Leave of Absence for Chief Executive*, N.Y. TIMES (June 11, 2017), <https://www.nytimes.com/2017/06/11/technology/uber-holder-report.html?smid=pl-share> [<https://perma.cc/U3ZD-9CC6>] (describing scandals embroiling Uber and Travis Kalanick); Aarian Marshall, *Google's Robocar Lawsuit Could Kill Uber's Future and Send Execs to Prison*, WIRED (Feb. 28, 2017), <https://www.wired.com/2017/02/googles-robocar-lawsuit-kill-ubers-future-send-execs-prison/> [<https://perma.cc/B4GY-7VBX>] (reporting on Google affiliate Waymo's lawsuit against Uber for theft of autonomous driving technology).

⁵ Covington Recommendations, *supra* note 2, at 2-4.

⁶ *Id.* at 10.

⁷ See Katie Benner, *How Uber's Chief Is Gaining Even More Clout in the Company*, N.Y. TIMES (June 12, 2017), <https://www.nytimes.com/2017/06/12/technology/uber-chief-travis-kalanick-stock-buyback.html> [<https://perma.cc/MGN2-BQUK>]; Uber, CRUNCHBASE <https://www.crunchbase.com/organization/uber> [<https://perma.cc/MZ77-2DFN>].

⁸ Neverland is a fictional island from the J.M. Barrie play *Peter Pan*, and a place where children never grow up. See Neverland, WIKIPEDIA, <https://en.wikipedia.org/wiki/Neverland> [<https://perma.cc/KSV8-RAGN>] (explaining the land from J. M. Barrie's *Peter Pan*).

its main product, an innovative blood testing technology, did not really exist.⁹ Zenefits' CEO was forced to resign when the company admitted to violating laws by allowing unlicensed employees to sell insurance.¹⁰ Like Uber, Theranos and Zenefits received founder-friendly financing, which gave founders voting power to control the board of directors.¹¹ This new financing model allowed founders to entrench their control with little investor oversight of their activities.

Although corporate scholars have taken note of the growing significance of “Unicorns”—large, highly capitalized non-reporting companies—legal commentary has focused mainly on disclosure issues.¹² Scholars have also expressed concern about the lack of public accountability and externality effects, especially for Unicorns engaged in disruptive business sectors.¹³ Thus far, there has been little academic discussion of the unique governance challenges posed by an increasing number of Unicorns without discernable plans to pursue the traditional exit strategy for a successful startup—an initial public offering (IPO).

It appears that, in the absence of an impending IPO, Unicorn managers and investors lack sufficient incentives to develop governance structures and

⁹ See Nick Bilton, *Exclusive: How Elizabeth Holmes's House of Cards Came Tumbling Down*, VANITY FAIR: HIVE (Oct. 2016), <https://www.vanityfair.com/news/2016/09/elizabeth-holmes-theranos-exclusive> [<https://perma.cc/5GTG-VGAH>] (discussing the exposure of Theranos's medical technology as a sham and the role that its founder played in perpetrating the fraud).

¹⁰ See Kia Kokalitcheva, *Major CEO Shakeup at Zenefits Over Regulatory Problems*, FORTUNE (Feb. 8, 2016), <http://fortune.com/2016/02/08/zenefits-parker-conrad-resigns/> [<https://perma.cc/5PH9-D845>] (“Zenefits . . . has faced significant legal challenges to its business tactics,” including a “brief ban from operating in Utah”).

¹¹ See, e.g., Ken Auletta, *Blood, Simpler: One Woman's Drive to Upend Medical Testing*, NEW YORKER (Dec. 15, 2014), www.newyorker.com/magazine/2014/12/15/blood-simpler [<https://perma.cc/C3PJ-C89K>] (reporting that Theranos' CEO Elizabeth Holmes insisted VCs abide by her terms “which included an understanding that she would retain control”); Erin Griffith, *The Ugly Unethical Underside of Silicon Valley*, FORTUNE (Dec. 28, 2016), <http://fortune.com/silicon-valley-startups-fraud-venture-capital/> [<https://perma.cc/TX4W-E65M>] (“Ever since Google's and Facebook's founders negotiated dual-class share structures to retain control over their companies, hot startups including Uber, Airbnb, Square, Snap, Palantir, and WeWork have pushed for, and gotten, similar founder-friendly terms.”).

¹² See, e.g., Jennifer S. Fan, *Regulating Unicorns: Disclosure and the New Private Economy*, 57 B.C. L. REV. 583 (2016) (arguing “for enhanced disclosure requirements that will alleviate the risks of unicorns without restraining their innovation”); Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 HASTINGS L. J. 445 (2017) (“[P]rovid[ing] a critique of the new public–private divide centered on its information effects.”); Michael D. Guttentag, *Patching a Hole in the JOBS Act: How and Why to Rewrite the Rules that Require Firms to Make Periodic Disclosures*, 88 IND. L. J. 151 (2013) (arguing for expanded disclosure requirements for certain large private companies).

¹³ See Donald C. Langevoort & Robert B. Thompson, “Publicness” in Contemporary Securities Regulation After the JOBS Act, 101 GEO. L. J. 337, 340 (2013) (“[W]e suspect that some portion of what we call securities regulation follows from an effort to create more accountability of large, economically powerful business institutions that is only loosely coupled with orthodox (and arguably more measurable) notions of investor protection.”).

practices appropriate for enterprises of their scale.¹⁴ At the same time, many VCs have made the strategic decision to cede control to founders at an early stage, hampering their ability to step in and prevent or correct misconduct.¹⁵ Uber investor Benchmark's recent lawsuit against Travis Kalanick illustrates this governance trap.¹⁶ Despite lacking board control, Uber's investors managed to force Kalanick to resign as CEO.¹⁷ Yet even after his resignation, Kalanick retained his board seat, filled other board vacancies, and allegedly interfered with efforts to select his successor.¹⁸

An economy in which large-scale private enterprises, characterized by a separation of ownership and control, can grow and thrive challenges key assumptions underlying corporate law theory. This phenomenon has been facilitated by the confluence of amendments to the federal securities laws¹⁹ and an increased willingness of private investors to cede control of the companies they finance to unseasoned and untested entrepreneurial CEOs.²⁰ With the expansion of electronic trading in start-up company shares, the separation of ownership from control has become a new reality for many Unicorns. These market developments have introduced to Unicorns the same agency problems

¹⁴ See Paresh Dave & James Rufus Koren, *Have Investors Allowed Tech Founders Like Uber's Travis Kalanick to Grow Too Powerful?*, L.A. TIMES (June 14, 2017), <http://www.latimes.com/business/technology/la-fi-tn-uber-investors-20170613-story.html> [<https://perma.cc/337L-F9XD>] (“Had Uber been created in a different era of the tech industry, the 8-year-old firm probably would have been publicly traded by now And many of the changes that [Holder] and Tammy Albarrán put forward would have long been in place.”).

¹⁵ See, e.g., Priya Anand & William Alden, *Why Uber's Board Is Standing By Its CEO*, BUZZFEED NEWS, (Mar. 24, 2017), https://www.buzzfeed.com/priya/why-ubers-board-is-standing-by-its-ceo?utm_term=.no7O1RM8o#.tegbBq15Y [<https://perma.cc/FMP2-Q8CW>] (explaining the difficulty of replacing a CEO who has sufficient votes to control the board of directors); Farhod Manjoo, *Uber's Lesson: Silicon Valley's Start-Up Machine Needs Fixing*, N.Y. TIMES (June 21, 2017), <https://www.nytimes.com/2017/06/21/technology/uber-start-up-lessons.html> [<https://perma.cc/9EYG-93HA>] (“Silicon Valley's investors created a culture where founders are given carte blanche, their pronouncements and tactics elevated to the level of divine infallibility.”).

