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Due Diligence Dilemma

Law Working Paper N° 849/2025
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Abstract

This Article examines venture capital ("VC") due diligence practices in the wake of FTX's collapse and a broader rise in startup fraud. It introduces the "due diligence dilemma": a core tension between the imperative to invest rapidly and the widespread, yet often unfulfilled, expectation that VC firms serve as effective gatekeepers through independent diligence. The Article argues that this dilemma is exacerbated by cyclical market conditions, which give rise to a collective action problem. Individual VC firms are incentivized to expedite investments and rely on others' diligence efforts in order to maintain a founder-friendly reputation. The result is "proxy due diligence"—a practice of inferring trustworthiness from the presence of other reputable investors rather than conducting independent verification. While this approach may be rational for VC firms and their limited partners—who can hedge against failure through portfolio diversification—it can result in real harms to employees, customers, and other stakeholders who treat VC investment as a proxy for reliability. The Article suggests that the current legal framework, which primarily depends on private ordering between sophisticated private parties, may not adequately address these wider implications. The Article explores potential legal and regulatory responses, ranging enforcement actions to more prescriptive due diligence requirements, and concludes by addressing the fundamental question underlying this discussion: are the potential impacts on uninvolved parties simply an unavoidable trade-off for innovation-driven economic growth, or might carefully designed policy interventions encourage venture capital firms to consider the wider social implications of their investment and oversight decisions?

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DUE DILIGENCE DILEMMA

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This Article examines venture capital ("VC") due diligence practices in the wake of FTX's collapse and a broader rise in startup fraud. It introduces the "due diligence dilemma": a core tension between the imperative to invest rapidly and the widespread, yet often unfulfilled, expectation that VC firms serve as effective gatekeepers through independent diligence. The Article argues that this dilemma is exacerbated by cyclical market conditions, which give rise to a collective action problem. Individual VC firms are incentivized to expedite investments and rely on others' diligence efforts in order to maintain a founder-friendly reputation. The result is "proxy due diligence"—a practice of inferring trustworthiness from the presence of other reputable investors rather than conducting independent verification. While this approach may be rational for VC firms and their limited partners, who can hedge against failure through portfolio diversification, it can result in real harms to employees, customers, and other stakeholders who treat VC investment as a proxy for reliability. The Article suggests that the current legal framework, which primarily depends on private ordering between sophisticated private parties, may not adequately address these wider implications.

The Article explores potential legal and regulatory responses, ranging from enforcement actions to more prescriptive due diligence requirements, and concludes by addressing the fundamental question underlying this discussion: are the potential impacts on uninvolved parties simply an unavoidable trade-off for innovation-driven economic growth, or might carefully designed policy interventions encourage VC firms to consider the wider social implications of their investment and oversight decisions?

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I. INTRODUCTION

"Doesn't anyone do due diligence anymore?" The question, posed by an industry observer, encapsulated one of the core issues brought to light by the collapse of FTX, once the world's third-largest crypto exchange by volume.[1] The crisis, characterized by John Ray, FTX's court-appointed CEO and chief restructuring officer, as the most severe he has encountered in his forty-year career,[2] has revealed a range of red flags that were seemingly overlooked in the investment process.[3] These include a lack of proper financial bookkeeping, record-keeping, and security controls to safeguard customers' funds, inadequate risk

1. Brooke Masters, *Doesn't Anyone Do Due Diligence Any More?*, FIN. TIMES (Nov. 29, 2022), https://www.ft.com/content/e739d9ed-b8ee-4d8e-ad29-0d01889d5775 [https://perma.cc/BTP9-4B2J].

2. *See* Jack Schickler, *SEC Investigating FTX Investors' Due Diligence: Reuters*, COINDESK (Jan. 9, 2023, 5:57 PM), https://www.coindesk.com/policy/2023/01/06/sec-investigating-ftx-investors-due-diligence-reuters [https://perma.cc/GA2Y-A4SP].

3. *See, e.g.*, Jonathan C. Lipson & David A. Skeel, *FTX'd: Conflicting Public and Private Interests in Chapter 11*, 77 STAN. L. REV. 369, 374 (discussing how FTX's collapse mirrors some of the most infamous corporate failures in history, such as Enron and Lehman Brothers, but with the added layer of complexity brought on by the global and decentralized nature of crypto markets).

management practices, inexperienced financial officers, previous vocal concerns that were raised by former team members regarding potential mishandling of funds, and significant conflicts of interest, especially due to the relationship between FTX and Alameda Research, a crypto-trading firm also founded by FTX's founder, Sam Bankman-Fried ("SBF").[4]

FTX's collapse has marked a fleeting moment of reckoning for Silicon Valley's storied venture capital firms. Unlike previous high-profile startup scandals, such as Theranos and WeWork, where Silicon Valley could claim a safe distance, attributing faults to outsiders or operational misjudgments in sectors far removed from the tech epicenter,[5] FTX was undeniably a creature of Silicon Valley. Its founder, SBF, born and raised on the Stanford University campus to two Stanford Law School professors, embodied the quintessential tech-prodigy archetype.[6] The company drew over $2 billion in investments from a diverse mix of investors including New Enterprise Associates ("NEA"), Sequoia Capital, Lightspeed Venture Partners, Institutional Venture Partners, Insight Partners, Third Point

4. *See* Brandon Kochkodin, *The Red Flags on FTX We All Seemed to Miss*, FORBES (Nov. 16, 2022, 1:43 PM), https://www.forbes.com/sites/brandonkochkodin/2022/11/11/the-red-flags-on-ftx-we-all-seemed-to-miss/ [https://perma.cc/72LK-VMDK]; Georges Ugeux, *The FTX Collapse: Why Did Due Diligence, Regulation, and Governance Evaporate?*, CLS BLUE SKY BLOG (Nov. 30, 2022), https://clsbluesky.law.columbia.edu/2022/11/30/the-ftx-collapse-why-did-due-diligence-regulation-and-governance-evaporate/ [https://perma.cc/NY8A-GZ6W].

5. *See* ILYA STREBULAEV & ALEX DANG, THE VENTURE MINDSET: HOW TO MAKE SMARTER BETS AND ACHIEVE EXTRAORDINARY GROWTH 95–98 (2024); Sebastian Mallaby, *What Elizabeth Holmes and Theranos Reveal About Venture Capitalism*, N.Y. TIMES (Jan. 24, 2022), https://www.nytimes.com/2022/01/24/opinion/theranos-venture-capital.html [https://perma.cc/AA9S-X669] ("The Theranos debacle fails as an indictment of venture capital for two reasons. First, nearly all the money raised by the company came not from venture capitalists but from technology outsiders."); Randall Stross, *Don't Blame Silicon Valley for Theranos*, N.Y. TIMES (Apr. 27, 2016), https://www.nytimes.com/2016/04/27/opinion/dont-blame-silicon-valley-for-theranos.html ("It is tempting to see Theranos as another example of Silicon Valley hype . . . however, Silicon Valley's most experienced investors in start-ups saw red flags at Theranos before anyone else."); Rebecca Heilweil, *Silicon Valley Wants You to Know Theranos Isn't Silicon Valley*, VOX (Sept. 10, 2021, 12:20 PM), https://www.vox.com/recode/22665179/silicon-valley-theranos-elizabeth-holmes-covid-tests [https://perma.cc/QB3L-8LPS] ("Silicon Valley doesn't seem fazed by the trial or concerned about its outcome. Theranos, though inspired by its culture, was not backed by major venture capital firms from the tech industry."); *see also* Jillian D'Onfro, *Bill Maris: Here's Why Google Ventures Didn't Invest in Theranos*, YAHOO FIN. (Oct. 20, 2015), https://finance.yahoo.com/news/bill-maris-heres-why-google-223355854.html [https://perma.cc/RXB8-49E2]; Henry Grabar, *We Blew It*, SLATE (Sept. 25, 2019, 7:52 PM), https://slate.com/business/2019/09/wework-adam-neumann-blew-it.html [https://perma.cc/J9UA-ZS2K] ("The WeWork debacle isn't an indictment of the tech industry—just companies that pretend to be part of it."); Vijay Govindarajan & Anup Srivastava, *No, WeWork Isn't a Tech Company. Here's Why That Matters*, HARV. BUS. REV. (Aug. 21, 2019), https://hbr.org/2019/08/no-wework-isnt-a-tech-company-heres-why-that-matters [https://perma.cc/KDK3-RN88] ("Pundits have long argued that it is not a tech company, but a modern-day real estate company . . . .").

6. *See* Elizabeth Weil, *Wait, But Weren't His Parents Law Professors? The Stanford Genius Bubble That Birthed SBF*, N.Y. MAG. (Nov. 19, 2022), https://nymag.com/intelligencer/2022/11/sbf-parents-stanford-genius-bubble.html [https://perma.cc/48FM-64P5].

Ventures, Tiger Global, and SoftBank, as well as large-scale financial institutions like Temasek Holdings and BlackRock.[7]

In the aftermath of FTX's collapse, the U.S. Securities and Exchange Commission ("SEC") asked the company's investors to provide information on whether they had established due diligence procedures and if these were followed in their decisions to invest in FTX.[8] Subsequently, the SEC's Division of Examinations included in its 2024 Examination Priorities evaluating due diligence practices of private equity ("PE") and VC fund advisers for consistency with their policies, procedures, and disclosures in assessing prospective portfolio companies.[9]

Alongside these regulatory inquiries, a class action lawsuit filed against Sequoia Capital, Thoma Bravo, and Paradigm Operations takes an aggressive stance on investor responsibility.[10] The lawsuit alleges that these investors were not merely victims of FTX's fraud, but rather active participants who lent crucial credibility to the crypto exchange through their investments and public endorsements.[11] It further claims that these experienced firms either failed to conduct proper due diligence or willfully overlooked red flags, effectively implicating them as enablers in FTX's fraudulent activities.[12]

The aftershocks of FTX's collapse have reverberated throughout the VC landscape, amplifying calls for a comprehensive overhaul of due diligence standards.[13] Addressing their own oversight, Sequoia Capital has openly committed to enhancing its due diligence for future investments, acknowledging that they were misled by FTX.[14] This sentiment has been further fueled by the recent tech downturn, which has laid bare a series of financial irregularities among VC-backed companies with alarming regularity.[15]

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7. *See* Hema Parmar & Gillian Tan, *FTX Fiasco Hits Investors from Tiger Global to Tom Brady*, BLOOMBERG (Nov. 9, 2022, 12:26 PM), https://www.bloomberg.com/news/articles/2022-11-09/tom-brady-tiger-global-among-investors-hurt-by-ftx-fiasco [https://perma.cc/9JUX-RAUK].

8. *See* Hannah Lang & Chris Prentice, *U.S. Securities Regulator to Drop Lawsuit Against Coinbase, Firm Says*, REUTERS (Feb. 21, 2025, 3:29 PM), https://www.reuters.com/technology/us-securities-regulator-drop-lawsuit-against-coinbase-exchange-says-2025-02-21/ [https://perma.cc/WC5U-VN9N].

9. SEC DIV. OF EXAMINATIONS, 2024 EXAMINATION PRIORITIES 11 (2024) https://www.sec.gov/files/2024-exam-priorities.pdf (last visited July 17, 2025) [https://perma.cc/E9WF-UDP9].

10. *See* Alison Frankel, *Column: Latest FTX Lawsuit Casts Investors Sequoia, Thoma Bravo as Co-Conspirators*, REUTERS (Feb. 15, 2023, 4:21 PM), https://www.reuters.com/legal/column-latest-ftx-lawsuit-casts-investors-sequoia-thoma-bravo-co-conspirators-2023-02-15/ [https://perma.cc/5YHM-DNNJ].

11. *See* Complaint at 2, 10, Rabbitte v. Sequoia Cap. Operations, LLC., No. 3:23-cv-655 (N.D. Cal. Feb. 14, 2023) [hereinafter Rabbitte Complaint].

12. *Id.* at 2.

13. *See* Valen Moscow, *Special Edition: DD Goes Forensic on FTX*, MEDIUM (Nov. 15, 2022), https://medium.com/@m5_20436/special-edition-dd-goes-forensic-on-ftx-b33c816bf66 [https://perma.cc/8V6A-SS63]; David Bogoslaw, *VCs Renew Their Focus on Due Diligence*, VENTURE CAP. J. (Mar. 1, 2023), https://www.venturecapitaljournal.com/ftx-fallout-vcs-renew-focus-on-due-diligence/ [https://perma.cc/H3PT-A9ZU].

14. *See* Vandana Singh, *Sequoia Capital to Improve Due Diligence After FTX Crypto Exchange Fiasco*, YAHOO FIN. (Nov. 23, 2022), https://finance.yahoo.com/news/sequoia-capital-improve-due-diligence-164848513.html [https://perma.cc/HQ4Y-UKWE].

