SECURITIES REGULATION IN THE U.S.:

DESIGNED TO PROTECT NAÏVE INVESTORS FROM SOPHISTICATED ISSUERS,

BUT DOES IT PROTECT NAÏVE ISSUERS FROM SOPHISTICATED INVESTORS?

by

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Introduction

The purpose of U.S. securities laws is to protect investors by requiring full disclosure on the part of the sellers of securities (issuers). The intent is to increase the efficiency and integrity of the nation's capital markets by ensuring that all material information is publicly available. Thus, the laws were created and have been amended to provide legal redress for investors who were not provided with sufficient information to make a reasoned decision. In most respects, these laws presume relative naïveté on the part of the investors and relative knowledge and power on the part of the issuer.

There is, however, anecdotal evidence suggesting that in the sphere of new ventures, the balance of power may be tipped in favor of the investors and away from the issuers. Indeed, it is often the case that entrepreneurs, though expert in their substantive field, tend to be naïve in financial and business matters. Investors, particularly venture capitalists, on the other hand, tend to be experienced and knowledgeable in financial matters. In these circumstances, the securities laws serve to exacerbate the power imbalance in favor of the investors and leave the entrepreneurs vulnerable to unfair dealing. Specifically, because of the tenuous financial position of new ventures, any heavy-handedness on the part of investors may well kill the venture, regardless of the merits of the investors' claims. Indeed, any threat of litigation, regardless of how spurious, can paralyze a new venture.

The authors of this paper have received a grant to collect data to examine the extent of the power imbalance between investors and entrepreneurs in new ventures, and the result of any such imbalance. This paper first examines the current research regarding control mechanisms used by investors in new ventures and conflicts that arise between investors and entrepreneurs. The legal environment associated with private securities litigation is then examined in detail. This analysis will provide a legal framework in which subsequently collected data will be examined to test the authors' general proposition regarding perceived power imbalances between investors and entrepreneurs—particularly focusing on proposed sources of negotiating power entrepreneurs may possess with respect to investors. This theoretical and analytical framework can then form the basis upon which subsequent policy recommendations can be made.

Business Start-Ups and Venture Capital

The iconic perspective of modern entrepreneurship is the handful of bright, young entrepreneurs developing their product with minimal resources, sometimes literally in a garage, only to be "discovered" by venture capitalists who fund and nurture the fledgling enterprise until it becomes a public corporation and leader in its industry. And, at the same time, turning the young entrepreneurs into wealthy captains of modern industry.

Since a start-up business does not have an established product in the market, there are generally little to no revenues in the business' nascent years. A small, start-up business has a variety of sources from which it may draw operating capital: the savings of the owners; bank loans, particularly those guaranteed by the Small Business Association; friends and relatives; wealthy individuals—often referred to as "angels"; and venture capitalists.

Loans to the business are limited to the extent of the collateral of the owners and create a repayment burden while the business is still developing. Selling part of the business to an investor offers a viable alternative, as the amount of invested funds is structured on the future value of the enterprise (rather than the current unencumbered assets of its owners) and there is no direct repayment burden.

Venture capitalists have become a significant source of new venture financing in recent years.[1] By 2003, there were nearly 2,000 venture funds actively managing over $250 billion in business investments.[2] The typical venture capital process is for a venture capital firm to form a limited partnership, with itself as the general partner. Limited partners are then solicited to pledge funds to a particular venture fund. The limited partners are usually institutional investors and high-wealth

individuals. The venture capital firm manages the fund, selecting which ventures to invest in. The venture capital firm collects a set management fee, as well as shares in positive returns earned by the fund.[3]

Angels, in contrast, are generally high-wealth individuals who invest directly in a business at a very early start-up phase. Often there is some form of personal relationship between the angel and the business owner—the angel may be a relative, friend, or business associate. The availability of angels has progressed beyond just "friends and families." Angels have become more prominent and accessible, even banding together into organizations to share leads and information.[4]

Whether the initial venture funding is provided by an angel or venture capitalists, it is expected that there will be subsequent rounds of financing as the business develops, often involving more than one venture capital fund.[5] The investors' goal is a liquidity event, usually in the form of an initial public offering (IPO) of the stock of the venture. The IPO creates a market for the stock of the venture, allowing the investors to sell their ownership interest in the venture—theoretically for a substantial profit. Even where the investors and the entrepreneur are equally committed to maximizing shareholder wealth, they may have recurring disagreements regarding how to prioritize operating goals.[6] The entrepreneur's ultimate goal is to build a viable business. The investors' "long term" goal is a positive return on investment within a few years. As a result, investors and the entrepreneur have different, and possibly conflicting, priorities.[7]

Investing in small, start-up ventures involves significant risk.[8] Risk can have its rewards: venture funds collectively reported returns of 150% in 1999. But risk also sometimes means loss: as venture funds collectively reported returns greater than negative 25% in 2002.[9] One study has indicated that approximately 7% of investments account for more than 60% of venture capitalists' profits, while one-third of investments result in (sometimes total) losses.[10]