¹⁶ Benchmark alleged Kalanick solidified control over Uber through fraud, by concealing the extent of his mismanagement of the company. See generally Verified Complaint, Benchmark Capital Partners VII, L.P. v. Kalanick, No. 2017-0575 (Del. Ch. Aug. 10, 2017). On August 30, 2017, the court referred Benchmark's claims to arbitration. See Tiffany Hsu & Nellie Bowles, *Kalanick's Feud With Benchmark Goes to Arbitration for Now, Judge Rules*, N.Y. TIMES (Aug. 30, 2017), <https://www.nytimes.com/2017/08/30/technology/kalanick-benchmark-uber-delaware.html?smid=pl-share> [<https://perma.cc/2Y3B-WZTM>].

¹⁷ See Mike Isaac, *Inside Travis Kalanick's Resignation as CEO*, N.Y. TIMES (June 21, 2017), <https://www.nytimes.com/2017/06/21/technology/uber-travis-kalanick-final-hours.html?smid=pl-share> [<https://perma.cc/G2KV-4GNH>] (providing an account of a “surprise visit” from Uber's lead investors in which Kalanick was persuaded to resign).

¹⁸ See Verified Complaint, *supra* note 16, at 1-9; Greg Bensinger, *Uber Ex-CEO Travis Kalanick Names Directors in Power Play*, WALL ST. J. (Sept. 29, 2017), <https://www.wsj.com/articles/travis-kalanick-exercises-right-to-appoint-two-uber-directors-1506729037> [<https://perma.cc/N9N2-MVUL>] (reporting Kalanick's appointment of two new directors to Uber's board).

¹⁹ See *infra* Section I.C.

²⁰ See Griffith, *supra* note 11 (“So inexperienced people are handed giant piles of money and told to flout traditions, break rules, and employ magical thinking. What could possibly go wrong?”).

that plague public companies, without the mechanisms—voting, litigation, or exit—public company shareholders rely on to discipline corporate managers.

This Essay highlights emerging governance problems presented by persistent Unicorns. It argues that recent market trends and deregulatory reforms have weakened or eliminated the principal mechanisms that imposed discipline on start-up company founders. Recent scandals at prominent Unicorns suggest that investors have erred in placing blind faith in the honesty and capabilities of start-up founders. Policymakers should learn from these disasters and close regulatory loopholes that allow Unicorns to persist in limbo between private and public status for extended periods of time.

Part I provides an overview of how the IPO has shifted from the preferred exit strategy in the eyes of entrepreneurs to a regulatory morass to be shunned. It traces developments in the market for start-up company shares, and regulatory reforms that facilitated the proliferation of Unicorns. Part II highlights unique governance risks posed by Unicorns, addressing both societal and investor protection concerns. Part III offers suggestions on how to address Unicorn risks, and raises fundamental questions about the future of Unicorns in our economy.

I. THE FADING ALLURE OF THE IPO

In the lore of Wall Street, the IPO functions as a venerable rite of passage. A stock market debut signifies that a promising new company has finally arrived, ready to join the “grown ups” in the economy by listing its shares on a national stock exchange.

The allure of this imprimatur apparently has faded as both the number of public companies and number of IPOs has plummeted in recent decades.²¹ As one commentator explains, “[i]n 1996 there were 706 initial public offerings, but in 2016 there were only 105.”²² In addition, “the total number of companies listed on the United States stock market plummeted by nearly half, to 3,671 last year from 7,322 in 1996.”²³

A number of recent securities reforms have been premised on the need to revive the IPO. The Jumpstart Our Business Startups Act of 2012 (the “JOBS Act”) had the principal objective of reducing regulatory burdens that

²¹ See Steven Davidoff Solomon, *A Dearth of I.P.O.s, but It's Not the Fault of Red Tape*, N.Y. TIMES (Mar. 28, 2017), <https://www.nytimes.com/2017/03/28/business/dealbook/fewer-ipos-regulation-stock-market.html?smid=pl-share> [<https://perma.cc/D8ZY-8DFS>]. Several scholars have also noted a precipitous decline in the number of IPOs. See e.g., Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1, 12 (2012); Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. PA. L. REV. 179, 181 (2012).

²² Davidoff Solomon, *supra* note 21.

²³ *Id.*

discouraged IPOs.²⁴ Despite its stated purpose, it is likely that the JOBS Act and related reforms had the opposite effect, and further discouraged start-up companies from going public.²⁵ More importantly, these reforms have contributed to a new governance problem by creating a class of unaccountable Unicorns, insulated both from the investor control that typifies private company governance and the public scrutiny and oversight that accompanies an IPO.

A. Traditional Motivations

For decades, the IPO served as the ultimate exit strategy for both start-up entrepreneurs and the VCs who provided capital and worked to nurture fledgling start-up enterprises.²⁶ An IPO served a number of objectives that made it the preferred exit strategy for start-ups.²⁷ First, under favorable market conditions a public offering represented the cheapest way for a company to raise funds needed to fuel its growth. Second, an IPO created liquidity for founders, early investors and employees, all of whom had significant wealth locked up within the firm. Third, an IPO created, almost by alchemy, a new form of currency—publicly traded stock—which the company could use to acquire other businesses and recruit employees. Finally, a successful IPO sent an important signal to the market that the company had arrived. Suppliers, banks, customers, and potential employees respected the cachet that came with an IPO, and would confer more credibility to the company going forward.

The advantages of going public came with significant costs, making the decision to launch an IPO a weighty one. Transaction costs run into the millions of dollars, and include underwriting commissions, auditing and legal fees, printing costs, and filing fees.²⁸ Intangible costs include the distraction of management and heightened liability risks for IPO participants including the company, underwriters, accountants, executives, and directors.

After a public offering, regulatory costs persist and loom over the company on a daily basis. By regulatory fiat, the firm is now a reporting company, subject to the SEC's expansive disclosure obligations.²⁹ Information regarding business

24 See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) ("An Act [t]o increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies.").

25 See de Fontenay, *supra* note 12, at 456 ("[T]he fact that the JOBS Act simultaneously liberalized private capital raising in turn rendered nugatory the Act's efforts to encourage IPOs.").

26 See Ibrahim, *supra* note 21, at 11 (stating "IPOs are the gold standard in VC success.").

27 JOHN C. COFFEE, JR. & HILARY A. SALE, *SECURITIES REGULATION: CASES AND MATERIALS* 28 (12th ed. 2012).

28 JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 149 (8th ed. 2017).

29 A reporting company must file quarterly and annual reports and comply with the SEC's proxy solicitation rules. See 15 U.S.C. §§ 78m, 78n (2012).

operations that once was confidential must now be disclosed to the public. In addition, federal corporate governance rules constrain management power and impose oversight duties on executives and directors.³⁰

Along with public disclosure comes intense scrutiny from investors, financial analysts, and the press. Public company investors are notoriously myopic and often react harshly to unexpected bad news.³¹ More importantly, every utterance by the company or its managers exposes the issuer and its agents to the risk of potentially ruinous securities fraud liability.³²

Despite these regulatory burdens, for decades the traditional calculus held that the enhanced public profile, wealth creation, financial stability, and operational flexibility that came with an IPO far outweighed the perceived costs, such that the IPO served as a logical step in the life cycle of a successful growing company. More recently, this calculus has changed as many likely candidates are avoiding or delaying an IPO. Well-known companies like Airbnb, Uber, and Spotify have deferred IPOs despite their significant market capitalization, name recognition, and likely strong public demand for their shares.³³

B. *Diminishing Market Incentives*

Many observers attribute the decline in the number of IPOs to increased regulation of public companies. Certainly, the Sarbanes-Oxley and Dodd-Frank Acts enhanced perceptions of the burdens associated with public company status. However, market factors likely play a more significant role in the IPO's demise. A series of developments in the market for private company shares has relieved the demand for liquidity that previously pushed start-ups toward an IPO. In addition, securities reforms adopted in the early 2000s weakened or eliminated legal imperatives that motivated firms to pursue an IPO.