15. *See* Erin Griffith, *The End of Faking It in Silicon Valley*, N.Y. TIMES (Apr. 15, 2023), https://www.nytimes.com/2023/04/15/business/silicon-valley-fraud.html [https://perma.cc/6SF9-GZ6A]; Erin Griffith, *No*

However, determining the appropriate scope of due diligence that VCs should undertake remains a difficult question. Due diligence practices in VC are predominantly influenced by market norms and the internal policies of each fund and are not governed by specific regulatory mandates.[16] General partners ("GP") in VC funds have a legal obligation to act in the best interests of the fund and its limited partners ("LP"), which requires a certain level of care and diligence when making investment decisions.[17] Under Delaware alternative entity law, which is commonly applied to these partnerships, GPs have a duty of care to refrain from gross negligence, reckless conduct, intentional misconduct, or knowingly violating the law while managing the partnership's business.[18] However, in practice, fiduciary duties often play a limited role in VC because limited partnership agreements ("LPA") frequently include exculpations that modify or limit these default duties and restrict the remedies available to LPs.[19] Likewise, while promising to conduct due diligence, and then failing to do so, may constitute an actionable misrepresentation, VCs rarely make explicit commitments to perform specific due diligence activities.[20] This approach reflects the need for flexibility in VC, where investments inherently involve high-risk decisions that often must be made quickly.[21]

Given this deliberately flexible approach to VC investing, recent calls for increased due diligence appear to rest on a flawed premise that clear, standardized criteria exist for VC firms to evaluate potential portfolio companies. However, the reality is more nuanced: due diligence practices evolve with market dynamics,[22] and the legal literature provides no definitive framework for their appropriate scope. Though due diligence remains an essential tool for risk mitigation, it imposes tangible and reputational costs, as well as significant time

Oversight: Inside a Boom-Time Start-Up Fraud and Its Unraveling, N.Y. TIMES (Dec. 22, 2023), https://www.nytimes.com/2023/12/22/technology/headspin-silicon-valley-startups.html [https://perma.cc/HUQ2-3LYQ].

16. *See* Wulf A. Kaal, *Private Fund Investor Due Diligence: Evidence from 1995 to 2015*, 36 REV. BANKING & FIN. L. 257, 312 (2016) ("[L]egal guidance on private fund due diligence is very limited and the private fund industry is left to its own devices to ensure adequate due diligence standards.").

17. *See* Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 SUFF. U. L. REV. 927, 927–28 (2004).

18. DEL. CODE. ANN. tit. 6, § 15-404(c) (2025). *See also* Claire A. Hill & Brett H. McDonnell, *Stone v. Ritter and the Expanding Duty of Loyalty*, 76 FORDHAM L. REV. 1769, 1795 (2007) ("Classic duty of care cases also involve a director taking for herself something which should otherwise be the corporation's: her attention and diligence.")

19. *See, e.g.*, David Rosenberg, *The Two "Cycles" of Venture Capital*, 28 J. CORP. L. 419, 432 (2003) (Delaware cases on general partner fiduciary duties focus on interpreting partnership agreements rather than default legal duties.); *see also* William W. Clayton, *High-End Securities Regulation: Reflections On The SEC's 2022–23 Private Funds Rulemaking*, 13 HARV. BUS. L. REV. 71, 107 (2023) (describing that, as demand for PE and VC investments increased, fund managers negotiated for more flexible non-price covenant terms in limited partnership agreements); Deborah A. DeMott, *Corporate Officers as Agents*, 74 WASH. & LEE L. REV. 847, 869 (2017) ("Agency law acknowledges the possibility of contractual solutions by embracing a role for agreements between principals and agents that define in advance the applicable standard of performance.").

20. *See* Kaal, *supra* note 16, at 286.

21. Jennifer S. Fan., *Nontraditional Investors*, 48 BYU L. REV. 463, 527 (2022).

22. *See infra* Section IV.A.

constraints, on VC firms.[23] Therefore, the decision to pursue due diligence extends beyond a simple transaction-level cost-benefit analysis.[24] In particular, cyclical patterns in the VC market, combined with factors like power law returns and path dependency, significantly influence both the incentives and capacity for due diligence.[25] During boom periods, intense competition for coveted deals elevates the importance of speed and efficiency, often compelling VCs to streamline their diligence process.[26] The reputational risk of being perceived as slow or difficult to work with can jeopardize future deal flow, creating a powerful counterbalance to exhaustive evaluation.[27] Conversely, market downturns typically allow for more deliberate and comprehensive due diligence as deal flow naturally slows.[28]

This analysis highlights the unintended consequences of high-risk VC strategies. Skipping or cutting corners on due diligence may sometimes be optimal for LPs, but it can lead to broader social costs. VC investments serve as credibility indicators for startups to key stakeholders such as employees, customers, and suppliers.[29] These stakeholders erroneously assume that thorough due diligence precedes capital deployment.[30] The mismatch between this perception and actual practices during market peaks can lead to adverse consequences that extend beyond individual deals, potentially impacting the broader ecosystem's integrity.[31]

This Article explores approaches to improving VC due diligence while acknowledging their limitations. One proposal suggests mandatory regulations prescribing strict requirements, but such mandates risk constraining essential flexibility and may trigger capital substitution without improving deal integrity.[32] While the SEC and Department of Justice ("DOJ") play important roles, their enforcement efforts face resource constraints and competing priorities, particularly regarding public companies.[33] Overreliance on ex post enforcement may also weaken incentives for robust ex ante due diligence. [34]

Instead, this Article proposes refining soft-law instruments and quasi-regulatory mechanisms to elevate standards without mandating rigid procedures. First, we recommend that the SEC issue non-binding guidance on context-sensitive due diligence, including sector-specific expectations. Industry bodies might develop a voluntary VC Due Diligence Code similar to corporate governance codes. Furthermore, RegTech tools could streamline diligence tasks, reducing the tradeoff between speed and scrutiny. Finally, enforcement should target high-

23. *See infra* Section IV.A.
24. *See infra* Section IV.A.
25. *Infra* Section II.A.
26. *See infra* notes 81–84 and accompanying text.
27. *See infra* Section IV.B.
28. *See infra* notes 81–84 and accompanying text.
29. *Infra* Section III.C.
30. *Infra* Section III.C.
31. *Infra* Section III.C.
32. *See infra* Section IV.B.
33. *See infra* Section IV.B.
34. *See infra* Section IV.B.

salience deterrent cases involving gross negligence or fraud, not routine judgment errors. This balanced approach improves standards through incentive alignment, information infrastructure, and selective enforcement rather than heavy-handed regulation.

This Article continues as follows: Part II revisits VC due diligence practices, contrasting prevailing assumptions with their application in today's fast-paced VC markets.[35] It also examines the rise of "proxy due diligence" as a response to competitive pressures and its detrimental effect on meaningful diligence and fraud detection.[36] Part III analyzes liability frameworks for due diligence failures available to both LPs within VC funds and third parties, including breach of fiduciary duty, securities fraud, and misrepresentation.[37] It then examines whether these liability arrangements create efficient or inefficient outcomes.[38] Part IV offers policy recommendations, proposing that VCs act as the "cheapest cost avoider" in the startup ecosystem.[39] It further explores solutions such as mandatory due diligence regulations, public enforcement, and technology-based approaches.[40] It concludes by considering whether these proposed remedies might prove worse than the disease itself, while advocating for a more balanced approach.[41] We close by emphasizing the need for a balanced regulatory framework that promotes both innovation and accountability in the VC landscape.[42]

II. REVISITING DUE DILIGENCE PRACTICES IN VC

While due diligence is often described as a meticulous process of separating unicorns from donkeys in the startup herd, actual VC practices frequently take a less rigorous approach, relying more on quick judgments and gut feelings than exhaustive investigations.[43] This section explores the discrepancies between the thorough scrutiny often portrayed in VC literature and the realities of investment decision-making, particularly during market peaks.

A. Conventional Wisdom on VC Due Diligence

Research describes VC firms as financial intermediaries, directing funds from investors to promising startups.[44] A critical component of their value added

35. *See infra* Part II.
36. *See infra* Section II.C.
37. *See infra* Part III.
38. *See infra* Section III.C.
39. *See infra* Section IV.A.
40. *See infra* Section IV.B.
41. *See infra* Section IV.B.
42. *See infra* Part V.
43. *See infra* Part II.
44. *See, e.g.*, Paul Gompers & Joshua Lerner, *The Venture Capital Revolution*, 15 J. ECON. PERSPS. 145, 155 (2001) ("Specialized financial intermediaries, such as venture capital organizations, can alleviate these information gaps . . . .").

is purportedly their thorough deal selection process. For instance, Strebulaev and Dang describe the "venture mindset," portraying VCs as "risk reduction engineers,"[45] and explaining that VCs approach potential investments with an almost scientific rigor, using investment memoranda to "pressure-test ideas" and bring hidden risks to light instead of hiding them.[46] This characterization of VCs as meticulous risk assessors is supported by survey findings on how VCs define their role and strategy for value creation. In a large-scale survey of nearly 900 VC investors, respondents were asked to rank three core aspects of their work: deal sourcing, deal selection, and post-investment value-add services.[47] Nearly half (49%) identified deal selection as the most critical driver of value,[48] far surpassing post-investment involvement (27%) and deal sourcing (23%).[49]

VCs focus on what is often called the 'three Ts': team, technology, and total addressable market ("TAM").[50] The process typically begins with exploratory due diligence, combining information provided by founders with VCs' own initial research.[51] Initial founder-provided materials typically include a business plan, while personal interviews offer deeper insights into the proposed product or service, target market, and the founding team's experience.[52] If this exploratory phase proves promising, VCs proceed to more in-depth confirmatory due diligence after signing a term sheet.[53]

In contrast, the confirmatory stage occurs after signing a term sheet and includes a more thorough examination of the target company.[54] This latter stage, often conducted by external service professionals, aims to verify and expand upon the information gathered during the exploratory phase.[55] The scope of due diligence typically varies based on the investment round, with early and later rounds focusing on different aspects of the company.[56] Early-round due diligence examines three key areas: capitalization matters—including cap tables, convertible securities, cash flow rights, protective provisions, pre-emptive rights, voting

45. STREBULAEV & DANG, *supra* note 5, at 101–04.

46. *Id.*

47. *See* Paul A. Gompers, Will Gornall, Steven N. Kaplan & Ilya A. Strebulaev, *How Do Venture Capitalists Make Decisions?*, 135 J. FIN. ECON. 169, 186 (2020)

48. *Id.*

49. *Id.*

50. *See* James J. Marcellino & Dexter L. Kenfield, *Due Diligence as a Two-Edged Sword: Potential Liability of Venture Capitalists Funding High-Tech Start-Ups*, 2 SANTA CLARA COMPUT. & HIGH TECH. L.J. 41, 48 (1986).

51. *Id.*; *see also* Aram Attar, *Why Venture Capital Due Diligence Fails*, VC FACTORY, https://thevcfactory.com/why-venture-capital-due-diligence-fails/ (last visited July 17, 2025) [https://perma.cc/2QRG-UFMU]; Nelson Ctr. for Entrepreneurship, *Good Governance in Venture Capital Conference*, BROWN UNIV. (Feb. 14, 2023), https://entrepreneurship.brown.edu/good-governance-venture-capital/ [https://perma.cc/AU5S-74BR] ("References are both on sheet and off sheet so you call the people they don't tell you about that maybe they've worked with and that can tell you a lot.") .

52. *See* Marcellino & Kenfield, *supra* note 50.

53. *See* Attar, *supra* note 51.

54. *Id.*

55. *Id.*

56. NICHOLAS A. DORSEY & VIRGINIA M. ANDERSON, VENTURE CAPITAL 2024 USA: LAW & PRACTICE 10 (Chambers and Partners ed. 2024), https://www.cravath.com/a/web/qtauHRtkL68hXNS4WE7Unz/91Paqo/chambers_venture-capital-2024_020_usa-lp.pdf [https://perma.cc/FS9N-86JB].

agreements, and outstanding debt;[57] incentive alignment among founders, key employees, and stockholders through employment and equity arrangements;[58] and ownership of essential intellectual property, including patents, licenses, and IP assignment agreements.[59]

As companies progress to later investment rounds, the due diligence process becomes more robust, encompassing a wider range of legal and business aspects, including: a comprehensive review of the company's financial statements, legal documents, and debt agreements, if relevant;[60] scrutiny of the product or service, assessing its scalability, intellectual property protection, and production process;[61] market analysis, examining the company's positioning and growth potential;[62] revenue growth, margins, cash management, and projections;[63] risk assessment, including potential legal claims;[64] corporate structure, material agreements with customers and suppliers, and asset evaluation;[65] and labor and employment agreements, including compensation arrangements and assignment of intellectual property[66] and so on.

The due diligence process unfolds in a structured manner, beginning with the lead investor providing a due diligence request list to the company.[67] In response, the company typically populates a virtual data room with the requested materials.[68] This initial exchange is often followed by a period of back-and-forth communication between the company and investor, addressing various follow-up requests based on initial findings.[69] As part of this process, diligence sessions may be scheduled with management, covering critical topics such as business overview, valuation model, or regulatory matters.