There are significant unknown variables associated with start-up ventures. By definition, the business model of a start-up has not been tested against an actual market. Most start-ups do not yet even have a product. It is unknown whether the idea can be converted to a marketable product, whether a competitive product is about to be introduced in the market, or whether the entrepreneur can manage an operational and growing business.[11] In addition, each party's self-interests may increase the risk of failure. Venture capitalists are only willing to provide the minimum funds necessary for the venture to meet discrete milestones, thereby minimizing the venture capitalists' risk if the venture appears unsuccessful in its early stages. At the same time, the entrepreneur is loath to give up too much ownership and control in the business. "Thus both venture capitalists and entrepreneurs willingly conspire to impose stringent limits on the resiliency of their enterprises."[12] While venture capitalists and entrepreneurs may initially believe they have common goals and are a partnership, when things go badly, their interests diverge.[13]

Venture capitalists attempt to control risk through governance procedures. Studies indicate that venture capitalists pursue less industry and geographic diversification when investment risk is high; therefore they manage risk through monitoring and involvement rather than through diversification.[14] When deciding whether to fund a new venture, venture capitalists must consider more than the potential success of the venture, and hence the positive return on investment. Venture capitalists must also decide how best to structure the financing to protect their own interests while simultaneously enhancing the likelihood that the new venture will succeed.[15] The foundation of this structure is governance and control.[16]

Although venture capitalists do not usually purchase a majority of the venture's stock, they do purchase enough to eventually control the company's board of directors, which has the ultimate responsibility of managing the company. The venture capitalists' equity investments in new ventures is typically in the form of convertible preferred stock.[17] In addition, venture capitalists provide financing in stages, replenishing capital only if the venture remains a potentially viable investment.[18] As the venture capitalists invest more funds over time, they generally gain more control of the venture.[19]

With this level of control, venture capitalists can exert a number of powers. For example, the venture capitalists will require disincentives for the entrepreneur to exit from the venture, particularly by requiring that entrepreneurs sell their interest in the company (back to the company) should they leave.[20] At the same time, however, venture capitalists will obtain the ability to terminate the entrepreneur if they believe more competent senior management is needed and the entrepreneur is no longer necessary for the viability of the venture.[21] Research indicates the most significant reason new ventures fail is because of ineffective senior management, meaning that venture capitalists will "frequently" fire the original senior management.[22] Some anecdotal evidence suggests the entrepreneurs face a much harsher reality as they place confidence in venture capitalists whose business models are based on generating enormous returns on a small percentage of their many investments, rather than nurturing fledgling entrepreneurs. Indeed, some entrepreneurs have thought their dreams of a successful start-up were realized when venture capitalists agreed to invest, only to find that they were left with nothing.[23] Ultimately, if the venture capitalists believe the venture is no longer viable, they can liquidate it, which includes having the company buy back the venture capitalists' stock (if there are assets to pay for the redemption).[24]

The entrepreneur, understandably, will more than likely fight any termination or liquidation decision by the venture capitalists. The entrepreneur is also not necessarily powerless, if the entrepreneur holds the knowledge necessary to make the venture viable. This may set up a conflict between the entrepreneur and the venture capitalists that ultimately may be destructive to the venture. In addition, one commentator has argued that since venture capitalists typically obtain control of the venture in the early stages of financing, they are essentially "locked in" during the early stages of the investment relationship.[25] If the venture capitalists are at odds with the entrepreneur, but the entrepreneur is too valuable to the venture to terminate or the relationship is in too early of stage for the venture capitalists to have control, the result may be retaliation.

There are reputational costs associated with venture capital financing. The expertise of venture capitalists underlies and justifies their role.[26] Having to abandon an investment altogether would logically negatively impact a venture capitalist's reputation. Abandonment because of conflicts with the entrepreneur would create a high exit cost for the venture capitalist. However, research indicates that individuals facing high exit costs may choose not to exit unfair transactions, choosing instead to remedy the unfairness by retaliating against the other party.[27] This retaliation may be in the form of litigation filed against the entrepreneur.

Of the new venture investors, venture capitalists are the most sophisticated, as indicated by the manner in which they structure their investments so as to gain control over the venture.[28] Although, as discussed below, new venture investors are usually qualified as legally "sophisticated," they may not necessarily be sophisticated from a practical perspective. Without the control mechanisms, investors can quickly find themselves committed to a venture which is not progressing as they had hoped, or is being run by an entrepreneur with which they do not agree. Without the control mechanisms favored by traditional venture capitalists, investors, such as angels or even early-stage venture capitalists, may find themselves with high exit costs and therefore also resort to retaliation.

In situations where an investor files suit against the entrepreneur, some form of claim of misrepresentation will be pursued. Unfortunately for the entrepreneur, the history surrounding the development of securities law in the United States since the 1930's has strongly favored investors over the issuer of securities (here, the entrepreneur).