Today's technology companies have lower capital needs than more traditional start-ups.³⁴ There is currently an abundance of capital available in private equity markets for these technology companies.³⁵ It is not entirely

³⁰ See de Fontenay, *supra* note 12, at 463-65 (describing federal corporate governance requirements).

³¹ See Lynne L. Dallas, *Short-Termism, The Financial Crisis and Corporate Governance*, 37 J. CORP. L. 265, 267-68 (2011) (describing the short-term focus of many investors).

³² Rule 10b-5 of the Securities Exchange Act imposes liability on any person who makes a false or misleading statement in connection with the purchase or sale of a security. 17 C.F.R. §240.10b-5 (2009).

³³ See Brian Deagon, *Will Snapchat IPO Set Stage For Stampede Of Unicorns?*, INV. BUS. DAILY (Jan. 6, 2017), <http://www.investors.com/news/technology/will-snapchat-ipo-set-stage-for-stampede-of-unicorns/> [<https://perma.cc/223S-K4CP>] (discussing a number of prominent Unicorns that have yet to launch an IPO).

³⁴ See, e.g., Darian M. Ibrahim, *Equity Crowdfunding: A Market for Lemons?*, 100 MINN. L. REV. 561, 579 (2015) (explaining that "capital-efficient" tech start-ups are less dependent on funding to launch or to grow).

³⁵ Fifty-eight billion dollars were invested in U.S. VC-backed firms in 2016. See PRICEWATERHOUSECOOPERS LLC & CB INSIGHTS, MONEY TREE REPORT: Q4 AND FULL-YEAR 2016, 4 (2017), <https://www.cbinsights.com/reports/MoneyTree-Q4-2016.pdf> [<https://perma.cc/F2JA-GKSC>].

clear why so much capital is pouring into private equity markets. Part of the cause may be dramatic dips in value in public equity, real estate, and asset-backed securities that investors have experienced during the past twenty years. As investors pulled funds from these asset classes, they needed to find other sectors in which to deploy them.

1. The Traditional VC Role

At one time, investors in private companies fell into three broad categories: founders, wealthy individuals, and venture capital firms—professionally-managed aggregations of funds from individual and institutional investors. Since the 1980s, VCs have comprised the dominant group of investors in start-up companies. VCs have historically employed a set of devices to maintain control over the companies they funded.

VC control mechanisms include staged investments, restrictive covenants, board representation, and registration and redemption rights.³⁶ These provisions accorded VCs power to force liquidating transactions or replace founders when intractable disagreements with management arose. VCs typically maintained an investment horizon of 5-7 years and would aim for a public offering, sale, or liquidation to allow them to cash in on their investment within that time frame.³⁷ Their contractual rights empowered VCs to maintain constant pressure on entrepreneurs to hit milestones to assure the continued flow of funds, and to prepare for a sale or an IPO.

Under this financing structure, the interests of founders and VCs were not perfectly aligned. Start-up founders typically held common stock, while VCs held preferred stock, giving VCs seniority with regard to distributions, as dividends or as liquidation payments.³⁸ This structure created opportunities for VCs to exploit founders by pushing for deals that favored their interests at the expense of common stockholders. With board representation and the power of the purse, VCs had the ability to replace management, essentially kicking the founders out of the companies they created.

Despite this power imbalance, standard VC terms created a workable framework for the governance of start-ups that relied on outside financing for their capital needs. Founders and employees worked to execute the founders' vision. Although founders had day-to-day authority over the enterprise,

Thirty-three billion dollars were invested during the first half of 2017. See CB INSIGHTS, VENTURE CAPITAL FUNDING REPORT Q2 2017 (2017), <https://www.cbinsights.com/research/report/venture-capital-q2-2017/> [<https://perma.cc/3WHV-L9A8>].

³⁶ See Ibrahim, *supra* note 34, at 574 (describing staged financing techniques and preferred stock terms as means of protecting VC investments).

³⁷ See Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 FORDHAM L. REV. 3389, 3401 (2013).

³⁸ See Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1413-14 (2008) (describing typical preferred stock terms).

ultimate control was in the hands of the investors who contributed the cash, connections, and guidance the company needed to grow. This governance structure minimized agency problems, as there was limited separation of ownership (i.e., investor capital) and control.³⁹

2. New Sources of Capital

In the 1990s, VCs were joined by a second prominent group of sophisticated investors. Angel investors are wealthy individuals, often successful entrepreneurs, willing to invest at an earlier stage and in smaller increments than the typical VC round. Like VCs, Angels offered expertise and advice, and helped nurture firms into the VC stage. The terms of Angel financing tended to be founder-friendly. Angels often accepted common stock and did not demand the control rights typical in a VC deal.⁴⁰ As such, Angels' investment strategy preserved space for VCs to step in and impose a more demanding command and control structure.⁴¹

More recently, money has poured into the start-up space from less traditional sources. Mature corporations, sovereign wealth funds (SWFs), and mutual funds have all rushed to fund private technology companies.⁴² These new sources of funding compete with conventional VCs for deal flow, but take a more passive approach to monitoring their investments.⁴³ As VCs vied with other powerful players for access to promising start-ups, they began to offer financing on terms more friendly to founders.⁴⁴

³⁹ See Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1073-74 (2003) (“[T]he governance structure of a venture capital-backed early stage, high technology company allocates to the venture capital investors disproportionately greater control than equity.”).

⁴⁰ See Ibrahim, *supra* note 38, at 1422-24 (describing typical terms of an angel investor contract).

⁴¹ See *id.* at 1433-35 (explaining how VC contracts are “costlier to design, write, monitor, and enforce” as an explanation for differences from angel contracts).

⁴² See Jeff Schwartz, *Should Mutual Funds Invest in Startups? A Case Study of Fidelity Magellan Fund's Investments in Unicorns (and Other Startups) and the Regulatory Implications*, 95 N.C. L. REV. 1341, 1349 (2017); Jennifer S. Fan, *Catching Disruption: Regulating Corporate Venture Capital*, COLUM. BUS. L. REV. (forthcoming 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2889443 [<https://perma.cc/7DBH-DKWD>] (describing the increased prominence of corporate venture capital in the start-up space); Sophie Baker, *Sovereign Wealth Funds Turn More to Digital, Technology Deals—report*, PENSIONS & INV. (Sept. 12, 2017), <http://www.pionline.com/article/20170912/ONLINE/170919975/sovereign-wealth-funds-turn-more-to-digital-technology-deals-8212-report> [<https://perma.cc/VK36-789N>].

⁴³ See Yao Zeng, *Mutual Funds as Venture Capitalists? Evidence from Unicorns*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 23, 2017), <https://corpgov.law.harvard.edu/2017/01/23/mutual-funds-as-venture-capitalists-evidence-from-unicorns/> [<https://perma.cc/C9DB-SH2E>].