The depth and breadth of the due diligence process is reflected in the substantial time and resources VCs invest in deal selection. The same survey by Gompers et al. found that on average, VCs spend 118 hours per investment, take eighty-three days to close a deal, and call ten references per deal.[70] According to the literature, this meticulous approach results in high selectivity, with empirical

57. *Id.*
58. *Id.*
59. *Id.*
60. *Id.*
61. *See* Rachel Landy, *Exit Engineering*, 20 N.Y.U. J.L. & BUS. 27, 50–55 (2023) (business lawyers' role in preparing startups for due diligence). *See generally* Brendan Daley, Thomas Geelen & Brett Green, *Due Diligence*, 79 J. FIN. 2115 (2024) (due diligence in the M&A context).
62. *See* Landy, *supra* note 61, at 86–87.
63. *Id.* at 50–53; *see also* Good Governance in Venture Capital Conference, *supra* note 51, at 56:10–56:22 (statement of Morgan Cheatham, Bessemer Venture Partners) (discussing analyzing the quality and transparency of data provided in data rooms).
64. DORSEY & ANDERSON, *supra* note 56.
65. Good Governance in Venture Capital Conference, *supra* note 51, at 56:28–56:39 ("[T]alking to customers, understanding why they purchased a product, do they plan to expand with a company").
66. DORSEY & ANDERSON, *supra* note 56.
67. *Id.*
68. *Id.*
69. *Id.*
70. *See* Gompers et al., *supra* note 47, at 177.

studies showing that VCs typically evaluate approximately 100 potential portfolio companies for each investment made.[71] Remarkably, this 100:1 ratio has remained consistent for almost three decades, evincing the enduring rigorousness of VC due diligence.[72]

While Gompers et al. quantify the actions taken during the due diligence process, Kaplan and Strömberg illuminate the qualitative reasoning VCs employ to transform their research into investment decisions.[73] Their study of forty-two portfolio company investments shows that VCs consistently include rationales in investment memoranda, focusing on market opportunities, management quality, and risk assessment.[74] The study further details how VCs conduct their due diligence, drawing on various sources including "other portfolio companies, independent consulting/research firms, surveys, and interviews of potential customers, industry participants, and investment banking analysts."[75] Importantly, they also find evidence suggesting that VCs' initial appraisals of the management team, competition, and strategy, are related to subsequent investment performance.[76]

Thus, the literature characterizes VCs as meticulous in their due diligence practices. However, recent high-profile incidents have cast doubt on the consistent application of this supposedly rigorous approach.[77] Notable scandals, exemplified by FTX's collapse, have prompted a critical reassessment. The following section describes the factors that contributed to apparent lapses in the due diligence process.

B. Due Diligence in a Frenzied VC Market

The idealized portrayal of VC due diligence in literature does not always align with actual VC behavior under certain market conditions. Douglas Cumming and Jeffrey MacIntosh recognized this situation in the aftermath of the dot-com crash.[78] Their analysis, "Boom, Bust, and Litigation in Venture Capital Finance," offers insights into how market cycles influence VC behavior, including

71. *See* STREBULAEV & DANG, *supra* note 5, at 99; Gompers et al., *supra* note 47, at 176 (explaining that for each deal closed, VCs consider 101 potential investments on average). *See generally* Bob Zider, *How Venture Capital Works*, HARV. BUS. REV., 131 (Nov.-Dec. 1998).

72. *Id.*

73. *See* Steven N. Kaplan & Per Strömberg, *How Do Venture Capitalists Choose Investments?*, 1 (Univ. of Chi., Working Paper, 2000).

74. *Id.* at 19–20.

75. *Id.* at 10.

76. *Id.* at 19.

77. *See, e.g.*, Yanying Lyu & Lingbo Shen, *Once Bitten, Twice Shy: Evidence From Venture Capital and Scam Startups*, ECGI (Aug. 6, 2023), https://www.ecgi.global/content/once-bitten-twice-shy-evidence-venture-capital-and-scam-startups [https://perma.cc/6CAA-7D2V] (noting that "scam startups are on the rise in recent years"); Kimberly Gleason, Yezen H. Kannan & Christian Rauch, *Fraud in Startups: What Stakeholders Need to Know*, 29 J. FIN. CRIME 1191, 1212 (2022) (describing how investors in Zenefits likely failed to investigate thoroughly or ignored red flags to participate in series C funding round).

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

due diligence.[79] Cumming and MacIntosh identify the "Boom Period Dilemma," stemming from the tension between the influx of new funds during boom periods and the scarcity of experienced managers to effectively deploy and oversee these investments.[80] They argue that the surge in capital leads to larger portfolio sizes per manager, straining managerial capacity and often compelling VCs to reduce per-investment effort, including scaling back on due diligence activities.[81] They also find that, during boom periods, VCs tend to shift their focus to later-stage investments, which inherently require less intensive scrutiny due to established track records and clearer market positions.[82] Consequently, according to Cumming and MacIntosh, the quality of the average firm in VCs' portfolios tends to decline in boom periods.[83]

The past decade has corroborated Cumming and MacIntosh's market cycle analysis. As VCs shifted their attention to later-stage investments, the emergence of "unicorns"—private companies valued at $1 billion or more—amplified the challenges they predicted.[84] The demand for unicorn deals strained VCs' managerial capacity, moving the industry away from traditional vetting processes.[85] Even established financial institutions have admitted to limited due diligence for high-profile deals.[86] Furthermore, since the dot-com era, new types of investors have gained significant influence in the startup ecosystem, intensifying the dynamics that Cumming and MacIntosh identified. These investors—including corporate VC arms, PE firms, mutual funds, hedge funds, and sovereign wealth funds—have introduced an unprecedented amount of capital and novel investment approaches.[87] Their presence has intensified competition for both favorable terms and deal speed, dramatically accelerating investment timelines and compressing due diligence.[88] For example, Tiger Global Management, a prominent hedge fund, has become known for its rapid investment decisions, sometimes

79. *Id.*

80. *Id.* at 879 (describing the challenge of profiting from rapidly raising and administering new funds given the "inelasticity of managerial talent in the short run").

81. *Id.*

82. *Id.*

83. *Id.*

84. *See The Complete List of Unicorn Companies*, CB INSIGHTS, https://www.cbinsights.com/research-unicorn-companies (last visited July 17, 2025) [https://perma.cc/6KFT-WCAX]; *see also* Renee M. Jones, *The Unicorn Governance Trap*, 166 U. PA. L. REV. ONLINE 165, 178 (2017) (describing the rise of the unicorns).

85. *See* Jennifer S. Fan, *Regulating Unicorns: Disclosure and the New Private Economy*, 57 B.C. L. REV. 583, 586–89 (2016); Matthew Wansley, *Taming Unicorns*, 97 IND. L.J. 1203, 1215 (2022) (describing instances of unicorn misconduct and lack of VC oversight).

86. For example, prior to Uber's 2019 IPO, Morgan Stanley offered its wealthiest clients a $475 million special fund of new Uber preferred stock, admitting to "limited due diligence" and no independent verification of provided information. *See* Fan, *supra* note 85, at 637–38.

87. *See* Anat Alon-Beck, *Alternative Venture Capital: The New Unicorn Investors*, 87 TENN. L. REV. 982, 990–91 (2020); Fan, *supra* note 21, at 466.

88. *See* Fan, *supra* note 21, at 507.

completing due diligence in mere days.[89] Similarly, SoftBank's Vision Fund adopted an aggressive investment strategy, often committing to multi-billion-dollar deals after minimal due diligence and brief meetings.[90] PE and hedge funds entering the VC space have introduced a more quantitative approach, focusing on financial metrics and growth rates rather than management teams or technology.[91]

The increased competition and persistently overheated market environment, fueled by a prolonged zero interest-rate environment, have led to severe time constraints for both investors and law firms, sometimes involving inexperienced legal staff in VC deals.[92] Consequently, due diligence has often become hurried and superficial, with investors occasionally cutting corners in the race to be the first to extend a term sheet.[93] Thus, the rigorous practices documented in Gompers et al.'s influential study,[94] appear anachronistic in the context of the 2020s VC landscape.[95] For instance, the average of ten reference calls per deal has been reduced or eliminated, and background checks are increasingly skipped.[96] Legal safeguards have also diminished, with legal opinions required in only about half of venture deals, compared to approximately three-quarters just three years prior.[97]

Still, the entry of new sources of capital represents only part of a larger picture. The following section explores how broader market dynamics and

89. *See How Tiger Global Is Changing Silicon Valley*, ECONOMIST (June 24, 2021), https://www.economist.com/business/2021/06/24/how-tiger-global-is-changing-silicon-valley [https://perma.cc/72LC-EKW5]; *see also* Everett Randle, *Playing Different Games: Or Why Tiger Is Eating Your Lunch (& Your Deals)*, VALLEY OF DUNNING-KRUGER (Apr. 12, 2021), https://randle.substack.com/p/playing-different-games [https://perma.cc/P78W-P7EX] (Everett Randle, Principal at Founders Fund, takes pride in "[e]xtremely light diligence process, sometimes just one day with a single meeting and a P&L [profit and loss] or any readily available financial data").

90. *See* Arash Massoudi, Kana Inagaki & Leo Lewis, *SoftBank: Inside the 'Wild West' $100bn Fund Shaking Up the Tech World*, FIN. TIMES (June 19, 2018), https://www.ft.com/content/71ad7cda-6ef4-11e8-92d3-6c13e5c92914 [https://perma.cc/L3KE-LX6A]; *see also* Kate Clark, *The Dark Side of the Funding Boom: Skimpy Due Diligence, Burnout*, INFO. (Aug. 12, 2021, 6:00 AM), https://www.theinformation.com/articles/the-dark-side-of-the-funding-boom-skimpy-due-diligence-burnout [https://perma.cc/KMV2-5L4T] ("Increasingly, venture capitalists are facing more intense pressure to not only win deals but ink them as quickly as possible."); William Mcquillan, *The Importance of Speed in Venture Investing*, FRONTLINE (July 15, 2020), https://frontline.vc/blog/the-importance-of-speed-in-venture-investing/ [https://perma.cc/UV5Z-Y3QV] (describing how historically, VCs could afford to be slow, but market dynamics have changed and speed is now a competitive advantage, which is why strategies like the "swarm" process to accelerate due diligence help VCs stay competitive in closing deals quickly).

91. Marc Vartabedian, *Asset Managers Help Supercharge Venture-Capital Sector*, WALL ST. J. (July 14, 2021, 6:00 AM), https://www.wsj.com/articles/asset-managers-help-supercharge-venture-capital-sector-11626256800 [https://perma.cc/5DC4-WNUN]; SEBASTIAN MALLABY, THE POWER LAW: VENTURE CAPITAL AND THE MAKING OF THE NEW FUTURE 273–300 (2022).

92. Vartabedian, *supra* note 91; *see also* Hilary J. Allen, *Interest Rates, Venture Capital, and Financial Stability*, 2025 U. ILL. L. REV. (forthcoming 2025) ("In such an environment, it would not be surprising for herding to intensify, startup valuations to increase, and diligence standards to suffer . . . .").

93. *See* Fan, *supra* note 21, at 507–08.

94. *See* Gompers et al., *supra* note 47, at 170.

95. *See id.* at 189.

96. *See* Fan, *supra* note 21, at 507–09.

97. *Id.* at 509–10.

competitive pressures within the VC ecosystem influence investment decisions, often in ways that challenge traditional notions of VC due diligence.

C. "Proxy Due Diligence" and the Neglect of Fraud Detection

VC success hinges not on avoiding poor investments, but rather on participating in rare "home runs"—investments that yield exponential returns.[98] Data shows that a tiny fraction of VC investments (around 6%) accounts for the majority of returns (typically 60% or more).[99] A single extraordinarily successful company can make or break a VC's portfolio by offsetting losses from underperforming investments.[100] This power law distribution of returns shapes the VC landscape, driving funds to aggressively pursue certain deals. Moreover, success in VC is path dependent: firms with profitable exits gain access to promising startups, while those without such a track record are sidelined.[101] This dynamic intensifies pressure to join high-profile deals, sometimes leading firms to invest with minimal scrutiny to avoid missing transformative opportunities.[102]

The fear of missing out ("FOMO") on the next unicorn due to cautious decision-making or prolonged due diligence has become a significant concern for investors, altering the nature of VC competition.[103] Traditionally, VC competition centered on valuation—the price investors pay for equity in a startup.[104] However, with abundant capital and limited top-tier entrepreneurial talent, the battleground has shifted to non-price elements, particularly founder-

98. *See* PETER THIEL & BLAKE MASTERS, ZERO TO ONE: NOTES ON STARTUPS, OR HOW TO BUILD THE FUTURE 86–87 (2014) (discussing the power law of VC returns and stating that "the best investment in a successful fund equals or outperforms the entire rest of the fund combined"); Hervé Lebret, *Venture Capital Is Not Even a Home Run Business. It's a Grand Slam Business*, START-UP (Oct. 3, 2016), https://www.startupbook.com/2016/10/03/venture-capital-is-not-even-a-home-run-business-its-a-grand-slam-business/ [https://perma.cc/3QHS-TKKR].

99. Lebret, *supra* note 98.

100. *See, e.g.*, SCOTT KUPOR, SECRETS OF SAND HILL ROAD 39 (2019) ("[W]hat matters most is your 'at bats per home run.'").

101. *Id.* at 36–37 ("To become a top VC firm . . . you have to get yourself into that good part of the power-law curve."); *see also* Mark Suster, *The Changing Structure of the VC Industry*, FORTUNE (July 22, 2014, 9:15 AM), https://fortune.com/2014/07/22/the-changing-structure-of-the-vc-industry/ [https://perma.cc/FE3E-ZZKE] (noting that leading venture capital firms are consistently attracting and securing a disproportionate and growing share of the total available investment capital in the industry); Abraham J.B. Cable, *Incubator Cities: Tomorrow's Economy, Yesterday's Start-Ups*, 2 MICH. J. PRIV. EQUITY & VENTURE CAP. L. 195, 238 (2013) (explaining industry concentration and how VCs favor a small number of industries, noting that some commentators believe that "VC firms continue their historical industry focus because of path dependency—they have expended significant resources acquiring industry-specific knowledge that they use to select, monitor, and provide managerial assistance to their portfolio companies").