Securities Regulation and Litigation

The stock market crash of 1929 exposed significant shortcomings in the regulation of the sale of securities in the United States. Post-crash, it was discovered that billions of dollars had been invested in practically worthless securities.[29] In formulating legislation to regulate the securities market, the attitude in the U.S. Senate was that "organizations and promoters … [had] sold 'fake' securities throughout this country to the tune of billions of dollars, and [had] sunk their fangs into the pocketbooks of the innocent investors with greater rapacity than a school of sharks ever sank teeth into human flesh."[30] Congressional hearings "indicted a system as a whole that had failed miserably in imposing those essential fiduciary standards that should govern persons whose function it was to handle other people's money."[31]

In 1933, President Roosevelt recommended to Congress legislation for federal supervision of traffic in investment securities. While the federal government would not take any action that could be construed as approving or guaranteeing that newly issued securities are sound or will earn a profit, it did have an obligation to insist that every issue of new securities be accompanied by full disclosure. Further, President Roosevelt believed that in order to protect the public, the burden should be on the seller of securities to tell the whole truth—changing the ancient rule of *caveat emptor* (let the buyer beware) when dealing with securities to *caveat venditur* (let the seller beware.)[32]

The result of the post-crash investigations were two major pieces of federal legislation, both of which are integral to current securities markets. The Securities Act of 1933[33] regulates the initial offering of securities to the public by requiring full disclosure of all matters relevant to the securities, through the form of a registration statement filed with the Securities and Exchange Commission (SEC) and the distribution of a prospectus to all potential purchasers. The Securities Exchange Act of 1934[34] regulates transactions in securities, particularly by regulating the activities of securities brokers and dealers and requiring companies that offer their securities to the public to regularly file reports with the SEC.

Since the aim of the Securities Act of 1933 is to protect the general public, securities that are not offered for sale to the general public can be exempt from the Act. Certain of these exempted offerings are considered "limited" because they qualify for exemption if they meet limits in the amount of funds raised and/or they are offered only to a limited number or class of investors. In 1982, the SEC promulgated Regulation D[35] to simplify and clarify existing limited offering exemptions from registration and to expand the availability of these exemptions.[36]

In particular, sales of securities to "accredited" investors are generally exempt from the Securities Act. Accredited investors include institutional investors, "insiders" (i.e., officers and directors of the company issuing the stock), and high-wealth individuals.[37] A company (issuer) is under no statutory obligation to make disclosures as long as all of the securities it offers are purchased by accredited investors. The theory is that accredited investors are experienced, sophisticated, and can afford to assume the risks of their investments.[38]

This does not mean that exempt securities are completely free of all securities regulation.[39] Regardless of the disclosure requirements from which a security offering may be exempt, all sales of securities are subject to the anti-fraud provisions of the Securities Exchange Act of 1934.[40] The SEC enforces this anti-fraud provision through Rule 10b-5, which makes unlawful the use of any scheme or artifice to defraud, as well as untrue statements of material facts, or the omission of material facts.[41] The Securities Exchange Act's anti-fraud provision may also be enforced by private parties through a civil action.

When new venture investors have lost control so that they are either in disagreement with the manner in which the venture is operated and/or they are in fear of losing their investment, they may invoke section 10b of the Securities Exchange Act. To establish a claim for securities fraud under section 10b and Rule 10b-5, the investor must prove that the entrepreneur (1) made a misstatement or an omission of a material fact; (2) with scienter (i.e., with knowledge of its falsity and with an intent to deceive); (3) in connection with the purchase or the sale of a security; (4) upon which the investor reasonably relied;

and (5) the investor's reliance was the proximate cause of his or her injury.[42] The fact that the investor purchased the securities under an exemption which did not require specific disclosures eliminates one possible defense to a securities fraud action: that the information forming the basis of the alleged misstatement or omission was fully disclosed to the investor and despite the disclosure, the investor chose to still invest in the venture.

In theory, sophisticated or professional investors who invest in new ventures via purchases in exempt offerings of securities, such as venture capital firms that are also sophisticated enough to negotiate control mechanisms, generally will insist on enough disclosures from the entrepreneur to make it highly unlikely that significant material facts can remain undisclosed without making the disclosures they do demand either false or misleading.[43] However, the current law regarding issuer disclosure obligations under the antifraud provisions of federal securities laws is both unclear and complex.[44] In addition, the new venture investor may not be as sophisticated and professional as a venture capital firm (e.g., friends and family, or an angel) and may not require sufficient disclosures, creating a later opportunity to claim that material information was not disclosed. Regardless, the mere threat to file a securities fraud claim against the entrepreneur may be sufficient to allow the investor to regain control of the venture, or to force an early buyout favorable to the investor.

Filing a lawsuit initiates a long, complex, and expensive process. A lawsuit can achieve a certain perceived strategic advantage for the plaintiff, even if there is no legitimate chance of culminating in a favorable verdict. From a new venture perspective, being accused of securities fraud has a number of consequences. First, it taints the venture. It raises the specter that the entrepreneur has misled—even swindled—the investor. Second, it freezes follow-on financing. It is a signal that the investor who has filed the lawsuit will not be providing future financing. In addition, the filing of the lawsuit raises the distinct possibility—regardless of the improbability—the venture is at risk of paying a large verdict (or settlement) in the near future. Investors will not invest in the venture if they believe they will be financing a judgment rather than actual business activities. Finally, the process of the litigation not only extracts costs in the form of funds that would otherwise be directed to actual business activities, but managers' time and energy are also diverted from the business to the litigation.