⁴⁴ See Thomas Lee, *Uber Stayed Private, but Couldn't Shield Finances or Failures*, S.F. CHRON. (June 23, 2017), <http://www.sfchronicle.com/business/article/Uber-stayed-private-but-couldn-t-shield-11240652.php> [<https://perma.cc/KFP2-EX7A>] (discussing how VC firm “Andreessen Horowitz rose to prominence in part by promising to be friendlier to founders, and as it snatched

In this founder-friendly model now popular in Silicon Valley, founders receive shares with super voting power (typically ten votes per share), allowing founders to maintain board control despite having an insignificant monetary stake in the company.⁴⁵ This form of dual-class capitalization had been implemented at well-known tech companies, like Google and Facebook, before an IPO when VCs were poised to make their exit.⁴⁶ By introducing this model to start-ups at an early stage in their development, VCs diluted the discipline and accountability they traditionally provided as members of a start-up company's board.

C. Regulatory Imperatives Withdrawn

At the same time that the flow of capital to tech start-ups was accelerating, and expectations of investors were relaxed, the SEC began to ease restrictions on issuing and transferring start-up company shares. These developments helped increase the appeal of start-up shares, while relieving pressure on start-ups to achieve liquidity through a sale of the company or an IPO.

1. Shortening Rule 144 Holding Periods

The first significant changes that eased IPO pressure were SEC reforms that relaxed restrictions on the transfer of start-up company shares. Most sales of shares by investors are exempt from registration under Section 4(a)(1) of the Securities Act of 1933 (the Securities Act).⁴⁷ Investors can resell shares if they establish they purchased the shares with investment intent, not for further distribution.⁴⁸ Investors demonstrate investment intent by holding their shares for a set period of time, which ranged from two to three years under judicial doctrine.⁴⁹

The SEC adopted Rule 144 to reduce uncertainty surrounding resales of restricted shares. As originally adopted, Rule 144 permitted resales, subject to certain conditions, after a two-year holding period was satisfied.⁵⁰ After

prime deals away from rival firms, they mirrored its approach in giving founder-CEOs a lot of leeway in running their companies”).

⁴⁵ See Fan, *supra* note 12, at 611-37 (reviewing the terms of the Certificates of Incorporation of prominent Unicorns, including Airbnb, Dropbox, Pinterest and Uber).

⁴⁶ See, e.g., Google, Inc., Registration Statement (Form S-1) at iii (April 29, 2004) (“In the transition to public ownership, we have set up a corporate structure that will make it harder for outside parties to take over or influence Google.”).

⁴⁷ 15 U.S.C. § 77d(a)(1) (2012).

⁴⁸ See COX ET AL., *supra* note 28, at 348-49.

⁴⁹ See *id.*

⁵⁰ Notice of Adoption of Rule 144 Relating to the Definition of the Terms “Underwriter” in Sections 4(1) and 2(11) and “Brokers’ Transactions” in Section 4(4) of the Securities Act of 1933,

three years, resales were permitted without conditions.⁵¹ The initial Rule 144 holding periods tracked guidelines established by doctrine. Still, investors resisted burdens imposed on resales and the SEC responded by shortening holding periods in a series of reforms.⁵² In 1997, the SEC shortened the Rule 144 holding period from two years to one, with conditions applying during the period between one and two years from acquisition.⁵³ In 2007, the SEC shortened Rule 144 holding periods again.⁵⁴ Currently, under Rule 144, investors who acquire shares from an issuer in an unregistered transaction can resell their shares after one year with no conditions.⁵⁵

By shortening Rule 144 holding periods, the SEC relieved pressure on start-ups to pursue an IPO. Investors and employees seeking liquidity can sell their shares to anyone after satisfying a brief one-year holding period.⁵⁶ Shortly after these reforms, web-based trading platforms emerged to facilitate resales of start-up company shares.⁵⁷ In 2009, SharesPost and SecondMarket (now Nasdaq Private Market) launched electronic trading platforms to connect shareholders in start-ups with investors interested in purchasing their shares. Nasdaq Private Market reports it has handled trading in the shares of 116 private companies for 15,350 total transaction participants, with an aggregate market value of \$6.1 billion.⁵⁸ SharesPost reports it “has nearly \$3 billion in closed transactions for more than 180 leading technology companies.”⁵⁹ The rapid growth of private secondary markets as an outlet for shares in pre-IPO start-ups relieved pressure Unicorns once faced to provide liquidity for founders, early investors, and employees.

Adoption of Form 144, and Recission of Rules 154 and 155 Under That Act, Securities Act Release No. 33-5223, 37 Fed. Reg. 591 (Jan. 14, 1972).

⁵¹ *Id.* Conditions continued to apply to resales by affiliates until 90 days after they ceased to be affiliates. *Id.*

⁵² The SEC also adopted Rule 144A which allows sales of unregistered securities to Qualified Institutional Buyers (QIBs). The Rule 144A market facilitates trading mainly in debt securities and equity securities of foreign issuers. See COFFEE & SALE, *supra* note 27, at 513-17.

⁵³ Revision of Rule 144, Rule 145, and Form 144, Securities Act Release No. 33-7391, 62 Fed. Reg. 9,246 (Feb. 28, 1997).

⁵⁴ Revisions to Rules 144 and 145, Securities Act Release No. 33-8869, 72 Fed. Reg. 71,546 (Dec. 17, 2007).

⁵⁵ 17 C.F.R. § 230.144 (2017). For public companies, the holding period is only six months, with conditions on resale during the period between six months to one year from acquisition. *Id.*

⁵⁶ Start-up company shares are typically subject to transfer restrictions which require company consent for any proposed sale. See Ibrahim, *supra* note 21, at 44 (describing typical company rights of first refusal on sales of employee shares).

⁵⁷ *Id.* at 36-39 (describing the development and operation of SharesPost and SecondMarket).

⁵⁸ *Private Company Liquidity*, NASDAQ (2017), <https://www.nasdaqprivatemarket.com/private-companies> [<https://perma.cc/ZC6T-DH7T>].

⁵⁹ Press Release, SharesPost, SharesPost Initiates Coverage of Spotify (Nov. 9, 2017), https://dw5kjuwox7gn.cloudfront.net/assets/files/9678/sharespost_initiates_coverage_of_spotify.pdf [<https://perma.cc/T6KP-6D2U>].

2. Regulation D

Just as amendments to Rule 144 reduced pressure for liquidity events, changes to the Securities Act's Regulation D eased challenges private companies faced when raising capital. Most private financing transactions proceed under Rule 506 of Regulation D, which allows companies to raise an unlimited amount of money from an unlimited number of accredited investors (financial institutions and wealthy individuals).⁶⁰ Until recently, one thorny condition to Regulation D complicated the private financing process.

Rule 502(c) forbade general solicitation and advertising for transactions exempt from registration under Regulation D.⁶¹ This ban on general solicitation prohibited the use of sales meetings, newsletters, cold calling, or the Internet to identify potential investors.⁶² Start-ups could only approach investors with whom they had pre-existing relationships, or work through intermediaries who had requisite connections to qualified investors.⁶³ As the Internet emerged as a dominant communication channel, entrepreneurs chafed at Rule 502(c)'s restrictions.⁶⁴ Despite aggressive lobbying by the industry, the SEC refused to ease its restrictions.⁶⁵

Congress intervened, and, as part of the JOBS Act, directed the SEC to exempt Rule 506 transactions with accredited investors from the ban on general solicitation.⁶⁶ In response, the SEC adopted new Rule 506(c), which allows companies to engage in general solicitation, including through the Internet, as long as the company takes steps to ensure that all investors are accredited.⁶⁷ The effort required to raise capital is now significantly reduced. VCs and Angels can efficiently syndicate their investments and identify potential investors via the Internet.⁶⁸ With new alternatives for raising private capital, the IPO has become increasingly obsolete.⁶⁹

⁶⁰ 17 C.F.R. § 230.506 (2017).

⁶¹ 17 C.F.R. § 230.502(c)(1) (2017).

⁶² See COX ET AL., *supra* note 28, at 277-79.

⁶³ *Id.*

⁶⁴ *Id.* at 281.