102. Fan, *supra* note 21, at 507–08.

103. *See, e.g.*, Rizki Candra, Aisah Aisah, Nugraha Nugraha & Imas Purnamasari, *Fear of Missing Out (FOMO) & Investment Decision: A Systematic Literature Review*, *in* 288 ADVANCES IN ECON., BUS. & MGMT. RSCH.: PROCEEDINGS OF THE 8TH GLOB. CONF. ON BUS., MGMT., & ENTREPRENEURSHIP (GCBME 2023) 68, 68 (2024) (reviewing studies on Fear of Missing Out and investment, with a focus on VC); Allen, *supra* note 92.

104. Cumming & MacIntosh, *supra* note 78, at 867–68.

friendliness.[105] Prominent firms like Founders Fund build their brands around a philosophy of backing founders' judgment, offering autonomy attractive to high-quality entrepreneurs who value control to implement their vision.[106]

This shift reshapes due diligence by subtly redirecting attention away from fraud detection and toward assessing a startup's innovative potential. In venture capital, some degree of failure is expected—and even valued—as part of the broader process of technological advancement.[107] As Schumpeter famously observed, startups drive technological progress through "creative destruction"—the necessary upheaval of existing market structures.[108] Therefore, high failure rates are not merely accepted but serve as a crucial mechanism for market refinement and technological advancement.[109] But while innovation risk is essential and unavoidable, fraud risk stems from deliberate deception aimed at unlawful gain.[110] Fraudulent activities corrode the startup ecosystem by misallocating capital, undermining market integrity, and eroding trust.[111] Unlike innovation risk, fraud represents an unnecessary and destructive force that should be minimized.[112] Yet in practice, the competitive drive to secure access to top deals and maintain founder-friendly reputations encourages investors to concentrate on innovation narratives rather than probe for signs of misconduct. [113] Engaging founders on vision and upside is seen as productive and relationship-enhancing; asking hard questions about finances or governance is not. The result is a diligence culture skewed toward optimism—one that may overlook warning signs of fraud until it is too late.

105. *See* Josh Lerner, *Venture Capital in a Time of Turmoil*, *in* FINANCIACIÓN EMPRESARIAL Y EMPRENDIMIENTO, at 17 (2024) (highlighting that the rise of "founder friendly" terms in VC deals can be attributed to increased competition among VCs for access to potentially high-return startups in a landscape where returns are heavily skewed toward a few successful deals); *see also* Brian J. Broughman & Matthew T. Wansley, *Risk-Seeking Governance*, 76 VAND. L. REV. 1299, 1305 (2023) ("VCs with founder-friendly reputations gain a competitive advantage in ex ante pricing when contracting with risk-averse founders.").

106. *See* Bruce Gibney, *What Happened to the Future? Our Manifesto*, FOUNDERS FUND, https://foundersfund.com/2017/01/manifesto/ (last visited July 17, 2025) [https://perma.cc/MRY9-FY5H] ("Founders Fund has never removed a single founder—we invest in teams we believe in, rather than in companies we'd like to run—and our data suggest that finding good founding teams and leaving them in place tends to produce higher returns overall.").

107. Bogoslaw, *supra* note 13.

108. *See* JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY 81–87 (1943).

109. *See* William R. Kerr, Ramana Nanda & Matthew Rhodes-Kropf, *Entrepreneurship as Experimentation*, 28 J. ECON. PERSPS. 25, 38 (2014) ("Innovation requires running experiments that will often fail."); *see also* Elizabeth Pollman, *Startup Failure*, 73 DUKE L.J. 327, 366 (2023) (discussing the advantages of Silicon Valley's approach to startup failures which is to normalize failure and redeploy the resources); Gustavo Manso, *Motivating Innovation*, 66 J. FIN. 1823, 1824 (2011) (showing that incentive structures designed with tolerance for early failure and reward for long-term success are most effective in motivating innovation).

110. *See generally* Elizabeth Pollman, *Private Company Lies*, 109 GEO. L.J. 353 (2020).

111. *Id.*

112. *Id.* at 369; Verity Winship, *Private Company Fraud*, 54 UC DAVIS L. REV. 663, 681 (2020) (on the applicability of these key anti-fraud provisions to private companies); Wansley, *supra* note 85. *See generally* Kimberly C. Gleason, Yezen H. Kannan & Christian Rauch, *Fraud in Startups: What Stakeholders Need to Know*, 29 J. FIN. CRIME 1191 (2022). On investors' role in this development, see generally Andrew Jennings, *Criminal Investors*, 93 GEO. WASH. L. REV. 46 (forthcoming 2025) (discussing when culpable investors should be prosecuted).

113. Wansley, *supra* note 85, at 1207.

Thus, pressure to maintain a competitive edge has created a collective action problem: While thorough due diligence would benefit the entire ecosystem, each individual VC is incentivized to rely on others' diligence efforts while expediting their own investments to maintain a founder-friendly reputation necessary for securing future deals.[114] This dynamic leads investors to engage in "proxy due diligence," relying on vetting conducted by other, often more established firms.[115] As Bill Gurley, a prominent VC and partner at Benchmark, cautioned: "Perhaps the biggest mistake untapped investors will make is assuming that because there are branded investors already in the company, that the new investment opportunity must be of high quality. They use the reputation of the other investors as a proxy for due diligence."[116] This practice effectively turns fraud detection into a game of hot potato, increasing systemic risk in the industry.[117]

Indeed, post-mortem accounts reveal how FTX's investors prioritized examining technological and market potential and overlooked fraud and governance risks.[118] Sequoia Capital exemplifies this pattern: despite claiming a "rigorous diligence process," they invested $214 million and failed to uncover the problematic ties between FTX and Alameda Research.[119] The hyper-competitive 2021 market had put intense time pressure on Sequoia's team, led by Alfred Lin and Michelle Bailhe, likely pushing them to rely on reputation and other investors rather than conduct deep vetting.[120] But this oversight was not unique to Sequoia. Tiger Global, another major investor, had hired Bain & Co. for due

114. *See, e.g.*, Jennifer S. Fan, *Catching Disruption: Regulating Corporate Venture Capital*, 2018 COLUM. BUS. L. REV. 341, 382 (2018) (explaining that "since general partners are repeat players in the venture capital industry, there is an understanding between them and their portfolio companies that they will act appropriately and conform to shared expectations based on previous deals in the venture capital arena"); Bernard Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 254 (1998) (arguing that "[t]he venture capital fund's proffer of its reputation to third parties who have dealings with a portfolio company is credible because the fund is a repeat player").

115. *See generally* Attar, *supra* note 51 (discussing the connection between factors like FOMO, cost concerns, competence gaps and the emergence of "proxy due diligence"). *See also* Douglas Cumming & Simona Zambelli, *Due Diligence and Investee Performance*, 23(2) EUR. FIN. MGMT. 211, 213 (2017) (finding that in the private equity context, in-house due diligence leads to better investee performance, while outsourced diligence may result in poorer fund-investee matching and weaker outcomes); Jack Xiaoyong Fu & Lucian A. Taylor, *Due Diligence and the Allocation of Venture Capital* (Wharton Sch. Research Paper, Nov. 8, 2024), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=5014747 (documenting, through cell phone signal data, the intensity of due diligence in venture capital and finding that lower diligence, driven by market heat and geographic distance, is associated with more volatile investment performance).

116. *See* Bill Gurley, *On the Road to Recap: Why the Unicorn Financing Market Just Became Dangerous . . . For All Involved*, ABOVE THE CROWD (Apr. 21, 2016), https://abovethecrowd.com/2016/04/21/on-the-road-to-recap/ [https://perma.cc/BPT5-2MDL] (coining the term "proxy due diligence").

117. *Id.*

118. *See* Aram Attar, *SBF, Holmes, Madoff: How They Fooled Investors*, VC FACTORY, https://thevcfactory.com/sbf-holmes-madoff-how-they-fooled-investors/ (last visited July 17, 2025) [https://perma.cc/7AFG-C8FZ].

119. *Id.*

120. *Id.*

diligence before their $38 million investment.[121] Yet, both granted SBF too much leeway, dazzled by his wunderkind image and the hype surrounding FTX.

In summary, the divergence between idealized due diligence and its actual practice during market peaks presents a challenge. The prevalence of proxy due diligence and the neglect of fraud risks suggest a need for intervention. However, any regulatory approach must be carefully calibrated to balance fostering innovation with safeguarding against misconduct. The next section examines the legal frameworks governing potential liability for VC due diligence failures, which largely rely on private ordering.

III. LIABILITY FOR FAILING TO CONDUCT DUE DILIGENCE

As VCs face mounting scrutiny over due diligence practices, their liability follows two distinct paths: well-established frameworks of private ordering with investors and nascent standards for third-party claims.

A. From the Perspective of the Limited Partners in the VC Fund

VC funds are predominantly structured as limited partnerships, which operate under a different governance framework than corporations.[122] While corporations are governed by boards of directors elected by shareholders, limited partnerships are controlled exclusively by GPs, with LPs typically restricted to passive investment roles under the LPA and relevant state law.[123] Delaware law, under which most of these partnerships are registered, allows for extensive tailoring of fiduciary duties and restriction of LPs' rights to sue for breaches.[124] This legal flexibility, combined with the VC industry's strong path dependency in returns, creates a significant disincentive for LPs to bring claims against GPs for failing to conduct due diligence.[125]

This section outlines the key causes of action available to LPs and third parties when VCs perform inadequate due diligence. We examine the main legal theories, including breaches of fiduciary duty, securities law violations, contractual breaches, aiding and abetting, and negligent misrepresentation. While other

121. *See* Hema Parmar, *Tiger Global's Now-Worthless FTX Bet Had Bain's Due Diligence*, BLOOMBERG (Nov. 21, 2022, 10:03 PM), https://www.bloomberg.com/news/articles/2022-11-21/tiger-global-s-now-worthless-ftx-bet-had-bain-s-due-diligence [https://perma.cc/XLU8-V8PS].

122. Ribstein, *supra* note 17, at 934.

123. *See* DEL. CODE ANN. tit. 6, § 17-303(a) (2024) (codifying the control limitation on LPs).

124. The Delaware Revised Uniform Limited Partnership Act ("DRULPA"), DEL. CODE ANN. tit. 6 §§ 17-1101(c) et seq., and many other state limited partnership statutes give partners in a limited partnership a significant amount of freedom to contractually modify the default provisions of the applicable state statute, with the exception of a bad faith violation of the implied contractual covenant of good faith and fair dealing, which cannot be waived.

125. *See* Kyle D. Calzia, Note, *Venture Capital Culpability: Potential Liabilities for Venture Capital Investment of Fraudulent Portfolio Companies*, 40 SANTA CLARA HIGH TECH. L.J. 331, 347 (2024) ("There are few examples of limited partners of a VC fund bringing any claim against the venture capitalists who manage the fund, and even fewer where suit is brought against a venture capitalist from both subsets of investors (LP Fund investors and portfolio company investors)."); Rosenberg, *supra* note 19, at 421 (discussing reasons for LPs' reluctance to sue GPs).

claims—such as professional malpractice, and common law fraud—may be pertinent, this discussion concentrates on the most frequently invoked legal frameworks.[126]

1. Breach of Fiduciary Duty

GPs in VC funds owe fiduciary duties to the fund and its LPs—unless the parties agree otherwise.[127] These duties, primarily the duty of care and the duty of loyalty, arise from common law under principles of equity.[128] The duty of care requires GPs to exercise the level of prudence that a reasonably careful person would in similar circumstances, while the duty of loyalty requires GPs to act in the best interests of the fund and its LPs, avoiding self-dealing and conflicts of interest without proper disclosure and approval.[129]

Drawing from corporate law principles, GPs are generally expected to consider all material information reasonably available before making significant investments—a standard that typically entails conducting due diligence to gather material facts about potential investments.[130] However, the VC landscape is significantly shaped by private ordering.[131] Delaware Revised Uniform Limited Partnership Act ("DRULPA") permits LPAs to expand, restrict, or eliminate any duties (including fiduciary duties) of a member, manager, or other person,[132]

126. *See* Kaal, *supra* note 16, at 283 (presenting the causes of action listed in the plaintiffs' complaints against private fund adviser defendants from 1995 to 2015).

127. DEL. CODE ANN. tit. 6, § 17-303(a) (2024); *see also* Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555, 560 (2012) ("[U]nder Delaware alternative entity law, managers owe fiduciary duties as a default, in the absence of an agreement to the contrary."); Rosenberg, *supra* note 19, at 431–32 ("Delaware limited partnerships–in all areas of business including venture capital-overwhelmingly choose to modify the default duties under Delaware law, and to negotiate specific fiduciary duties suitable to their specific relationship.").

128. *See* Manesh, *supra* note 127, at 561.