Disgruntled investors can therefore use litigation (or even just the threat of litigation) to obtain a strategic advantage—either to force a cash-out of their investment or a significant change in management or business strategy. Even if the litigation effectively ends the venture, it will at least provide a degree of liquidation from the remaining proceeds which still possibly preserves the investor's reputation—the investment decision was based on the entrepreneur's alleged fraud rather than the investor's poor decision-making.

The Private Securities Litigation Reform Act of 1995

While the U.S. Congress recognizes that private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action, it also is aware of substantial abuses in private securities litigation.[45] In 1995, Congress amended the Securities Act of 1933 and the Securities Exchange Act of 1934 by enacting the Private Securities Litigation Reform Act (PSLRA)[46] to address certain private securities litigation abuses, including:

> (1) the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action; (2) the targeting of deep pocket defendants, including accountants, underwriters, and individuals who may be covered by insurance, without regard to their actual culpability; (3) the abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle; and (4) the manipulation by class action lawyers of the clients whom they purportedly represent.[47]

The main concern of Congress was the phenomenon of "professional plaintiffs" who own a nominal number of shares in a wide range of publicly traded companies and who "race" to the courthouse, with the aid of class-action law firms, to file abusive lawsuits whenever stock prices drop.[48] While this scenario is different from the issue of disputed control between investors and entrepreneurs within new ventures, the procedures promulgated under the PSLRA apply nonetheless.

Regardless of the motive of a securities lawsuit, the reality is that it is very expensive to defend. Most of the litigation cost—up to 80%—is incurred during pre-trial discovery. [49]The cost of discovery often forces innocent parties to settle frivolous securities class actions. In addition, the threat that the time of key employees will be spent responding to discovery requests, including providing deposition testimony, often forces coercive settlements.[50] Hence, the mere threat of litigation can lead to a forced outcome favorable to a disgruntled new venture investor.

A significant portion of the PSLRA attempts to minimize the potential for frivolous securities litigation. One important strategy of the PSLRA is to raise the requirements for alleging securities fraud by requiring pleading fraud with particularity. Specifically, where a plaintiff alleges that the defendant made an untrue statement of a material fact or omitted to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading, then the plaintiff's complaint must specify each statement alleged to have been misleading, and the reason or reasons why the statement is misleading.[51]

The PSLRA reinforces the heightened pleading requirements by allowing a defendant to file a motion to dismiss the lawsuit if the plaintiff's complaint fails to meet the heightened pleading requirements.[52] To expedite the process and

minimize costs, discovery can be stayed while the court considers the motion to dismiss.[53] The plaintiff is also required to prove that the acts or omissions complained of actually caused the plaintiff to suffer the loss for which the plaintiff seeks to recover damages.[54] The PSLRA also strengthens provisions for awarding a defendant attorneys fees and costs associated with a lawsuit the court determines was brought for an improper purpose, unwarranted by existing law, legally frivolous, or not supported by facts.[55]

But Congress' attempts to stem securities litigation abuse were also self-defeating. Although Rule 9(b) of the Federal Rules of Civil Procedure already requires that fraud be pleaded with particularity, Congress believed that that rule alone had not prevented securities litigation abuse.[56] This was, in part, because the various federal courts have interpreted Rule 9(b) in different ways. Although Congress recognized that the Second Circuit Court of Appeals had adopted the most stringent interpretation of Rule 9(b) (and therefore the most stringent requirements for alleging securities fraud), Congress expressly chose not to codify the Second Circuit's interpretation in the PSLRA. This means that Congress specifically chose not to include in the pleading standard for securities fraud certain language relating to motive, opportunity, or recklessness.[57] This has resulted in confusion as to what is specifically required to successfully allege securities fraud.[58]

The confusion is reflected in a split among various federal courts as to what must be stated in a complaint for securities fraud. The split revolves primarily around the standards required to establish scienter, which is a long-established requirement for a private lawsuit under section 10(b) and Rule 10b-5.[59] An investor who has purchased the stock of a new venture does not have to prove that the entrepreneur actually set out with the intent to defraud the investor. Intent can be established indirectly—it can be inferred through the entrepreneur's conduct or through the surrounding circumstances. This is where the complexity and legal uncertainties lie.

The Second Circuit Court of Appeals interprets the fraud pleading standards under the PSLRA to establish scienter as requiring a showing, at a minimum, of a strong inference that the defendant acted with the required state of mind (i.e., to defraud).[60] This

> inference may arise where the complaint sufficiently alleges that the defendants: (1) benefited in a concrete and personal way from the purported fraud; (2) engaged in deliberately illegal behavior; (3) knew facts or had access to information suggesting that their public statements were not accurate; or (4) failed to check information they had a duty to monitor.[61]

The Third Circuit Court of Appeals has interpreted the requirements for establishing a strong inference of an intent to defraud as either an allegation of facts (a) to show that the "defendants had both motive and opportunity to commit fraud" or (b) that "constitute strong circumstantial evidence of conscious misbehavior or recklessness".[62] In contrast, the Sixth Circuit Court of Appeals has ruled that a plaintiff "may plead scienter in [section 10b] or Rule 10b-5 cases by alleging facts giving rise to a strong inference of recklessness, but not by alleging facts merely establishing that a defendant had the motive and opportunity to commit securities fraud."[63]

