Summary of Doctoral Research Project

Conflicting Fiduciary Duties and Fire Sales of VC-backed Start-ups

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Venture capital plays an important role in building many of the most visionary and influential firms across the world. Besides providing capital, VC investors add value through strong corporate governance facilitated by sophisticated contractual provisions and active involvement as board of directors that oversees the operation of portfolio firms.

However, VC-affiliated board members have dual fiduciary duties which often conflict with each other. On the one hand, VC-affiliated board members have powerful financial incentives and legal obligation to maximize the return of limited partners investing in the VC fund, which typically holds convertible preferred shares in startups. On the other hand, VC-affiliated board members face the legal duty to maximize the value of the corporation for the benefit of its common shareholders – typically founders and other employees. However, due to various VC contractual terms such as liquidation preferences in the convertible preferred shares, the preferred and common shareholders often have different payoffs. Such conflicts are particularly evident when VC funds are forced to exit from portfolio firms under liquidity pressure caused by the limited lifespan of traditional fund structure, which has become an increasingly common source of VC-related litigation based on fiduciary grounds.

My doctoral research project provides the first systematic evidence that sales by VC funds near the end of fund lives are characterized by a substantially lower sale price, a greater probability of being sold to industry outsiders with lower bidding valuation and a positive abnormal return for acquirers. These features indicate the existence of fire sales, i.e., forced sales at dislocated price, which satisfy VCs' liquidation preferences but hurt common shareholders' interest, thus leaving board members with conflicting fiduciary duties. Exploiting a critical case ruling of *In re Trados* by the Delaware Court of Chancery in 2013, which established the landmark rule of common shareholder value maximization and received a large amount of attention in the VC community, we find that maturing VCs become less likely to exit by fire sales and distribute cash to their investors less timely after the court ruling due to increased litigation risks. However, the U.S. VC market experienced a "chilling effect" on fundraising compared to international markets, suggesting the potential cost of a common-favoring legal regime.

My research is directly related to Sequoia's recent radical restructuring into a singular and permanent fund so that Sequoia can avoid incentive misalignment and provide patient capital for promising firms that choose to stay private for longer. On a broader level, my work highlights the limitation of existing corporate law system rooted in "more traditional" public and closely held corporations, which are characterized by a homogeneous shareholder basis with an indefinite investment horizon. Such model has not kept pace with the innovative VC-backed startups that have complex financial structures and different types of shareholders. Fiduciary duties are critical institution of almost all important jurisdictions worldwide including Canada. Therefore, understanding the trade-offs of optimal fiduciary design for board members in VC-backed startups will allow venture capital to better foster innovation for Canada through better corporate governance.