⁶⁵ *Id.*

⁶⁶ Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201(a)(1), 126 Stat. 313 (2012).

⁶⁷ 17 C.F.R. § 230.506(c) (2017).

⁶⁸ See Ibrahim, *supra* note 34, at 585-86 (noting that transaction costs of finding new investments is lower with the Internet).

⁶⁹ Tom Braithwaite, *Death of IPOs Leads Early Tech Backers to the 'Unicorn Shuffle'*, FIN. TIMES (Sept. 22, 2017), <https://www.ft.com/content/78a8ad9e-9f4b-11e7-8cd4-932067fbf946> [<https://perma.cc/ZZF9-XJX2>] (reporting on the recent trend of early-round VC investors selling their stakes in Unicorns to other VCs or institutional investors).

3. Amendments to Section 12(g)

Until 2012, even thriving companies with adequate funding faced a future IPO on the horizon. As its shareholder base expanded, a start-up faced the prospect of mandatory registration under the Securities Exchange Act of 1934 (the Exchange Act). Exchange Act Section 12(g) required companies with more than \$10 million in assets and a class of equity securities held by 500 or more shareholders to register the securities with the SEC.⁷⁰ Start-ups facing the prospect of Exchange Act registration almost always chose to pursue an IPO to create a public trading market for their shares.⁷¹

With the JOBS Act, Congress decreed such mandatory registration unnecessary. As amended, Section 12(g) increased the number of shareholders that compels registration from 500 to 2000.⁷² According to the SEC, 87% of existing public companies would be excluded from registration under this definition, leaving only 400 companies that would be compelled to register solely because of Section 12(g).⁷³ As such, new Section 12(g) essentially eliminates the prospect of mandatory registration.⁷⁴

To summarize, increased flows of capital from non-traditional sources diluted the bargaining power of VCs, who once employed an array of structural mechanisms to exert tight control over the companies they funded. At the same time, expanded liquidity in markets for private securities reduced pressure on companies to race toward an exit through a sale of the company or an IPO. These market shifts were facilitated by a series of deregulatory reforms, including amendments to Rule 144 and Regulation D. The JOBS Act amendments to Section 12(g) struck a final blow to the system of discipline that encouraged start-ups to mature as they grew. The result of these regulatory and market changes has been a proliferation of Unicorns that linger for extended periods in an ill-defined space between public and private status.

⁷⁰ See 15 U.S.C. § 781(g) (2006); 17 C.F.R. § 240.12g-1 (2011). Rule 12g-1 increased Section 12(g)'s \$1 million in assets threshold to \$10 million.

⁷¹ See Pollman, *supra* note 21, at 192 ("This rule has had the practical effect of forcing some companies to become public reporting companies earlier than they would otherwise choose.").

⁷² 15 U.S.C. §781(g)(1). Certain categories of shares are excluded from the calculation, such as shares issued under employee compensation plans or under the SEC's crowdfunding exemption. If an issuer has 500 or more shareholders who are unaccredited investors, however, registration under Section 12(g) is nonetheless required. 15 U.S.C. §§ 781(g)(5)–(6).

⁷³ COX ET AL., *supra* note 28, at 583. To deregister under the Exchange Act, the number of record holders at the end of the fiscal year must fall below 300. 15 U.S.C. §781(g)(4).

⁷⁴ See Langevoort & Thompson, *supra* note 13, at 370 ("A threshold of 2,000 record shareholders, excluding employees and crowd-funding investors, is not going to reach many companies in today's market before they seek a stock-exchange listing or a registered public offering.").

II. THE UNICORN GOVERNANCE TRAP

A. *The Rise of the Unicorn*

The number of Unicorns has increased dramatically in the past five years, from a mere 40 in 2013 to a reported 267 today.⁷⁵ Because Unicorns are no longer as rare as their moniker implies, a new category of super Unicorns or “Decacorns” has entered the financial lexicon. A Decacorn is a private company with a valuation of \$10 billion or more. There are reportedly seven Decacorns, including such well-known brands as Airbnb, Dropbox and Pinterest.⁷⁶

In hindsight, it appears that the prospect of an IPO had a significant disciplining effect on managers of start-ups. The drive toward an IPO forced start-ups and their advisers to work to assemble a management team and infrastructure that would pass muster with underwriters and the public. In the traditional scenario, as a successful start-up approached an IPO it brought in seasoned executives to support or replace its entrepreneurial founders.⁷⁷ For instance, Google hired Eric Schmidt as CEO in 2001, three years before its successful IPO.⁷⁸ Similarly, Facebook hired Sheryl Sandberg as Chief Operating Officer in 2008, four years before its IPO.⁷⁹

With the demise of the IPO as the optimal exit strategy, founders no longer face intense external pressure to professionalize as they scale their operations. As long as billions of dollars continue to pour into private equity markets and cash-hungry employees can sell shares in private transactions, there is little reason for founders or investors to push for an IPO. As a result, disruptive companies that skirt or challenge laws face little external pressure to bring their business conduct in compliance with the law.

⁷⁵ CrunchBase Unicorn Leaderboards, TECHCRUNCH (Sept. 25, 2017), <https://techcrunch.com/unicorn-leaderboard/> [<https://perma.cc/DS2L-WMWL>]. CBInsights puts the number of unicorns at 216. *The Global Unicorn Club*, CBINSIGHTS, <https://www.cbinsights.com/research-unicorn-companies> [<https://perma.cc/4K7B-EVKX>].

⁷⁶ See Avery Hartmans, *The \$10 Billion Club: Meet the 7 Most Valuable Startups in the US*, BUS. INSIDER (June 5, 2017), <http://www.businessinsider.com/most-valuable-us-startups-10-billion-decacorns-2017-6/#7-dropbox-1> [<https://perma.cc/2P2L-3R6F>].

⁷⁷ See also Chris Zook & James Allen, *Why Startups Like Uber Stumble Over Problems They Could Have Avoided*, HARV. BUS. REV. (June 23, 2017), <https://hbr.org/2017/06/why-startups-like-uber-stumble-over-problems-they-could-have-avoided> [<https://perma.cc/4W5Q-F3BL>] (describing the problem of the “unscalable founder” who is not equipped to grow a start-up beyond its early stage).

⁷⁸ See Eric Schmidt, *How I Did It: Google's CEO on the Enduring Lesson of a Quirky IPO*, HARV. BUS. REV. (May 2010), <https://hbr.org/2010/05/how-i-did-it-googles-ceo-on-the-enduring-lessons-of-a-quirky-ipo> [<https://perma.cc/N7GV-QBP3>].

⁷⁹ George Anders, *Sheryl Sandberg Could Be Billionaire in Facebook IPO*, FORBES (Jan. 30, 2012), <https://www.forbes.com/sites/georgeanders/2012/01/30/sheryl-sandberg-could-be-billionaire-in-facebook-ipo/#5339ade23aaf> [<https://perma.cc/L75J-XTAZ>].

B. Unicorn Risks

The securities laws' disclosure rules seek to shine light on corporate activities that pose risks to investors and other stakeholders. These laws create remedies for investors when managers fail to disclose required information on conflicts of interest and other corporate misconduct.⁸⁰ Because Unicorns are free from public disclosure requirements, they can engage in questionable activities with less fear of exposure, and do not face the same threat of securities fraud claims that helps discipline managers of public companies.

Unicorns have a significant influence on our economy, yet they operate fully shielded from the accountability mechanisms to which investors traditionally turn to constrain the conduct of corporate managers. Persistent Unicorns present a number of unique risks that regulators failed to appreciate as they created space for Unicorns to thrive. These risks fall into two broad categories: those that raise societal concerns and those that impact investors.