The Second, Third, and Sixth Circuits' approaches were summarized by the Ninth Circuit Court of Appeals when it noted that a court may: (1) apply the Second Circuit standard requiring plaintiffs to plead mere motive and opportunity or an inference of recklessness; (2) apply a heightened Second Circuit standard rejecting motive and opportunity, but accepting an inference of recklessness; or (3) reject the Second Circuit standard and accept only an inference of conscious conduct.[64] The Ninth Circuit chose to adopt a standard somewhere between the second and third approach: the evidence must create a strong inference of, at a minimum, deliberate recklessness. In other words, within the Ninth Circuit Court of Appeals, plaintiffs proceeding under the PSLRA cannot just allege intent in general terms of mere "motive and opportunity" or "recklessness," but rather, must state specific facts indicating no less than a degree of recklessness that strongly suggests actual intent.[65]

Because the pleading standards for a private lawsuit alleging securities fraud are in flux throughout the courts in the United States, the PSLRA's attempts to stem securities litigation abuse are weakened. With confusion comes opportunity. Disgruntled investors can argue that the entrepreneur's intent to deceive is inferred either through the fact the entrepreneur had the motive and opportunity or was extremely reckless in regard to the disclosures made to the investor. This leaves open the opportunity for the disgruntled investor in a new venture to attempt to force a redemption or regain control through threatened (or actually filed) securities fraud litigation, regardless of the merits of such a claim.

Examination of Power Imbalances Between Entrepreneurs and Investors

Since securities laws continue to offer a method by which disgruntled investors can regain control, force an exit, or retaliate, it is important to examine the potential power imbalances between entrepreneurs and investors. It is presumed that when an entrepreneur is negotiating with potential investors, the relative power of the entrepreneur and investor largely determine who receives the greater benefit from the investment—and, hence, greater control. It is also presumed that where the entrepreneur has more power, there is less likelihood for litigation. An entrepreneur's personal and resource attributes can enhance his or her power relative to the investor. The authors of this paper have generated nine propositions regarding potential sources of power to entrepreneurs with respect to investors, which the authors plan to investigate further and attempt to validate through the collection of data from entrepreneurs and investors.

Entrepreneurs vary in terms of financial and technical expertise and experience. The authors of this paper believe four of these factors may be important in affecting the entrepreneur's power vis-à-vis the investor: experience in new venture finance, general financial experience, expertise in the entrepreneur's industry, and negotiating experience.

Experience in New Venture Finance

While many entrepreneurs are new to the market for venture financing, other entrepreneurs have repeated experience. Entrepreneurs have been described as "novice" entrepreneurs, who have no prior business ownership experience; "serial" entrepreneurs, who have sold or closed a business in which they had an ownership stake and currently have an ownership stake in new, independent business; and "portfolio" entrepreneurs, who have concurrent ownership stakes in two or more independent businesses.[66] The latter two categories suggest that experience in entrepreneurship increases the entrepreneur's power for three reasons. First, experience provides the entrepreneur with a basis for comparison when negotiating with investors. Second, an experience curve effect may enable the entrepreneur to capitalize on his or her existing knowledge base and internal infrastructure, thereby reducing costs of capital. Third, experience is likely to generate credibility on the part of the entrepreneur.[67] The entrepreneur's experience is used by potential investors to screen applications for assistance.[68] Thus, not only will experience help the entrepreneur to see the relationship with the investor and the actual terms in a more sophisticated light, experience will also allow the entrepreneur to be seen by the investor as more capable and credible. It is therefore proposed that entrepreneurs with more entrepreneurial experience will have more power relative to investors than entrepreneurs with less entrepreneurial experience.

Financial Expertise

Expert power is demonstrated when an individual has knowledge or expertise relevant to another.[69] One commentator has suggested that the hallmark of expertise is the ability to adjust one's skills to be adaptive and successful even in the face of changes in situational demands.[70] In venture finance situations, it can generally be assumed that the investor has more financial knowledge and expertise than most entrepreneurs. However, to the extent that the entrepreneur has his or her own financial expertise, the entrepreneur's power relative to the negotiator will be enhanced. It is therefore proposed that entrepreneurs with financial expertise will have more power relative to investors than entrepreneurs without financial expertise.

Rare Substantive Expertise

Rare substantive expertise in the entrepreneur's field may also enhance the entrepreneur's power, particularly when the field is a popular one for venture capital. Where the value of the enterprise lies within the entrepreneur, then it is less likely that the investor will jeopardize the relationship with the entrepreneur than if the value lay within physical assets or intellectual property. It is therefore proposed that entrepreneurs with rare expertise in their fields will have more power relative to investors than entrepreneurs without rare expertise in their fields.

Negotiating Experience

Specific experience or training in negotiations should also give entrepreneurs power in their negotiations with investors. One study has found that while both expert and amateur negotiators were able to reach integrative solutions over time, expert negotiators were more integrative early in the negotiations and tended to secure higher average outcomes than amateur negotiators.[71] Another commentator has found that experienced negotiators make more accurate judgments about the other party's priorities and are more likely to negotiate more favorable agreements.[72]

It can be expected, then, that entrepreneurs who are experienced negotiators will be ale to negotiate more favorable terms than will novice negotiators. It is therefore proposed that entrepreneurs with specific training or experience in negotiations will have more power relative to investors than entrepreneurs without training or experience in negotiations.