129. While the DRULPA does not explicitly state this standard, Delaware courts have often looked to corporate fiduciary duty principles when evaluating the actions of GPs in limited partnerships. *See* In re USACafes, L.P. Litigation, 600 A.2d 43, 43 (Del. Ch. 1991) (the Court of Chancery held that those in control of a limited partnership owe fiduciary duties similar to those owed by corporate directors, including duties of care and loyalty); *see also* Rosenberg, *supra* note 19, at 430 ("[DRLPA] does not define these duties. Rather, they have been defined in the state's case law addressing the same duties in the corporate context, and then applied directly to cases involving limited partnerships.").

130. *See* Smith v. Van Gorkom, 488 A.2d 858, 872–73 (Del. 1985) (explaining that the duty of care is "a director's duty to exercise an informed business judgment").

131. *See* Manesh, *supra* note 127 ("[U]nlike Delaware corporate law, Delaware alternative entity law has long allowed firms to contractually limit or even eliminate the fiduciary duties of managers through the terms of the firm's operating agreement.").

132. *See* DEL. C. ANN. tit. 6 § 18-1101(c) (2024); *see also* Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 817 A.2d 160, 170 (Del. 2002) ("[A] general partner owes the traditional fiduciary duties of loyalty and care to the limited partnership and its partners, but [the Delaware Limited Partnership Act] expressly authorizes the . . . modification, or enhancement of these fiduciary duties in the written agreement governing the limited partnership.").

except for the implied contractual covenant of good faith and fair dealing.[133] This covenant, inherent in all Delaware contracts, requires parties to act consistently with the agreed-upon spirit of the contract and not to undermine its purpose, but it cannot be invoked to reintroduce fiduciary duties that have been expressly waived in the agreement.[134]

In practice, LPAs typically include exculpation provisions that protect the GP and its affiliates from liability for breaches of the duty of care.[135] For example, a typical clause might state:

> Notwithstanding any other terms of this Agreement, whether express or implied, or obligation at law or in equity, neither the General Partner, nor the Management Company nor their respective members, former members, assignees, employees, agents or Affiliates, nor Advisory Board members in their capacities as Advisory Board members, (individually, an "Exculpated Party" and collectively, the "Exculpated Parties") shall be liable to a Limited Partner or the Partnership for honest mistakes of judgment, or for action or inaction, taken reasonably and in good faith for a purpose that was reasonably believed to be in the best interests of the Partnership.[136]

Such clauses effectively raise the standard of liability, making it difficult for LPs to bring successful claims based on ordinary negligence. Courts generally uphold these waivers when they are clear, unambiguous, and result from negotiations between sophisticated parties.[137] Given that LPs are typically institutional investors, such as pension funds, endowments, and family offices, or high-net-worth individuals capable of understanding complex agreements, courts tend to enforce explicit waivers.[138]

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133. *See* Leo E. Strine, Jr. & J. Travis Laster, *The Siren Song of Unlimited Contractual Freedom*, in RESEARCH HANDBOOK ON PARTNERSHIPS, LLCS AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS 25–26 (Robert W. Hillman & Mark J. Loewenstein eds., 2015).

134. *See* Nemec v. Shrader, 991 A.2d 1120, 1131 (Del. 2010) (emphasizing that the implied covenant "should not be applied to give the plaintiffs contractual protections that they failed to secure for themselves at the bargaining table").

135. *See* Manesh, *supra* note 127, at 558 (examining operating agreements of publicly traded Delaware alternative entities and finding that 88% either fully waived fiduciary duties of managers or eliminated liability arising from breaches of such duties).

136. *See* Shea Tate-Di Donna & Kaego Ogbechie Rust, *Example: Limited Partnership Agreement—LPA*, *in* THE VENTURE FUND BLUEPRINT BOOK, 49.

137. *See* Manti Hldgs., LLC v. Authentix Acquisition Co., 261 A.3d 1199, 1237 (Del. 2021); *id.* at 1232. When evaluating reasonableness, courts consider five factors: (i) a written contract formed through actual consent, (ii) a clear provision, (iii) sophisticated stockholders who understand the provision's implications, (iv) the ability to reject the provision, and (v) the presence of bargained-for consideration. *Id.* at 1204.

138. *See, e.g.*, Norton v. K-Sea Transportation Partners L.P., 67 A.3d 354, 356 (Del. 2013) (the Delaware Supreme Court upheld a limited partnership agreement that eliminated fiduciary duties owed by the general partner to the limited partners. The court emphasized that when the partnership agreement clearly modifies or eliminates fiduciary duties, and the parties are sophisticated, such provisions are enforceable.); Brinckerhoff v. Enbridge Energy Co., Inc., 159 A.3d 242, 252–53 (Del. 2017) (the Delaware Supreme Court upheld dismissal of fiduciary duty claims based on a partnership agreement that eliminated common-law fiduciary duties and replaced them with contractual standards. The court found that the agreement's provisions were clear and should be enforced as written.); New Enterprise Assoc. 14, L.P. v. Rich, C.A., 295 A.3d 520, 593 (Del. Ch. 2023) (the court found that a fiduciary waiver in a stockholders' agreement will be upheld if sophisticated stockholders

This general deference to managerial discretion is not limited to the contractual context of limited partnerships. Even in corporate law, where fiduciary duties are generally retained, Delaware courts apply doctrines that make oversight-based liability difficult to establish. Under the business judgment rule, courts presume that directors' decisions are made in good faith, on an informed basis and in the best interests of the corporation.[139] Under the *Caremark* doctrine, Delaware courts distinguish between two types of oversight failures: (1) "a board decision that results in a loss because that decision was ill advised or 'negligent'" and (2) "an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss."[140] Claims in the first category are reviewed under the business-judgment rule; liability can be imposed only if the directors acted with gross negligence, meaning they failed to inform themselves adequately before acting.[141] Claims in the second category require a showing of bad-faith nonfeasance; liability attaches only upon showing "a sustained or systematic failure of the board to exercise oversight."[142]

The *Caremark* framework creates analytical challenges in the due diligence context. A GP's inadequate or omitted due diligence could be characterized both as a monitoring failure and as a business decision. From a monitoring perspective, it might constitute the type of oversight failure that *Caremark* addresses—specifically, failing to implement reasonable systems to evaluate investments (a "mission critical" function for the fund),[143] assess fraud risks, and monitor portfolio companies. Yet, from a business judgment perspective, it could represent a calculated decision made in response to market pressures—including the need to allocate limited resources more efficiently, the risk of losing competitive deals

make an informed and unforced decision to do so. However, the court decided that under Delaware's public policy on contracts, the agreement could not protect the defendants from liability for intentional wrongdoing, and it found that in the specific case this claim was sufficiently established.).

139. *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."), overruled on other grounds by *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); *see also In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 52 (Del. 2006) (reaffirming that courts do not second-guess directors' decisions under the business judgment rule absent gross negligence or bad faith).

140. *See In re* Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 967 (Del. Ch. 1996) [hereinafter Caremark]. In *Caremark*, the Delaware Court of Chancery held that corporate directors have an affirmative obligation to ensure that adequate information and reporting systems are in place within the corporation to provide timely and accurate information, particularly regarding compliance with law and business performance. *Id.* at 959. This duty goes beyond passive reliance on existing systems and requires proactive measures to monitor and detect potential misconduct. *Id.*; *see also* Jennifer Arlen, *The Story of Allis-Chalmers, Caremark and Stone: Directors' Evolving Duty to Monitor*, *in* CORPORATE LAW STORIES 323 (J. Mark Ramseyer ed., 2009).

141. *See* Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 370 (Del. 2006); *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 122 (Del. Ch. 2009).

142. *Caremark*, 698 A.2d at 971.

143. *See* Marchand v. Barnhill, 212 A.3d 805, 822, 824 (Del. 2019) (emphasizing the board's oversight obligations regarding "mission critical" aspects of the company's business).

due to extended diligence periods,[144] and concerns about being perceived as an overly demanding investor.[145]

Plaintiffs might invoke *Caremark* principles to argue that GPs owe LPs a fundamental duty to implement reasonable systems for evaluating investments and monitoring portfolio companies.[146] Under this theory, a systematic failure to maintain robust due diligence procedures might constitute the type of oversight failure that traditionally triggers liability in the corporate context.[147] However, such a claim will need to clear a particularly high bar, as courts generally require evidence of gross negligence or willful misconduct, rather than mere deviation from industry practice, to overcome the business judgment rule.[148] Proving such misconduct remains challenging given VC funds' limited transparency and LPs' restricted control rights.

In summary, the combination of exculpation in LPAs, courts' deference to private ordering among sophisticated parties, and the high legal thresholds for proving breaches of fiduciary duty—whether characterized as a monitoring failure or a business decision—make it challenging for LPs to hold GPs accountable for failures to conduct due diligence, adding to the practical considerations that typically lead LPs to avoid litigation against GPs.

2. *Securities Fraud Claims*

Beyond fiduciary duty claims, LPs may seek recourse under federal securities laws if GPs engage in fraudulent or misleading practices. However, once again, these claims are particularly challenging in the VC context due to the unique structure and nature of limited partnerships. The Securities Act of 1933

144. *Cf.* Smith v. Van Gorkom, 488 A.2d 858, 872–73 (Del. 1985) (finding directors breached their duty of care by approving a merger after only two hours of consideration, despite the CEO's insistence on a quick decision due to time pressure). The decision was widely criticized as overly harsh and led Delaware to adopt section 102(b)(7) permitting corporations to exculpate directors from monetary liability for breaches of the duty of care. DEL. CODE ANN. tit. 8, § 102(b)(7) (2024); *id.*

145. *Supra* Section II.C.

146. *See* Patrick Warczak, Jr., *Giving Compliance Its Due: Caremark Duties in the Context of Mergers and Acquisitions*, 23 U. PA. J. BUS. L. (forthcoming 2024) (manuscript at 34–39) (arguing that *Caremark* duties require boards to implement robust due diligence systems and that recent Delaware cases have strengthened accountability for diligence failures); *see also* Gregory A. Markel, Daphne Morduchowitz & Matthew C. Catalano, *A Director's Duty of Oversight after Marchand in "Caremark" Case*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 23, 2022), https://corpgov.law.harvard.edu/2022/01/23/a-directors-duty-of-oversight-after-marchand-in-caremark-case/ [https://perma.cc/H44V-APZY] (explaining that the *Caremark* decision sets a high bar for liability, as breaches are typically found only in cases of sustained or systematic failure to exercise oversight—amounting to bad faith or gross negligence).

147. *See Marchand*, 212 A.3d at 820–21 ("To state a Caremark claim, a plaintiff must plead with particularity that the board either (1) 'utterly failed to implement any reporting information systems or controls' or (2) 'having implemented such systems or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.'" (quoting Stone v. Ritter, 911 A.2d 362, 370–72 (Del. 2006) and Desimone v. Barros, 924 A.2d 908, 935 (Del. Ch. 2007))).

148. *See, e.g.*, Matana v. Merkin, No. 13 Civ. 1534(PAE), 2014 WL 426857, at *3 (S.D.N.Y. Feb. 4, 2014) (holding that a fund manager did not breach his fiduciary duty by failing to disclose or learn facts about Bernie Madoff's Ponzi scheme); CMMF, LLC v. J.P. Morgan Inv. Mgmt., Inc., 992 N.Y.S.2d 158 (N.Y. Sup. Ct. 2013) (finding that the investment advisor was not liable for breach of fiduciary duties related to purchasing and holding risky financial products during the 2007 Housing Crisis).

and the Securities Exchange Act of 1934 contain anti-fraud provisions, such as Section 10(b)[149] and Rule 10b-5,[150] which prohibit making any untrue statement of a material fact or omitting to state a material fact necessary to make statements not misleading in connection with the purchase or sale of securities.

Unlike fiduciary duties, securities fraud liability cannot easily be circumvented through contractual provisions, as Section 29(a) of the Exchange Act explicitly forbids waiving fraud protections.[151] Even if VCs limit disclosures to the bare minimum in an attempt to sidestep Rule 10b-5, any statements made are still subject to its stringent anti-fraud standards.[152] Therefore, if a VC fund's offering documents, such as the private placement memorandum or marketing materials, explicitly state that the GP will conduct due diligence as part of its added value, and it is shown that its representatives intentionally failed to do so, LPs may have a viable claim for securities fraud.[153]

In practice, however, fund managers often undermine these formal protections through the use of so-called "big boy" letters or non-reliance clauses embedded in subscription agreements and side letters.[154] These provisions require investors to acknowledge that they are sophisticated parties making investment decisions with potentially incomplete information and disclaim reliance on any extra-contractual representations.[155] While these clauses do not expressly waive legal rights, they are often used to preempt fraud claims by attacking the reliance element of Rule 10b-5. The enforceability of such clauses remains unsettled: some courts —most notably in the Second and Seventh Circuits—have enforced such clauses in transactions between sophisticated parties, treating them as strong evidence that negates reliance and may justify dismissal of fraud claims at an early stage.[156] By contrast, other courts—including the First, Third, and

149. Exchange Act Section 10(b) makes it unlawful "[t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . any manipulative or deceptive device or contrivance." 15 U.S.C. § 78j(b).

150. 17 C.F.R. § 240.10b–5(b) (making it unlawful, among other things, "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading").

151. *See* 15 U.S.C. § 78cc(a) ("Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder . . . shall be void.").

152. *See* James C. Spindler, *How Private Is Private Equity, and at What Cost?*, 76 U. CHI. L. REV. 311, 322–23 (2009).