1. Societal Concerns

a. *Employee Relations*

Thus far corporate scholars have paid scant attention to how Unicorn mismanagement affects their employees. Unicorns have workforces that rival those of many public companies. Uber reportedly has more than 14,000 employees, a figure that does not include its drivers.⁸¹ Theranos employed 1000 people before the discovery of its fraud.⁸² By comparison, Google had 1900 employees at the time of its public offering, while Facebook had 3200 full time employees.⁸³

Insulation from the scrutiny that comes with public company status facilitates the development of toxic cultures at Unicorns. Press accounts of the culture at Uber and Theranos suggest that Unicorn investors have failed to create accountability mechanisms that replicate the disciplining effect of an impending IPO. A slew of press accounts reported that women working at Uber were systematically subject to discrimination and harassment.⁸⁴ Uber

⁸⁰ See generally Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859 (2003).

⁸¹ See Benner, *supra* note 7.

⁸² See Kimberly Weisul, *How Playing the Long Game Made Elizabeth Holmes a Billionaire*, INC. (Nov. 1, 2015), <https://www.inc.com/magazine/201510/kimberly-weisul/the-longest-game.html> [<https://perma.cc/9DW2-LYAA>].

⁸³ Facebook, Inc., Registration Statement (Form S-1), at 94 (February 1, 2012); Google, Inc., Registration Statement (Form S-1), *supra* note 46, at 68.

⁸⁴ See, e.g., Isaac, *supra* note 1; Kara Swisher & Johana Bhuiyan, *Uber CEO Kalanick Advised Employees on Sex Rules for a Company Celebration in 2013 'Miami Letter'*, RECODE (June 8, 2017), <https://www.recode.net/2017/6/8/15765514/2013-miami-letter-uber-ceo-kalanick-employees-sex->

employees who complained about their treatment alleged that they were rebuffed or ignored.⁸⁵ An independent investigation into the sexual harassment complaints ended with the dismissal for misconduct of twenty Uber employees.⁸⁶

Uber's deficiencies in human resource management not only affected the rights and well-being of individual employees, but also undermined Uber's culture and stability. In the first few months of 2017, Uber suffered a wave of high-level departures, and has struggled to fill senior executive positions including the key posts of CEO, COO, and CFO.⁸⁷

Theranos similarly suffered from a toxic corporate culture. According to reports, CEO Elizabeth Holmes maintained a culture of secrecy and silence. Holmes refused to disclose how Theranos technology worked or publish assessments of its reliability in peer-reviewed journals.⁸⁸ She forbade Theranos employees from talking about their jobs, even to each other.⁸⁹ This culture of silence enabled Holmes to conceal the reality that Theranos's technology did not work as claimed.⁹⁰ After journalists uncovered the truth about Theranos's products, the company scaled back operations and cut its workforce from 1000 employees to just over 200.⁹¹

rules-company-celebration [https://perma.cc/9QR7-4EVE] (reporting on a crass letter Kalanick sent to employees on how they should conduct themselves at an upcoming company celebration).

⁸⁵ See Susan J. Fowler, *Reflecting on One Very, Very Strange Year at Uber*, SUSAN J. FOWLER BLOG (Feb. 19, 2017), <https://www.susanjowler.com/blog/2017/2/19/reflecting-on-one-very-strange-year-at-uber> [https://perma.cc/FTM2-KJ7K].

⁸⁶ Craig Timberg & Elizabeth Dwoskin, *Uber Fires 20 Employees as Part of Harassment Investigation*, WASH. POST (June 6, 2017), https://www.washingtonpost.com/news/the-switch/wp/2017/06/06/uber-fires-more-than-20-employees-as-part-of-sexual-harassment-investigation/?utm_term=.98a14ca0587b [https://perma.cc/6AYY-XP53].

⁸⁷ Erin Griffith, *What Does a Management Shakeup Mean for Uber (and Silicon Valley)?*, FORTUNE (June 12, 2017), <http://fortune.com/2017/06/12/what-does-a-management-shakeup-mean-for-uber-and-silicon-valley/> [https://perma.cc/KE7W-M8WP] (reporting at least ten senior Uber executives had departed during the year). On August 27, 2017, Uber selected Dara Khosrowshahi as CEO. Mike Isaac, *Uber Chooses Expedia's Chief as C.E.O., Ending Contentious Search*, N.Y. TIMES (Aug. 27, 2017), <https://www.nytimes.com/2017/08/27/technology/uber-ceo-search.html?smid=pl-share> [https://perma.cc/7NM4-9BPT].

⁸⁸ See Ken Auletta, *Blood, Simpler: One Woman's Drive to Upend Medical Testing*, NEW YORKER (Dec. 15, 2014), www.newyorker.com/magazine/2014/12/15/Sblood-simpler [https://perma.cc/KV4H-AAA5] (describing Holmes's explanation of Theranos technology as "comically vague").

⁸⁹ See Bilton, *supra* note 9.

⁹⁰ See John Carreyrou, *Hot Startup Theranos Has Struggled with its Blood-Test Technology*, WALL ST. J. (Oct. 16, 2015), <https://www.wsj.com/articles/theranos-has-struggled-with-blood-tests-1444881901> [https://perma.cc/E23E-ZMC2].

⁹¹ See Sarah Buhr, *Theranos Slashes Another 41 Percent of its Workforce*, TECHCRUNCH (Jan. 6 2017), <https://techcrunch.com/2017/01/06/theranos-slashes-another-41-percent-of-its-workforce/> [https://perma.cc/5D4N-U8HN]; Weisul, *supra* note 82.

b. *Disruptive Business Strategies*

A number of prominent Unicorns, including Uber and Airbnb, have based their business strategy on changing, skirting, or violating existing law.⁹² These Unicorns seek to disrupt established industries by challenging the regulatory system through innovation facilitated by technology. Instead of waiting for clarity on how the law impacts their business, some Unicorns have incorporated law-breaking into their business plans. These Unicorns hoped to evade detection or break the will of regulators through public campaigns supported by customers and employees.⁹³

Both Uber and Airbnb are currently engaged in protracted struggles with drivers, localities, and regulators over contested interpretations of federal, state, and local regulations regarding licensing, tax, and classification of employees.⁹⁴ These contested issues affect core business operations. An adverse ruling or policy pronouncement could lead to serious setbacks for the firms. For example, London's transportation agency recently revoked Uber's license to operate in the city (its largest European market), concluding the company was not "fit and proper" to hold a taxi license.⁹⁵ In addition, a British employment tribunal just ruled that Uber drivers are employees, not independent contractors, and are therefore entitled to minimum wage, paid time off, and other employee protections.⁹⁶ Similarly, the Centers for Medicare and Medicaid Services banned Elizabeth Holmes from owning or managing a medical laboratory for two years, derailing Theranos's business model.⁹⁷

These Unicorns' brash attitude toward compliance with law would present problems if they were to pursue an IPO. Material legal risks must be disclosed

⁹² See Shu-Yi Oei & Diane M. Ring, *Can Sharing be Taxed?*, 93 WASH. U. L. REV. 989, 992-95 (2016) (discussing challenges in interpreting and enforcing tax laws as they apply to participants in the so-called sharing economy); Elizabeth Pollman & Jordan M. Barry, *Regulatory Entrepreneurship*, 90 S. CAL. L. REV. 383, 385-387 (2017) ("Uber and many other businesses are built around and based upon a plan to change the law—and, in some instances, to simply break the law in the meantime.").

⁹³ Mike Isaac, *How Uber Deceives the Authorities Worldwide*, N.Y. TIMES (Mar. 3, 2017), <https://www.nytimes.com/2017/03/03/technology/uber-greyball-program-evade-authorities.html?smid=pl-share> [https://perma.cc/DKN9-HCY4] (describing the "Greyball" software Uber used to block local officials from monitoring Uber's activities in their jurisdictions).