Even where an entrepreneur has some personal attributes that may be advantageous in negotiations with investors, the entrepreneur is likely to strengthen his or her power through the accumulation of certain resources that are also likely to enhance power. These include strong intellectual property, loyal board members, high status alliance partners, high status legal counsel, and an advisory board.

Strong Intellectual Property

Theft of intellectual property, euphemistically called "competitive intelligence," is an important concern for every entrepreneur. Legitimate investors are acutely concerned with the protectability of entrepreneurs' intellectual property; the stronger the protection, the more valuable is the property. Less legitimate investors will be concerned for other reasons; the weaker the protection, the easier it is to appropriate. [73] In either event, strong intellectual property protection should provide

more power to entrepreneurs than weak intellectual property protection. It is therefore proposed that entrepreneurs who have strong intellectual property protection will have more power relative to investors than entrepreneurs with less experience.

Loyal Board Members

While it is often the case that investors will insist on board of directors seats, and even board control, loyal investors at least provide some buffer to this power.[74] It is therefore proposed that entrepreneurs with loyal members on the board of directors will have more power relative to investors than entrepreneurs without loyal members on the board.

High Status Alliance Partners

A number of scholars have argued that if an individual's partners possess considerable legitimacy or status, then the individual may derive legitimacy or status through that affiliation. This "borrowed" legitimacy or status has been shown to have a number of positive economic benefits for the actor, ranging from survival to organizational growth to profitability.[75]

In one of the more compelling demonstrations of the economic value of ties to high-status actors, one scholar examined the economic effects of interorganizational networks of privately held biotechnology firms and found that an affiliation with a prominent alliance partner increased the market value of the biotechnology firm.[76] Consistent with an interpretation of these ties as carriers of legitimacy, the effect of affiliations varies inversely with the age of the start-up.[77] In other words, young start-ups benefit more from the status of their network partners than did older start-ups. It is therefore proposed that entrepreneurs with high status alliance partners will have more power relative to investors than entrepreneurs without high status alliance partners.

High Status Legal Counsel

Just as high status alliance partners may be a signal of quality and hence give an entrepreneur more bargaining power, so too may the status of the entrepreneur's general counsel. Some law firms are known in the venture finance industry as higher status and more connected, knowledgeable, and capable than other law firms. Thus, such law firms may provide the entrepreneur with power relative to the investors in at least two ways. First, such law firms may suggest a certain sophistication on the part of the entrepreneur that will translate into more respect. Second, the expertise of the law firms themselves in the domain of venture capital should inure to the benefit of the entrepreneurs through good legal advice. It is therefore proposed that entrepreneurs with high status legal counsel will have more power relative to investors than entrepreneurs with low status legal counsel.

Advisory Board

One commentator has recommended that entrepreneurs create "quasi-boards of directors" or advisory boards to allow the entrepreneurs to gather expert advice without the imposing on the advisors the legal or fiduciary burdens of being board members.[78] These advisors can offer advice without becoming embroiled in operations or politics. Such advice can benefit the entrepreneur in two ways when negotiating with investors. First, the existence of the board of advisors signals that the entrepreneur is willing to listen to independent, outside advice. Second, the advisors can provide invaluable advice with respect to the negotiations themselves. It is therefore proposed that entrepreneurs with an advisory board will have more power relative to investors than entrepreneurs with no advisory board.

Conclusion

Investors in new ventures who are unhappy with the state of their investment may wish to regain control of the venture or exit the venture through liquidation. When either of those strategies becomes extremely difficult, investors may resort to retaliation by threatening to file a securities fraud lawsuit against the entrepreneur. Contrary to the assumptions of federal and state Blue Sky laws, investors in new ventures tend to be sophisticated and experienced and can use their sophistication and experience to take advantage of relatively naïve entrepreneurs. Not all venture finance deals are bad for entrepreneurs, however, suggesting that the attractiveness of the deal for the entrepreneur is contingent on a variety of factors. While the attempts to stem perceived abuses in private securities litigation through the Private Securities Litigation Reform Act of 1995 appear to soften the original securities law approach of "let the seller beware," subsequent court decisions indicate the PSLRA is no panacea. Disgruntled investors in new ventures still have a very significant weapon in their arsenal to regain control over the venture—the mere threat of a securities fraud lawsuit.

This paper has identified nine possible contingencies based upon the attributes of the entrepreneur and the entrepreneur's resources. Specifically, the authors suggest that the entrepreneur's experience in new venture finance, financial expertise, expertise in his or her field, and negotiating experience will positively affect the entrepreneur's ability to negotiate positive deals. It is further suggested that the strength of the entrepreneur's resources will positively benefit

entrepreneurs in their negotiations with investors. These resources include protectable intellectual property, loyal board members, high status alliance partners and legal counsel, and an advisory board. The authors hope to validate these suggestions by data collection—establishing attributes and resources entrepremeurs may rely upon to avoid potential securities litigation by disgruntled investors.