153. *See, e.g.*, FutureSelect Portfolio Mgmt., Inc. v. Tremont Grp. Holdings, Inc., 309 P.3d 555, 569–70 (Wash. 2013) (holding that the plaintiffs' allegations regarding losses stemming from a Ponzi scheme were sufficient to support claims of securities fraud and negligent misrepresentation).

154. Jonathan Shepard, Eric Dowell & Lauren Cooperman, *How Fund Managers Can Use Non-Reliance Clauses to Protect Themselves from Investor Claims of Misrepresentation*, PE L. REP. (Sept. 24, 2019), https://www.pelawreport.com/4020171/how-fund-managers-can-use-non-reliance-clauses-to-protect-themselves-from-investor-claims-of-misrepresentation.thtml [https://perma.cc/XW4Q-FQBL]; *see also* Edwin D. Eshmoili, Note, *Big Boy Letters: Trading on Inside Information*, 94 CORNELL L. REV. 133, 135 (2008).

155. *Id.*

156. *See, e.g.*, Harsco Corp. v. Segui, 91 F.3d 337, 343–46 (2d Cir. 1996); Rissman v. Rissman, 213 F.3d 381, 383–84 (7th Cir. 2000); *see also* Harborview Master Fund, LP v. Lightpath Tech., Inc., 601 F. Supp. 2d 537, 547 n.8 (S.D.N.Y. 2009); DDJ Mgmt., LLC v. Rhone Grp. LLC, 15 N.Y.3d 147 (2010); David K. Lutz, *The*

Sixth Circuits—have refused to treat non-reliance clauses as dispositive at the pleading stage, citing Section 29(a)'s anti-waiver mandate.[157]

As a result, LPs attempting to pursue securities fraud claims against GPs must overcome not only statutory and doctrinal hurdles, but also contractual language that courts may treat as dispositive or highly persuasive. This compounds the already formidable challenge of satisfying the substantive elements of a securities fraud action, particularly within the opaque and risk-tolerant framework of VC funds. To prevail on a claim, LPs must establish material misrepresentation or omission, scienter (i.e., intent to deceive, manipulate, or defraud), transactional causation, reliance, loss causation, and damages.[158] The structure and characteristics of VC limited partnerships make it particularly difficult for LPs to establish these elements.

First, demonstrating scienter is especially challenging, particularly in the context of VC investments. The Private Securities Litigation Reform Act ("PSLRA") imposes heightened pleading standards for securities fraud claims, requiring plaintiffs to state with particularity the facts constituting the alleged fraud and the defendant's scienter.[159] This demands that LPs marshal detailed evidence of fraudulent intent at the pleading stage—a difficult task in an environment characterized by ambiguity and entrepreneurial risk.[160] What may appear as deception may just as easily be explained as misjudgment. Courts typically require evidence of an intent to mislead, not mere negligence or failed projections.[161] That said, some jurisdictions recognize recklessness—defined as an extreme departure from the standards of ordinary care—as sufficient for establishing scienter, which may provide a slightly more favorable standard under

Law and Economics of Securities Fraud: Section 29(a) and the Non-Reliance Clause, 79 CHI.-KENT L. REV. 803, 812–14 (2004).

157. *See, e.g.*, *Rogen v. Ilikon Corp.*, 361 F.2d 260, 266–67 (1st Cir. 1966); *AES Corp. v. Dow Chem. Co.*, 325 F.3d 174, 179–80 (3d Cir. 2003); *Brown v. Earthboard Sports USA, Inc.*, 481 F.3d 901, 921 (6th Cir. 2007); *see also* Eshmoili, *supra* note 154, at 153 ("Even if big boy letters are void under section 29(a), they can refute a plaintiff's claim of reasonable reliance.").

158. Iron Workers Loc. 580 Joint Funds v. NVIDIA Corp., 522 F. Supp. 3d 660, 673 (N.D. Cal. 2021) (quoting 17 C.F.R. § 240.10b–5(b) and Stoneridge Inv. Partners, LLC v. Scientific–Atlanta, Inc., 552 U.S. 148, 157 (2008)). Notably, certain state laws impose lower thresholds for liability by not requiring proof of scienter or reliance. *See* State of New York v. Rachmani Corp., 525 N.E.2d 704, 707 n.6. For example, the Martin Act in New York allows the Attorney General to pursue securities fraud cases without demonstrating intent or reliance, although it does not provide a private right of action for investors. *See id.* (stating that, unlike common-law fraud, the Attorney General need not allege or prove either scienter or intentional fraud to establish liability for fraudulent practices under the Martin Act).

159. *See, e.g.*, Tellabs, Inc. v. Makor Issues & Rts., Ltd., 551 U.S. 308, 314 (2007) (clarifying that the standard for pleading scienter under the PSLRA is "strong" and that an inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent).

160. Additionally, the safe harbor provisions of the PSLRA protect forward-looking statements if they are identified as such and accompanied by meaningful cautionary statements. *Id.* at 321. GPs could argue that optimistic projections or opinions about investment opportunities fall under this protection, further complicating LPs' ability to establish liability based on such statements. *Id.*

161. *See* Kaal, *supra* note 16, at 287.

certain state statutes that authorize private lawsuits.[162] This suggests that under specific state statutes that permit private lawsuits with less stringent requirements, LPs might have a better chance of holding GPs liable for due diligence failures.

Second, VC partnerships typically involve limited disclosure and no control rights for LPs.[163] These factors limit the ability of LPs to prove reliance and damages.[164] Without ongoing oversight or information rights, LPs may struggle to demonstrate that any misrepresentation caused their loss or even that they were in a position to rely on specific statements in the first place. This challenge is compounded when fund documents include non-reliance clauses, which, as discussed above, may be used to argue that the LP contractually disclaimed any such reliance—potentially defeating the claim outright or severely undermining its plausibility.[165]

Third, in VC funds, LPs often lack the ability to easily transact or divest their interests, creating a barrier to satisfying the "purchaser/seller" requirement essential for securities fraud private actions.[166] Because LPs cannot easily exit their positions or act on new information,[167] demonstrating transactional causation and reliance becomes far more complex than in public markets.

Courts have consistently imposed heightened legal standards in securities fraud cases involving private funds, requiring plaintiffs to allege clear and particularized evidence of intentional deception.[168] This judicial posture reflects a strong presumption in favor of sophisticated parties and freedom of contract—

162. *See* Richard A. Booth, *Deconstructing Scienter*, 16 VA. L. & BUS. REV. 1, 8 (2021) (stating that "[s]ince *Hochfelder*, all the circuits that have considered whether scienter may be established through recklessness have so held. But the Court continues to reserve the question while acknowledging that a recklessness standard has been applied by the lower courts (even in cases in which scienter itself is at issue)").

163. *See, e.g.*, Donna & Rust, *supra* note 136, at 30 ("The Limited Partners shall take no part in the control or management of the affairs of the Partnership nor shall a Limited Partner have any authority to act for or on behalf of the Partnership except as is specifically permitted by this Agreement."); *id.* at 42–43 ("The Limited Partners: (i) acknowledge that the General Partner is expected to acquire confidential third party information (e.g., through directorships held by members of the General Partner on the Partnership's portfolio companies) that, pursuant to related fiduciary, contractual, legal or similar obligations, cannot be disclosed to the Partnership or the Limited Partners; and (ii) agree that none of the General Partner or its members shall be in breach of any duty under this Agreement or the Act in consequence of acquiring, holding or failing to disclose such information to the Partnership or the Limited Partners so long as such obligations were undertaken in good faith.").

164. Spindler, *supra* note 152, at 323–25.

165. *See supra* note 161 and accompanying text.

166. Spindler, *supra* note 152, at 323–25.

167. *Id.*

168. *See, e.g.*, Matana v. Merkin, No. 13 Civ. 1534(PAE), 2014 WL 426857, at *5 (S.D.N.Y. Feb. 4, 2014) (holding that failure to disclose unknown facts did not constitute fraud absent clear intent to deceive); Prickett v. N.Y. Life Ins. Co., 896 F. Supp. 2d 236, 251 (S.D.N.Y. 2012) (dismissing policyholder's fraud claim due to insufficient evidence of scienter in failing to conduct due diligence); S. Cherry St., LLC v. Hennessee Grp. LLC, 573 F.3d 98, 108–10, 113 (2d Cir. 2009) (holding that allegations of failure to conduct due diligence did not give rise to a strong inference of intent to defraud); *In re* Beacon Assocs. Litig., 745 F. Supp. 2d 386, 412 (S.D.N.Y. 2010) (noting that when due diligence fails due to incompetence or mismanagement, the appropriate remedy is often a breach of contract claim rather than a securities fraud action); *cf. In re* J.P. Jeanneret Assocs., Inc., 769 F. Supp. 2d 340, 364 (S.D.N.Y 2011) (stating that "[o]nly when the adviser makes its promise with no intention of fulfilling it does the breach of contract claim turn into a federal securities claim").

particularly in private capital markets—thereby raising the bar for LPs seeking relief. In the VC context, where high-risk investing, minimal LP oversight, and pronounced information asymmetries are structural features of the asset class, this bar becomes especially formidable.

3. Breach of Contract or Misrepresentation

In addition to fiduciary duty and securities fraud claims, LPs may attempt to hold GPs liable under theories of breach of contract or misrepresentation, particularly where the LPA or side letters contain affirmative representations about due diligence practices.[169] For example, an LPA might include a covenant that the GP will conduct due diligence in accordance with industry norms, follow specified vetting procedures, or systematically evaluate relevant information before committing capital. If the GP materially fails to perform such contractual obligations, LPs may have a basis for a breach of contract claim. Likewise, if a GP misstates or exaggerates its diligence practices—either in offering materials or communications—LPs may argue that they were misled into investing based on false assurances, giving rise to a claim for misrepresentation.

Courts have, in some circumstances, recognized liability where defendants affirmatively misrepresented the scope or quality of diligence performed, ignored known red flags, or promised procedures they never intended to follow.[170] Generally, courts are willing to hold defendants liable for failing to perform promised vetting processes, misrepresenting the extent of their due diligence efforts, or ignoring red flags.[171]

However, in the VC context, such express obligations are rare.[172] The high-risk, opportunistic nature of early-stage investing often disincentivizes GPs from committing to fixed diligence protocols ex ante.[173] As a result, VC LPAs typically avoid detailed diligence requirements and instead include broad disclaimers of responsibility or performance standards.[174] These may state, for instance, that

169. *See, e.g.*, *In re* Beacon Assocs. Litig., 745 F. Supp. 2d at 412.

170. *See, e.g.*, *id.* (holding that, when a business commits to conducting due diligence but fails due to incompetence or mismanagement, investors are entitled to seek remedies through breach of contract rather than securities fraud); Sapirstein-Stone-Weiss Found. v. Merkin, 950 F. Supp. 2d 621, 624, 628–29 (S.D.N.Y. 2013) (finding that the defendants' failure to perform due diligence on investments linked to Madoff was unreasonable and violated their contractual and common law duties to the plaintiffs).

171. Schwarz v. ThinkStrategy Cap. Mgmt. LLC, No. 09 Civ. 9346(PAE), 2012 WL 2026365, at *1 (S.D.N.Y. May 31, 2012).

172. *See, e.g.*, *id.* at *19 (holding defendants liable for fraud due to misrepresenting the extent of their due diligence in connection with hedge fund investments); *In re* Optimal U.S. Litig., 813 F. Supp. 2d 351, 358 (S.D.N.Y. 2011) (finding that defendants failed to conduct adequate due diligence regarding Madoff, ignored red flags, and made misstatements and omissions).

173. *See* Kaal, *supra* note 16, at 267 (emphasizing the difference in due diligence approaches with different types of firms).

174. *See, e.g.*, *id.* at 286 (explaining that explicit promises of due diligence without subsequent performance is actionable misrepresentation).

the GP retains sole discretion over investment decisions and is not liable for losses absent gross negligence or bad faith.[175]

As noted above, further complicating LPs' position is the widespread use of non-reliance clauses, often embedded in fund subscription agreements or side letters. These provisions require LPs to acknowledge that they are sophisticated investors who are not relying on any extra-contractual representations or promises—including informal statements about due diligence practices. As with securities fraud claims, these clauses may significantly undermine contractual or tort-based misrepresentation claims by undercutting a core element: reasonable reliance. Therefore, while breach of contract and misrepresentation offer potential causes of action, they are of limited utility in the VC fund context. The absence of explicit diligence obligations, combined with contractual boilerplate disclaiming reliance and liability, makes it difficult for LPs to assert that the GP owed—and breached—a specific enforceable duty related to due diligence.

In summary, LPs in VC funds face significant structural and legal barriers when seeking recourse for due diligence failures. The primary avenues—fiduciary breach, securities fraud, and contract breach or misrepresentation—are all constrained by the terms of fund agreements, judicial skepticism of investor protection in private markets, and the nature of VC itself. Non-reliance clauses, in particular, operate across doctrinal categories to weaken LP claims, functioning as de facto shields for GPs not only in securities fraud litigation, but also in contractual and tort-based actions. These limitations are even more pronounced for third parties, who lack privity and often possess even fewer factual or legal bases for asserting liability against VC fund actors.