⁹⁴ See Oei & Ring, *supra* note 92, at 1019-27 (describing the debate over the application of self-employment taxes).

⁹⁵ See Prashant S. Rao & Mike Isaac, *Uber Loses License to Operate in London*, N.Y. TIMES (Sept. 22, 2017), <https://www.nytimes.com/2017/09/22/business/uber-london.html?smid=plshare&mtrref=undefined&gwh=A478C2AF7A1BC7E3829830598588CA90&gwt=pay> [https://perma.cc/6KZ6-S2BL]. Uber is appealing the decision. *See id.*

⁹⁶ Prashant S. Rao, *Uber Hit with New Blow in London as Panel Says Drivers Aren't Self Employed*, N.Y. TIMES (Nov. 10, 2017), <https://www.nytimes.com/2017/11/10/business/uk-uber-london.html?smid=pl-share&mtrref=undefined&gwh=5825310AE990C920A742C3005907E256&gwt=pay> [https://perma.cc/9UZW-KAVL].

⁹⁷ See Bilton, *supra* note 9.

in a company's public offering prospectus. Because these compliance risks go to the core of the companies' operations, their unresolved status would make it difficult for underwriters to market their shares.⁹⁸

The fast-track timeline toward an IPO created powerful incentives for VCs to replace founders who lacked the capacity to manage a growing enterprise. VCs and founders understood that underwriters would insist on a certain level of professionalism before taking a company public. They also understood that due diligence investigations were likely to unearth any deep-seated problems lurking within a firm. For a successful IPO, a company would have to persuade underwriters and investors that it had addressed flaws in its business plan and instituted necessary changes to bring its business practices into compliance with law.

2. Investor Protection

In addition to the societal concerns discussed above, commentators have drawn attention to problems caused by the dearth of information available to Unicorn investors under the current regulatory scheme. These disclosure concerns apply to investors who purchase shares directly from Unicorns and those who acquire shares in secondary trading markets. The lack of reliable information about Unicorn financial performance means publicly disclosed valuations of Unicorns are likely unreliable.⁹⁹

The Securities Act's private offering exemption is premised on the notion that investors have access to material company information and the sophistication to intelligently assess it.¹⁰⁰ Despite the broad presumption that accredited investors can rely on self-help to obtain important information, in some cases Unicorns sell shares to investors with no disclosure at all.¹⁰¹ Purchasers in secondary markets face even more difficulty assessing the value of Unicorn shares. Secondary market purchasers lack direct access to the company and are hampered in their ability to judge a company's performance. Post investment, secondary investors lack access to the traditional governance tools—periodic disclosure, proxy statements, and monitoring by the plaintiffs' bar—that could help them protect their financial interests.

When compared to the process for listing shares on a stock exchange, Unicorn founders face little threat to their secrecy and control when they allow their

⁹⁸ Cf. Deagon, *supra* note 33 ("Uncertainty never gets a good reception from Wall Street.").

⁹⁹ See, e.g., Robert P. Bartlett III, *A Founder's Guide to Unicorn Creation: How Liquidation Preferences in M&A Transactions Affect Start-up Valuation*, in RESEARCH HANDBOOK ON MERGERS AND ACQUISITIONS (Claire A. Hill & Steven Davidoff Solomon eds., 2016) (arguing that start-up valuations are unreliable in part because VC investors get special benefits not available with common stock).

¹⁰⁰ See SEC v. Ralston Purina, 346 U.S. 119, 125-26 (1953) (establishing the criteria for the private offering exemption under Securities Act Section 4(a)(1)).

¹⁰¹ See de Fontenay, *supra* note 12, at 481.

company's shares to trade in private secondary markets. No gatekeepers or analysts are involved in vetting the company.¹⁰² Founders need not worry as much about a shareholder revolt, since many have already locked down control over the board. In short, private trading markets allow start-ups and their founders to reap almost all of the benefits of an IPO without any of the associated costs.

III. WHAT SHOULD WE DO?

Unicorns rival established public companies in size and impact on the economy. Unicorns have raised \$168 billion from investors and have an estimated aggregate market value of \$900 billion.¹⁰³ Uber's estimated value is almost \$70 billion, while Dropbox, Pinterest, and Airbnb are all valued at over \$10 billion.¹⁰⁴ Their dispersed ownership structure creates many of the governance risks we typically associate with public companies. This new legal landscape invites renewed discussion of what it means to be a public company.

A. *Where to Draw the Line?*

Most recent efforts to discern the proper line between public and private companies focus on market capitalization as the relevant metric. For example, Jennifer Fan recommends that when a company reaches a valuation of \$1 billion it should be subject to limited financial reporting requirements.¹⁰⁵ Other commentators look to the extent of trading in company shares, determined by "public float," or whether shares are listed on a secondary market, to gauge disclosure obligations.¹⁰⁶

Although these metrics have merit for determining dividing lines, they sidestep governance concerns raised by exempting influential companies with a dispersed ownership structure from regulatory oversight. In addition to market capitalization, policymakers should focus on collective action problems when determining whether a company should be subject to mandatory reporting. The inquiry should focus on whether investors face obstacles to coordinated action, such that they cannot realistically protect themselves from self-dealing, mismanagement, or fraud.

Michael Guttentag's recent proposal regarding mandatory disclosure rules captures some of the concerns at the core of the Unicorn governance

¹⁰² Some private trading markets like SharesPost facilitate disclosure to investors or provide private analyst reports on companies whose shares they list for trading. The value of these research reports is hampered by the limited public information available about these firms. See Pollman, *supra* note 21, at 208-09.

¹⁰³ See CrunchBase Unicorn Leaderboards, *supra* note 75.

¹⁰⁴ *Id.*

¹⁰⁵ See Fan, *supra* note 12, at 608-10.

¹⁰⁶ See Pollman, *supra* note 21, at 222-23; Usha R. Rodrigues, *The Once and Future Irrelevancy of Section 12(g)*, 2015 U. ILL. L. REV. 1529, 1561 (2015).

trap.¹⁰⁷ Guttentag would exempt from mandatory disclosure requirements any company with a market capitalization below \$35 million or with fewer than 100 beneficial owners.¹⁰⁸ Other companies would be subject to disclosure obligations, unless they (1) maintain strict restrictions on the transfer of their shares, or (2) commit to public disclosure under an alternative regime that approximates the disclosure mandated by the Exchange Act.¹⁰⁹ The value in Guttentag's approach is that it distinguishes Unicorns from large private companies such as Cargill, Koch Industries, or Mars, which remain under family control and do not appear to present same governance problems as Unicorns, because their share ownership is not widely dispersed.¹¹⁰

B. Fundamental Questions

The significance of Unicorns in the U.S. and global economy is likely to expand. Commentary in the financial press suggests the financing model for Unicorns contributes to governance problems, and that similar structural weaknesses exist at unicorns across Silicon Valley.¹¹¹ Unfortunately, there is little concrete information available about unicorn governance and operations. We learn about problems at Unicorns only when they spill into the press through leaks, or as a result of legal or regulatory action. The absence of reliable public information about Unicorns creates barriers to research. Scholars and policymakers must make an effort to learn more about how Unicorns are governed. A range of important questions about Unicorns remains unanswered. Some avenues for future research are outlined below.