Footnotes

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[1] The venture capital market and firms whose creation and early stages were financed by venture capital are among the crown jewels of the American economy. Beyond representing an important engine of macroeconomic growth and job creation, these firms have been a major force in commercializing cutting-edge science, whether through their impact on existing industries as with the radical changes in pharmaceuticals catalyzed by venture-backed firms' commercialization of biotechnology, or by their role in developing entirely new industries as with the emergence of the Internet and World Wide Web. The venture capital market thus provides a unique link between finance and innovation, providing start-up and early stage firms—organizational forms particularly well-suited to innovation—with capital market access that is tailored to the special task of financing these high-risk, high-return activities.

Ronald J. Gilson, *Engineering a Venture Capitla Market: Lessons From the American Experience*, 55 STAN. L. REV. 1067, 1068 (2003) (footnote omitted).

[2] *See* Jeffrey M. Leavitt, *Burned Angels: The Coming Wave of Minority Shareholder Oppression Claims in Venture Capital Start-Up Companies*, 6 N.C. J.L. & TECH. 223 (2005).

[3] *See* Joseph Bankman & Marcus Cole, *The Venture Capital Investment Bust: Did Agency Costs Play a Role? Was It Something Lawyers Helped Structure*?, 77 CHI.-KENT L. REV. 211 (2001). *See also* Gilson, *supra* note 1.

[4] *See* Leavitt, *supra* note 2. *See also* Pui-Wing Tam, *Fresh Crop of Investors Grows in Silicon Valley*, WALL ST. J., May 1, 2006, at C1 (discussing the rise of angel investors in Silicon Valley who were previously start-up executives, particularly at Google, Inc.).

[5] *See* Michael Gorman & William A. Sahlman, *What Do Venture Capitalists Do?*, 4 J. BUS. VENTURING 231 (1989).

[6] *See* Harry J. Sapienza & Anil K. Gupta, *Impact of Agency Risks and Task Uncertainty on Venture Capitalist-CEO Interaction*, 37 ACAD. MGMT. J. 1618 (1994).

[7] In particular, entrepreneurs and venture capitalists may have different interests regarding the timing and form of exit. *See* D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA LAW REV. 315 (2005).

[8] *See id*.; and Manuel A. Utset, *Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital-Financed Firms*, 2002 WIS. L. REV. 45 (2002).

[9] *See* Douglas Cumming & Jeffrey MacIntosh, *Boom, Bust, and Litigation in Venture Capital Finance*, 40 WILLAMETTE L. REV. 867 (2004).

[10] *See* Amar Bhide, *Bootstrap Finance: The Art of Start-Ups*, HARV. BUS. REV., Sept.-Oct. 1990, at 109.

[11] *See* Sapienza & Gupta, *supra* note 6.

[12] Gorman & Sahlman, *supra* note 5 at 238.

[13] *See* Gorman & Sahlman, *supra* note 5.

[14] *See* Sapienza & Gupta, *supra* note 6.

[15] *See* Smith, *supra* note 7 at 316 ("Before venture capitalists invest, they plan for exit.").

[16] *See* Jay B. Barney et al., *The Structure of Venture Capital Governance: An Organizational Economic Analysis of Relations Between Venture Capital Firms and New Ventures*, ACAD. MGMT. PROC., 1989, at 64; and Utset, *supra* note 8.

[17] Gilson, *supra* note 1 at 1072. *See also* Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 875 (2003) ("[O]verwhelmingly, venture capitalists make their investments through convertible preferred stock.") (footnote omitted).

[18] *See* Gilson, *supra* note 1; and Smith, *supra* note 7.

[19] *See* Smith, *supra* note 7 at 324 ("More often than not, venture capitalists do not acquire a majority of the votes in the initial round of financing. In subsequent rounds of financing, the venture capitalists build their voting power, and at some time within the first few rounds, venture capitalists acquire a majority of the votes.") (footnotes omitted).

[20] *See* Utset, *supra* note 8.

[21] *See, e.g., infra* note 74 discussing an entrepreneur forced out of the company he founded two months after venture capitalists gained control of the company's board of directors.

[22] *See* Gorman & Sahlman, *supra* note 5.

[23] *See* Reynolds Holding, *Double-Crossed: Silicon Valley Entrepreneurs Say They Have Been Betrayed By Venture Capitalists and Lawyers, The Very People They Asked for Help*, S.F. CHRON., Nov. 17, 1999, at A1.

[24] *See* Utset, *supra* note 8.

[25] Smith, *supra* note 7 at 317. Indeed, Gilson & Schizer, *supra* note 17, argue that the use by venture capitalists of convertible preferred stock is more for tax purposes rather than control.

[26] *See* Bankman & Cole, *supra* note 3.

[27] *See* Utset, *supra* note 8.

[28] *See id*.

[29] *See* S. REP. NO. 73-47 (1933).

[30] 77 CONG. REC. 1019 (Mar. 30, 1933) (Change of Ccommittee Reference of S. 875 to the Senate Committee on Banking and Currency).

[31] James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959).

[32] *See* H.R. REP. NO. 73-85 (1933).

[33] 15 U.S.C. § § 77a to 77aa.