B. From the Perspective of a Third Party

While LPs face significant challenges in bringing due diligence-related claims against GPs, third parties—such as investors in failed startups, customers, or other affected stakeholders—encounter even steeper obstacles. This section explores the legal avenues available to these third parties when VCs may be held liable for inadequate due diligence. Specifically, it focuses on scenarios where VCs did not assume board seats or only held observer roles, thereby sidestepping formal governance responsibilities and the duties that come with them.[176] Although still emerging, this dynamic has gained traction, most notably in cases like that of FTX, where the founder was reportedly "very resistant" to having investors on the board.[177]

175. *See, e.g.*, Donna & Rust, *supra* note 136, at 49–50 (providing broad exculpation for the general partner for "honest mistakes of judgment, or for action or inaction, taken reasonably and in good faith for a purpose that was reasonably believed to be in the best interests of the Partnership").

176. *See* Nizan Geslevich Packin & Anat Alon-Beck, *Board Observers*, U. ILL. L. REV. (forthcoming 2025).

177. *See* Rosie Bradbury, *Bankman-Fried Was 'Very Resistant' to Calls for Board Seats, Paradigm Founder Says*, PITCHBOOK (Oct. 4, 2023), https://pitchbook.com/news/articles/ftx-sbf-paradigm-board-corporate-governance-crypto [https://perma.cc/YKF9-KDPY].

1. Aiding and Abetting Fraud or Securities Law Violations

One legal avenue for third parties is alleging that VCs aided and abetted fraud or securities law violations committed by a portfolio company. To succeed on an aiding and abetting claim, plaintiffs must establish the existence of a primary violation committed by the startup.[178] They must also demonstrate that the VC had actual knowledge of the violation, and that the VC provided substantial assistance or encouragement to the startup in committing the violation.[179]

However, the law severely limits third-party liability for venture investors who passively finance a startup without assuming governance roles. In *Central Bank of Denver v. First Interstate Bank of Denver*, the Supreme Court held that private plaintiffs cannot bring aiding and abetting claims under Section 10(b) of the Securities Exchange Act of 1934.[180] In other words, merely "aiding" someone else's securities fraud is not actionable in a private suit under federal law. Therefore, a secondary actor's conduct must satisfy every element or precondition necessary for §10(b) liability.[181]

In the absence of a direct federal cause of action, plaintiffs sometimes pursue alternative legal theories such as common-law aiding and abetting of fraud or breach of fiduciary duty. Most jurisdictions recognize these claims, but they set a high threshold: plaintiffs must prove that the VC firm had actual knowledge of the wrongdoing and gave substantial assistance to it.[182] Merely alleging that the investor should have uncovered the startup's fraud through better due diligence is not sufficient; courts require evidence of knowing participation. For example, the Second Circuit has dismissed claims against entities that facilitated Ponzi schemes, emphasizing that negligence or failure to detect fraud does not meet the standard for aiding and abetting liability.[183] While some courts have suggested that "willful blindness" or "conscious avoidance" could satisfy the knowledge requirement, this still demands proof of deliberate efforts to ignore clear warning signs, not just a failure to investigate.[184]

The litigation following the collapse of FTX demonstrates the diverse legal strategies being employed in multiple lawsuits against a wide array of

178. Marcellino & Kenfield, *supra* note 50, at 53.

179. *See, e.g.*, SEC v. Cedric Kushner Promotions, Inc., 417 F. Supp. 2d 326, 334 (S.D.N.Y. 2006). On VC liability based on aiding and abetting theory more broadly, see Marcellino & Kenfield, *supra* note 50, at 53.

180. *See* 511 U.S. 164, 164 (1994) (stating that liability under Section 10(b) does not extend to those who merely aid and abet a securities fraud but are not primary violators).

181. *See, e.g.*, *id.*

182. *See* Marcellino & Kenfield, *supra* note 50, at 54 (describing Terrydale Liquidating Trust v. Barness, 611 F. Supp. 1006 (S.D.N.Y. 1984), where the court noted that there aren't any cases that imposed, or even considered, a claim of aider and abettor liability on a showing of less than actual knowledge of wrongdoing in circumstances like those presented).

183. *See* Heinert v. Bank of America, N.A., No. 20-0691, 2020 WL 6689287 (2d Cir. Nov. 2, 2020).

184. *See* Global-Tech Appliances, Inc. v. SEB S.A., 563 U.S. 754, 766–68 (2011) (holding that willful blindness satisfies the knowledge requirement for induced infringement and stating that "defendants cannot escape the reach of these statutes by deliberately shielding themselves from clear evidence of critical facts that are strongly suggested by the circumstances"). For review of subsequent caselaw, see also Kenneth W. Simons, *The Willful Blindness Doctrine: Justifiable in Principle, Problematic in Practice*, 53 ARIZ. ST. L.J. 655, 665-67 (2021).

participants in the VC and crypto ecosystems. After FTX filed for bankruptcy in November 2022, a series of class actions were initiated, each pursuing different theories of liability. These lawsuits target not only FTX and its founder, Sam Bankman-Fried, but also extend to VC firms, celebrity endorsers, auditors, and banks connected to the exchange.[185] A notable thread in this litigation landscape involves claims against prominent venture firms such as Sequoia Capital, Thoma Bravo, and Paradigm.[186]

Plaintiffs allege that these firms were not merely defrauded investors, as portrayed in regulatory actions, but instead knowingly contributed to FTX's credibility through their investments and public endorsements.[187] For instance, one class action filed in federal court in San Francisco alleges these firms violated California state securities laws, business practices statutes, and advertising regulations while engaging in civil conspiracy to induce customers to open FTX accounts.[188] The lawsuits contend that the VC firms either knew, or should have known, about FTX's underlying issues through proper due diligence, yet continued to publicly praise Sam Bankman-Fried and market FTX as a reliable platform.[189]

The outcome of the FTX-related suits remains to be seen, but they illustrate the narrow path for holding passive investors liable: plaintiffs must plead around the strict limits on secondary liability by using state-law fraud claims and alleging a level of knowledge or reckless indifference approaching intent.

2. *Negligent Misrepresentation*

In certain jurisdictions, VC firms may be held liable for negligent misrepresentation to third parties—those not directly involved in a contract with the firm—particularly when the firm provides inaccurate information in a professional or business context. This is an exception to the economic loss doctrine, which ordinarily bars negligence claims for purely financial harm, but often allows recovery when a party with special expertise provides guidance intended to

185. *See, e.g.*, Alison Frankel, *In FTX Litigation, Feud Escalates Between Bankruptcy and Class Action Lawyers*, REUTERS (June 25, 2024); *see also* Garrison v. Paffrath, No. 1:23-cv-21023 (S.D. Fla. filed Mar. 15, 2023) (putative class action against influencers who allegedly promoted and assisted in FTX's offer and sale of unregistered securities under the Florida Securities and Investor Protection Act and the Florida Deceptive and Unfair Trade Practices Act); O'Keefe v. Sequoia Cap. Operations, LLC, No. 1:23-cv-20700 (S.D. Fla. filed Feb. 22, 2023), transferred to In re FTX Cryptocurrency Exchange Collapse Litigation, No. 1:23-md-03076 (S.D. Fla.) (alleging that banks, venture capital firms, law firms, and accounting firms aided and abetted fraud perpetrated through FTX).

186. *See id.* at 2, 10; *see also* Class Action Complaint and Demand for Jury Trial, Garrison v. Paffrath, No. 1:23-cv-21023 (S.D. Fla. Mar. 15, 2023) (putative class action against influencers who allegedly promoted and assisted in FTX's offer and sale of unregistered securities under the Florida Securities and Investor Protection Act and the Florida Deceptive and Unfair Trade Practices Act); Class Action Complaint, O'Keefe v. Sequoia Cap. Operations, LLC, No. 1:23-cv-20700 (S.D. Fla. Feb. 22, 2023), transferred to *In re* FTX Cryptocurrency Exchange Collapse Litigation, No. 1:23-md-03076-KMM (S.D. Fla. June 5, 2023).

187. *See* Rabbitte Complaint, *supra* note 11, at 2, 10.

188. *See id.* at 42–50.

189. *Id.* at 32–33, 46–47.

influence others in business decisions.[190] To succeed in a negligent misrepresentation claim, plaintiffs must demonstrate that the defendant, in the course of their business, profession, employment, or any other transaction in which they have a pecuniary interest, supplied false information intended to guide others in their business transactions,[191] without exercising reasonable care or competence in obtaining or communicating this information;[192] that the plaintiff justifiably relied on it; and that this reliance caused pecuniary loss.[193] The determination of a duty of care in negligent misrepresentation claims often hinges on the foreseeability of harm and the proximity of the relationship between the parties.[194] The defendant's liability is limited to losses suffered by specific individuals or a limited group for whom the defendant intended to supply the information (or knew it would be supplied), and who relied on it in transactions the defendant intended (or knew) the information would influence.[195]

To illustrate, consider a scenario in which a VC-backed AI startup publicly touts its ability to generate highly accurate financial forecasts. The venture firm, seeking to bolster the company's reputation, endorses without verifying their accuracy. If third-party investors subsequently rely on those endorsements and suffer losses when the technology proves overstated or ineffective, they may attempt to hold the VC liable for negligent misrepresentation.[196] In this case, the VCs

190. *See, e.g.*, *Bily v. Arthur Young & Co.*, 3 Cal. 4th 370 (1992) (determining that an auditor may "be held liable for negligent misrepresentations in an audit report to those persons who act in reliance upon those misrepresentations in a transaction which the auditor intended to influence"). For instance, Iowa has refused "to apply the economic loss doctrine to cases of professional negligence against attorneys, accountants, and financial advisors." *Id.* at 307.

191. "One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information." RESTATEMENT (SECOND) OF TORTS § 552(1) (AM. L. INST. 1977). It is important to note that the exact formulation of these elements can vary between jurisdictions. Some courts may require additional elements, such as the misrepresentation being of a material fact, or may consider factors like the defendant's state of mind. *See, e.g.*, Assilzadeh v. Cal. Fed. Bank, 98 Cal. Rptr. 2d 176, 185 (Cal. Ct. App. 2000); *see also* Sapirstein-Stone-Weiss Found. v. Merkin, 950 F. Supp. 2d 621, 629 (S.D.N.Y. 2013). Furthermore, some jurisdictions may require that the defendant intended for the plaintiff to rely on the information or knew that the plaintiff would rely on it, though this is not universally required. *See, e.g.*, Schwarz v. ThinkStrategy Capital Mgmt., LLC, 797 F. Supp. 2d 439, 446–47 (S.D.N.Y. 2011).

192. RESTATEMENT (SECOND) OF TORTS § 552(1) (AM. L. INST. 1977).

193. *Id.*

194. *See, e.g.*, Kimmell v. Schaefer, 89 N.Y.2d 257, 264, 675 N.E.2d 450, 454 (1996) (the court recognized that the existence of a duty depends on the special relationship between the parties, which is informed by factors like the speaker's awareness of the use of the information and the foreseeability of harm resulting from reliance on that information).

195. "Except as stated in Subsection (3), the liability stated in Subsection (1) is limited to loss suffered (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction." *See* RESTATEMENT (SECOND) OF TORTS § 552(2).

196. This hypothetical situation is inspired by the Federal Trade Commission's ("FTC") recent efforts to crack down on deceptive AI claims and schemes. In September 2024, the FTC announced, "Operation AI Comply," a series of enforcement actions against companies that made false or unsubstantiated claims about their AI

could potentially be held liable for negligent misrepresentation, as their public statements may have created a special relationship with the third-party investors, imposing a duty of care to ensure the accuracy of their representations.

A recent lawsuit in New York illustrates these issues. In late 2024, an investment firm that lost money in a failed startup ("Vesttoo") sued the VC fund, Hanaco Venture Capital Ltd., alleging that the VC's partners had misrepresented and mishandled the investment.[197] This case, still in litigation, shows that investors are indeed attempting to hold VCs accountable under misrepresentation theories.

Likewise, in the class action regarding FTX, the plaintiff alleges that the defendant VC firms made public statements or endorsements about FTX's viability, safety, and financial health that were misleading.[198] The complaint argues that these VCs negligently misrepresented material facts about FTX's operations and their own due diligence activities, without reasonable grounds for believing these representations to be true.[199] The plaintiffs claim that they and other class members justifiably relied on these statements when deciding to purchase, deposit, or transact assets with FTX, which they would not have done had they known the true nature of FTX's operations.[200] As a result, they suffered damages, including the inability to retrieve their assets from FTX accounts due to the company's insolvency.[201]

As these example underscore, however, prevailing on a negligent misrepresentation claim requires overcoming significant doctrinal hurdles. Courts typically require the existence of a "special relationship" between the parties—such as a contractual or fiduciary tie, or circumstances indicating that the defendant specifically intended the plaintiff to rely on the information provided.[202] In the VC context, such relationships are rare, as VCs usually lack direct contact with individual investors or customers. Even where a duty might plausibly be found,

products or services. *See FTC Announces Crackdown on Deceptive AI Claims and Schemes*, FED. TRADE COMM'N (Sept. 25, 2024), https://www.ftc.gov/news-events/news/press-releases/2024/09/ftc-announces-crackdown-deceptive-ai-claims-schemes [https://perma.cc/ZU2L-9VAJ]. While the FTC's press release does not specifically address VC liability, the enforcement actions serve as a general warning about the potential legal consequences of making or endorsing false claims in the AI sector. *See id.*

197. *See* Goldeneye Advisors, LLC v. Hanaco Venture Capital, Ltd., et al., No. 1:24-cv-09918 (S.D.N.Y. filed Nov. 9, 2024) (complaint alleging venture capital firm's partners made misrepresentations and acted with gross negligence in connection with an investment in Vesttoo, a now-bankrupt startup). This ongoing case represents a real-world counterpart to the hypothetical AI startup scenario. *Id.*

198. *See* Rabbitte Complaint, *supra* note 11, at 46.