1. Why do Investors Agree to “Founder-Friendly” Terms?

Scholars need to better understand the factors that motivate VCs and other start-up investors to agree to founder-friendly terms, and how these investors expect to protect themselves and their portfolio companies from founder overreaching. Do investors view companies like Uber, Theranos, and Zenefits as exceptions to the rule? Do they view an Uber investment as a home run despite the company's current controversies? The best way to

¹⁰⁷ See Guttentag, *supra* note 12, at 208-10 (describing the criteria for exempting firms from public disclosure requirements).

¹⁰⁸ *Id.* at 207.

¹⁰⁹ *Id.* at 208-211.

¹¹⁰ See Rodrigues, *supra* note 106, at 1554-55 (explaining that large, privately-owned companies have always been part of the U.S. corporate landscape, but these companies mostly remain under family control).

¹¹¹ See Griffith, *supra* note 11 (“Faking it, from marketing exaggerations to outright fraud, feels more prevalent than ever—so much so that it's time to ask whether startup culture itself is becoming a problem.”).

answer these questions is through interviews with venture capitalists and other Unicorn investors to discern how they weigh the costs and benefits of agreeing to founder-friendly terms.

2. Is Founder-Friendly Financing Sustainable?

Another way to gauge the fate of founder-friendly financing is through analysis of the trajectories of companies like Snapchat—parent company Snap, that embraced the founder-friendly model and preserved the structure in its IPO by issuing non-voting shares to public investors.¹¹² Although Snap succeeded in raising \$3.4 billion in its IPO, its shares have since fallen below the public offering price.¹¹³ If the Snap IPO comes to be viewed as a failure in the industry, it could dampen enthusiasm for financing structures that place inordinate control in the hands of start-up founders.

3. Corporate Law's Role in Resolving Disputes with Founders

Another fruitful area for future inquiry is the potential role of state corporate law in defining fiduciary duties of founders with controlling interests in Unicorns, obtained by means of founder-friendly financing terms. The outcome of Benchmark's current suit against Travis Kalanick will figure prominently in this analysis.¹¹⁴ Will courts treat Unicorn founders like controlling shareholders with heightened duties to minority shareholders including VCs?¹¹⁵ Or will courts conclude VCs acceded to founder-friendly terms on an informed, arms-length basis, and are therefore undeserving of special protections from the court?¹¹⁶ Because Unicorns possess features of both public and private companies, it is difficult to predict how courts will

¹¹² Kurt Wagner, *One Way Snapchat's IPO Will Be Unique: The Shares Won't Come With Voting Rights*, RECODE (Feb. 21, 2017), <https://www.recode.net/2017/2/21/14670314/snap-ipo-stock-voting-structure> [<https://perma.cc/GJ6J-922X>].

¹¹³ Reuters Staff, *Snap shares fall below \$17 IPO price for the first time*, REUTERS (July 20, 2017), <https://www.reuters.com/article/us-snap-stocks-idUSKBN19V2LT> [<https://perma.cc/63FE-S922>]. On November 14, 2017, Snap's stock closed at \$12.57, more than \$4 below the \$17 IPO price. MarketWatch Stock Quote, MARKETWATCH (Nov. 15, 2017), <http://www.marketwatch.com/investing/stock/snap> [<https://perma.cc/ZX2N-8WJA>].

¹¹⁴ See *supra* notes 16–18 and accompanying text. Benchmark has agreed to drop the litigation if a pending investment in Uber by Japanese investor SoftBank goes through. See Katie Benner & Mike Isaac, *Uber Reaches Deal to Sell Stake to SoftBank*, N.Y. TIMES (Nov. 12 2017), <https://www.nytimes.com/2017/11/12/business/uber-softbank-deal.html?mtrref=undefined&gwh=393A6F2E0C5D69E5768CB58A2CF3AF60&gwt=pay> [<https://perma.cc/XR9P-G4NY>].

¹¹⁵ See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (recognizing controlling shareholders' fiduciary duties to the minority shareholders).

¹¹⁶ See, e.g., *Equity Linked Inv'rs, L.P. v. Adams*, 705 A.2d 1040 (Del. Ch. 1997) (addressing conflict between preferred stockholders and the corporation by reference to contractual terms of the preferred stock, rather than fiduciary duties owed to the preferred stockholders).

approach conflicts that arise between inordinately empowered founders and sophisticated VCs.¹¹⁷

4. Wealth as a Proxy for Investment Sophistication

A final line of inquiry the academy should engage is the sharp departure from the *Ralston Purina* standards reflected in current private financing rules and practices.¹¹⁸ Under *Ralston Purina* and progeny, exemption from registration was conditioned on investors having access to adequate information about an issuer, and the sophistication to assess it intelligently.¹¹⁹ Over time, regulators have substituted wealth for sophistication as a basis for exemption, and eliminated other longstanding constraints on unregistered securities transactions.¹²⁰ The departure from *Ralston Purina* norms is reflected throughout SEC rulemaking initiatives, including Regulation D, Rule 144 and Rule 144A, and statutes like the JOBS Act.¹²¹ A quandary for policymakers is whether special dispensations for transactions with wealthy investors merit reconsideration in light of the emergence of active private trading markets, and the record of disastrous decisions by accredited investors and QIBs that contributed to the 2008 financial crisis.¹²²

CONCLUSION

Unicorn governance structures depart dramatically from that of the traditional venture-backed start-ups. Scholars have not yet adapted corporate governance theory to address this new phenomenon. Prominent Unicorns have stumbled due to founder mismanagement or fraud. These Unicorn problems stem from a governance structure in which founders, not investors, maintain control over the board. Investors and policymakers must take steps to address the problem of unaccountable Unicorns. Policymakers can act by

¹¹⁷ The Irving Firemen's Relief Fund's recent suit against Kalanick and Uber should provide additional fodder for analysis. See Kartikay Mehrotra, *Uber, Kalanick Sued by Investors for Scandal-Related Losses*, BLOOMBERG (Sept. 26, 2017, 12:46 PM), <https://www.bloomberg.com/news/articles/2017-09-26/uber-kalanick-sued-by-investors-for-misleading-over-scandals> [https://perma.cc/LA9A-WGFJ] (discussing allegations of "illicit business tactics" against Kalanick and Uber).

¹¹⁸ SEC v. *Ralston Purina Co.*, 346 U.S. 119, 125, 127 (1953) (tying the private offering exemption to offerees being able to "fend for themselves" and having "access to the kind of information that registration would disclose").

¹¹⁹ *Id.*

¹²⁰ See, e.g., Chris Brummer, *Disruptive Technology and Securities Regulation*, 84 FORDHAM L. REV. 977, 1011-15 (2015) (describing growing significance of the Rule 144A market for transactions among institutional investors); Rodrigues, *supra* note 37, at 3417-22 (explaining the widening divide between *Ralston Purina* standards and the current regulatory bases for securities exemptions).

¹²¹ See *supra* Section I.C.

¹²² See Langevoort & Thompson, *supra* note 13, at 362-63 ("[W]e have plenty of anecdotal evidence of institutional and wealthy individual investors fending for themselves poorly").

restricting trading in Unicorn shares in the absence of adequate disclosure. Unicorn investors can act by insisting on board representation and vigilantly attending to their duties as directors to provide discipline and accountability for Unicorns. Without concerted action to constrain founder misconduct we can expect to see more Ubers in the future.¹²³

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¹²³ In the most recent Unicorn governance failure, Social Finance founder and CEO Mike Cagney resigned amid allegations of sexual harassment, lax internal controls, and a general frat-like atmosphere at the \$4 billion start-up. Nathaniel Popper & Katie Benner, *It was a Frat House: Inside the Sex Scandal That Toppled SoFi's C.E.O.*, N.Y. TIMES (Sept. 12, 2017), <https://www.nytimes.com/2017/09/12/technology/sofi-chief-executive-toxic-workplace.html> [<http://perma.cc/K4UM-V94G>].