[34] 15 U.S.C. § § 78a to 78mm.

[35] 17 C.F.R. part 230.

[36] *See* Manning Gilbert Warren III, *A Review of Regulation D: The Present Exemption Regimen for Limited Offerings Under The Securities Act of 1933*, 33 AM. U. L. REV. 355 (1984).

[37] 17 C.F.R. § 230.501.

[38] *See* Warren, *supra* note 36.

[39] *See generally* Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985).

[40] Section 10b; 15 U.S.C. § 78j.

[41] 17 C.F.R. § 240.10b-5.

[42] *See* Anish Vashista et al., *Securities Fraud*, 42 AM. CRIM. L. REV. 877 (2005).

[43] *See* Harry S. Gerla, *Issuers Raising Capital Directly From Investors: What Disclosure Does Rule 10b-5 Require?*, 28 J. CORP. L. 111 (2002).

[44] *See id*.

[45] *See* H.R. CONF. REP. NO. 104-369 (1995).

[46] Pub.L. 104-67, 109 Stat. 737.

[47] H.R. CONF. REP. NO. 104-369, at 31 (1995).

[48] *Id*. at 32-33.

[49] *Id*. at 37.

[50] *Id*.

[51] 15 U.S.C. § 78u-4(b).

[52] 15 U.S.C. § 78u-b(b)(3)(A).

[53] 15 U.S.C. § 78u-b(b)(3)(B).

[54] 15 U.S.C. § 78u-b(b)(4).

[55] 15 U.S.C. § 78u-b(c). *See also*, H.R. CONF. REP. NO. 104-369, at 39 (1995).

[56] *See* H.R. CONF. REP. NO. 104-369 (1995).

[57] *Id*. at 41, n.23.

[58] *See* Joseph T. Phillips, *A New Pleading Standard Under the Private Securities Litigation Reform Act?*, 69 U. CIN. L. REV. 969 (2001).

[59] *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); and Novak v. Kasaks, 216 F.3d 300 (2nd Cir. 2000).

[60] Novak, *supra*.

[61] *Id*. at 311 (citations omitted).

[62] Press v. Chemical Investment Services Corp., 166 F.3d 529, 538 (3rd Cir. 1999).

[63] In re Comshare, Inc., Sec. Litig., 183 F.3d 542, 549 (6th Cir. 1999).

[64] *See* In re Silicon Graphics, Inc., Sec. Litig., 183 F.3d 970 (9th Cir. 1999).

[65] *Id*. at 979.

[66] *See* Paul Westhead et al., *Decisions, Actions, and Performance: Do Novice, Serial, and Portfolio Entrepreneurs Differ?*, 43 J. SMALL BUS. 393 (2005).

[67] *See id*.

[68] *See* Paul Westhead & Mike Wright, *Contributions of Novice, Portfolio and Serial Founders Located in Rural and Urban Areas*, 33 REGIONAL STUD. 157 (1999); and Ian MacMillan et al., *Criteria Used by Venture Capitalists to Evaluate New Venture Proposals*, 1 J. BUS. VENTURING 119 (1985).

[69] *See* John R. P. French & Bertran Raven, *The Bases of Social Power*, *in* STUDIES IN SOCIAL POWER 150 (Dorwin Cartwright ed., 1966).

[70] *See* Donald W. Fiske, *The Inherent Variability of Behavior, in* FUNCTIONS OF VARIED EXPERIENCE 326 (Donald W. Fiske & Salvatore R. Maddi eds., 1961).

[71] *See* Margaret A. Neale & Gregory B. Northcraft, *Experts, Amateurs, and Refrigerators: Comparing Expert and Amateur Negotiators in a Novel Task*, 38 ORG. BEHAV. & HUM. DECISION PROCESSES 305 (1986).

[72] *See* Leigh Thompson, *An Examination of Naïve and Experienced Negotiators*, J. PERSONALITY & SOC. PSYCHOL. 82 (1990).

[73] *See, e.g.*, Holding, *supra* note 23 discussing one incident in which an entreprenuer sought funding from a venture capital firm only to discover that the very next day a new company was formed to make the same product for the same market—funded by the same venture capital firm.

[74] *See, e.g.*, *id*., also discussing an incident in which an entrepreneur allowed a venture capital firm to gain control of the board of directors, only to find himself fired from his own company two months later.

[75] *See* Joel A. C. Baum & Christine Oliver, *Institutional Embeddedness and the Dynamics of Organizational Populations*, 57 AM. SOC. REV. 540 (1992); Joel M. Podolny & Damon J. Phillips, *The Dynamics of Organizational Status*, 5 INDUSTRIAL & CORP. CHANGE 453 (1996); and Joel M. Podolny, *A Status-Based Model of Market Competition*, 98 AM. J. SOC. 829 (1993).

[76] *See* Toby E. Stuart et al., *Interorganizational Endorsements and the Performance of Entrepreneurial Ventures*, 44 ADMIN. SCI. Q. 315 (1999).

[77] *See id*.

[78] *See* Harold W. Fox, *Quasi-Boards: Useful Small Business Confidants*, HARV. BUS. REV., Jan.-Feb. 1982, at 158.