199. *Id.*

200. *Id.*

201. *Id.* at 47.

202. *See* RESTATEMENT (SECOND) OF TORTS § 552(2) (AM. L. INST. 1977) (limiting liability to loss suffered "by the person or . . . limited group of persons for whose benefit and guidance [the defendant] intends to supply the information"); *see also* Bily v. Arthur Young & Co., 834 P.2d 745, 772 (Cal. 1992) (reviewing a Court of Appeal decision that had upheld a trial court's judgment of professional negligence against an accounting firm, and emphasizing that, because the plaintiffs were not clients of the firm but rather third-party investors, they could not recover under a general negligence theory without demonstrating the existence of a special relationship between themselves and the accounting firm).

plaintiffs must also establish that their reliance was justifiable. Courts often view general expressions of optimism or confidence as non-actionable "puffery," and are reluctant to impose liability absent concrete, factual assertions directed at a specific audience.[203]

In sum, while negligent misrepresentation in theory allows recovery for economic loss, third parties face significant doctrinal hurdles when asserting such claims against VC firms. Courts are generally reluctant to impose liability unless the VC affirmatively undertook to provide information for the plaintiff's guidance in a particular transaction. As with aiding-and-abetting theories, the law maintains a distinction between inadequate diligence and actionable misconduct.

C. Efficiency and Downstream Impacts in VC Liability Arrangements

The landscape of VC liability for due diligence failures—particularly within the GP-LP relationship—can be analyzed through a Coasean lens. The Coase theorem posits that, in the absence of transaction costs, parties will negotiate toward the most efficient allocation of rights, regardless of their initial distribution.[204] The VC ecosystem, with its sophisticated parties and well-defined contractual frameworks, exemplifies a relatively low transaction cost environment where Coasean bargaining can occur. The frequent inclusion of liability limitations for GPs in LPAs, permitted under the DRULPA, demonstrates how parties negotiate toward what they perceive as the most efficient allocation of risk and responsibility in the absence of significant bargaining frictions.

As described in Section II.C, several features of the VC model explain why LPs accept and even prefer liability limitations that place most future risks on themselves. First, the power-law distribution of returns and the path dependency of VC funds' performance shape the incentives and risk preferences of LPs.[205] This distribution, where a small number of highly successful investments drive the majority of returns, coupled with the tendency for top-performing funds to maintain their status over time, motivates VCs to prioritize riskier strategies.[206]

203. *See, e.g.*, Newcal Indus., Inc. v. Ikon Office Solution, 513 F.3d 1038, 1053 (9th Cir. 2008) (stating that "a statement is considered puffery if the claim is extremely unlikely to induce consumer reliance. Ultimately, the difference between a statement of fact and mere puffery resides in the specificity or generality of the claim."); Assilzadeh v. Cal. Fed. Bank, 82 Cal. App. 4th 399, 411–12, 98 Cal. Rptr. 2d 176 (2000) ("Statements concerning the value of property are generally deemed to be expressions of personal opinion and not actionable representations of fact upon which the other party can rely."); *see also* Gentry v. Harborage Cottages-Stuart, LLLP, 602 F. Supp. 2d 1239, 1252 (S.D. Fla. 2009), rev'd on other grounds, 654 F.3d 1247 (11th Cir. 2011) (noting that under the Interstate Land Sales Full Disclosure Act, "mere opinions or exaggerations concerning the qualities of an offering by a seller constitute non-actionable puffery").

204. R. H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 15 (1960) ("It is always possible to modify by transactions on the market the initial legal delimitation of rights. And, of course, if such market transactions are costless, such a rearrangement of rights will always take place if it would lead to an increase in the value of production."); *see also* Robert D. Cooter, *Economic Theories of Legal Liability*, J. ECON. PERSPS., Summer 1991, at 11, 21 (noting that allowing for the trading of liability rights can increase efficiency).

205. *See supra* Section II.C.

206. *See* Broughman & Wansley, *supra* note 105, at 1317–18 ("It is the VCs who want their portfolio companies to take more risks . . . . The most important fact about venture investing is that the returns follow a power law.").

Second, the structural risk insulation in VC funds limits the impact of any single bad investment. LPs in VC funds benefit from a dual layer of protection: they have limited liability as investors in a limited partnership, which caps their exposure at their committed capital, and they enjoy an additional layer of separation as different portfolio companies within the fund are separate entities.[207] This structure limits LPs' exposure to losses beyond their committed capital to the fund, regardless of the fund's overall performance or any potential liabilities.[208] Moreover, a failure in one portfolio company due to fraud does not directly affect investments in other portfolio companies within the same fund.[209] For instance, according to Sequoia's 2022 letter to its LPs, the fund's $150 million loss on FTX was offset by its roughly $7.5 billion realized and unrealized gains on other companies.[210]

The allocation of liability also minimizes transaction costs in several ways. Limiting GP liability for due diligence failures decreases the likelihood of costly litigation between LPs and GPs over unsuccessful investments.[211] GPs can also make investment decisions more swiftly without the constant threat of liability looming over each decision.[212] As discussed in Sections II.B and II.C, this is particularly practical in the fast-paced VC environment, where timing can be crucial to securing desirable deals.[213] Moreover, instead of relying on legal liability, the VC industry largely depends on market forces and reputational concerns to maintain accountability.[214] GPs, who are primarily compensated through carried interest, have a strong incentive to dedicate an appropriate level of diligence to each investment opportunity.[215] This incentive is further reinforced by the industry's reliance on repeat relationships and fundraising cycles. GPs who consistently misjudge the necessary level of due diligence, resulting in poor investment outcomes, will struggle to raise future funds.

207. *See* Eric W. Shu, *Piercing the Veil in California LLCs: Adding Surprise to the Venture Capitalist Equation*, 45 SANTA CLARA L. REV. 1009, 1031–32 (2005).

208. *See id.*

209. *Id.* at 1031 ("An investment in one company cannot destroy an investment in another, and therefore the investors' diversification strategies remain intact."); *cf. id.* at 1009–10 (arguing that veil-piercing doctrine in California LLC law undermines venture capitalists' risk management strategy of portfolio diversification). Furthermore, sophisticated LPs often adopt a portfolio strategy by investing across multiple VC funds or investing via fund of funds. *Id.* at 1009. This diversification further mitigates the impact of any single company's poor performance and aligns with LPs' interests in pursuing riskier strategies, including reduced due diligence. *Id.* at 1009, 1013.

210. *See* Erin Arvedlund, *FTX Founder and CEO Sam Bankman-Fried 'Misled and Deceived' Sequoia Capital, Firm Says*, PENSIONS & INVS. (Nov. 6, 2023, 8:00 AM), https://www.pionline.com/cryptocurrency/sam-bankman-frieds-guilty-verdict-highlights-ftx-losses-sequoia-capital-other [https://perma.cc/47VR-9442].

211. *See* Kaal, *supra* note 16, at 262.

212. *See* Shu, *supra* note 207, at 1012.

213. *See* discussion *supra* Sections II.B–C.

214. *See, e.g.*, William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473, 513 (1990) (discussing how the VC industry relies on reputation and implicit contracts to align incentives between GPs and LPs).

215. *Id.*

However, what is privately efficient is not necessarily socially optimal. The very same GP-LP liability arrangements that appear efficient internally may leave third parties exposed to harm or without recourse when things take a downturn. Because GPs and LPs capture most of the upside from risky investments while bearing limited downside beyond their capital exposure, they may rationally under-invest in due diligence from a broader societal perspective. This creates a moral hazard: if a startup turns out to be fraudulent or grossly unsound, GPs typically suffer only the loss of their investment and, at most, reputational damage—provided no legal liability or internal sanctions follow. LPs, protected by limited liability and insulated by portfolio diversification, may similarly tolerate lax diligence, as any single loss rarely threatens their overall returns. As a result, the costs of undetected fraud or failure are often borne by third parties who have no contractual relationship with the fund.

This misalignment becomes especially consequential because of the "certification effect" that VC investment carries. Venture backing not only attracts capital but also influences the judgments of employees, customers, suppliers, and other investors. Research by Shai Bernstein and co-authors shows that startups backed by top-tier VCs attract significantly more job-seeker interest, particularly at early stages.[216] Similarly, David Hsu has shown that entrepreneurs accept lower valuations from reputable VCs, reflecting the perceived value of affiliation.[217] When due diligence is inadequate, this certification effect amplifies the risks: third parties may misread VC investment as a signal of reliability, exposing them to potential harm. Moreover, the risks are no longer confined to traditional VC circles, as new investment vehicles increasingly channel retail capital into startup portfolios through publicly traded instruments that package private shares.[218]

The FTX collapse provides a concrete illustration; initially, it resulted in an estimated $8 billion in missing customer funds.[219] The fallout highlights how the consequences of due diligence failures can extend far beyond the firm itself. While FTX's court-approved bankruptcy plan allows for the eventual repayment of up to $16.5 billion in recovered assets to customers,[220] this partial remedy has

216. *See* Shai Bernstein, Kunal Mehta, Richard R. Townsend & Ting Xu, *Do Startups Benefit from Their Investors' Reputation? Evidence from a Randomized Field Experiment*, 24 (Nat'l Bureau of Econ. Rsch., Working Paper No. 29847, 2022), https://www.nber.org/papers/w29847 [https://perma.cc/YUX9-6MA6] ("[E]vidence strongly suggests that the attractiveness of a startup to potential employees is affected by who has invested in it."); *see also* Yifat Aran, *Making Disclosure Work for Start-Up Employees*, 2019 COLUM. BUS. L. REV. 867, 941–42 (2019) (describing how misinformation and confusing price signals can affect startup employees).

217. *See* David H. Hsu, *What Do Entrepreneurs Pay for Venture Capital Affiliation?*, 59 J. FIN. 1805, 1807 (2004).

218. Matt Levine, *TD Was Convenient for Criminals*, BLOOMBERG (Oct. 14, 2024, 2:28 PM), https://www.bloomberg.com/opinion/articles/2024-10-14/td-was-convenient-for-criminals [https://perma.cc/QSS4-6LXB].

219. *See* Lipson & Skeel, *supra* note 3 and accompanying text.

220. Steven Church & Jonathan Randles, *Sam Bankman-Fried's Bankrupt FTX Crypto Exchange Is Cleared to Repay Customers*, BLOOMBERG (Oct. 7, 2024, 3:19 PM), https://www.bloomberg.com/news/articles/2024-10-07/ftx-clear-to-repay-customers-as-firms-seek-slice-of-1-billion [https://perma.cc/FMU4-AVEL].

required enormous legal and financial resources to implement.[221] As John J. Ray III, the bankruptcy administrator, emphasized, even the best outcome cannot yield a full economic recovery for all creditors and non-insider equity investors.[222]

The broader impact went beyond direct financial losses, affecting employees who had relocated to work for FTX and were suddenly left facing severe financial hardship and job insecurity.[223] In parallel, public agencies such as the Commodity Futures Trading Commission (CFTC), the DOJ, and the SEC committed substantial taxpayer-funded resources to investigate and respond to the crisis.

In sum, the Coasean bargain between GPs and LPs efficiently allocates risk within the fund but does not account for the broader impact on individuals and institutions affected by venture-backed failures. The result is a partial vacuum of accountability, in which no single actor is responsible for the downstream harm facilitated by poor gatekeeping. This creates a "due diligence dilemma": how to preserve a dynamic, fast-paced investment ecosystem while introducing regulatory mechanisms that encourage VCs to take greater responsibility for the broader consequences of their decisions. The following section examines this dilemma, exploring potential regulatory measures that could help balance the need for agile investment practices with the need to reduce harm to non-contracting parties.

IV. POLICY RECOMMENDATIONS AND LIMITATIONS

The increased scrutiny of VCs following high-profile startup collapses, like FTX's, has highlighted a critical gap: the current legal framework fails to incentivize thorough due diligence by VCs. This gap persists despite VCs being potentially the most efficient actors to prevent fraud and mitigate harm in the startup ecosystem.

A. Exploring Possible Solutions

In the wake of FTX and other startup fraud scandals, U.S. regulators and industry leaders have responded in several ways. These responses generally fall into three categories: regulatory guidance clarifying due diligence expectations,

221. The costs which are being paid from the FTX bankruptcy estate and thus reducing potential returns to creditors, amount to up to $1.5 million per day, translating to approximately $50 million per month. Jesse Hamilton, *FTX Bankruptcy Burning Through $1.5M in Legal Costs Every Day*, COINDESK (Aug. 24, 2023, 2:33 PM), https://www.coindesk.com/policy/2023/08/23/ftx-bankruptcy-burning-through-15m-in-legal-costs-every-day/ [https://perma.cc/2YHC-J3Y2]. In the initial seven months of the bankruptcy proceedings, the total fees reached $200 million, directly diminishing the assets available for creditor reimbursement. *See id.*

222. Scott Chipolina & Joe Miller, *How Will the Cost of Sam Bankman-Fried's Crimes Be Counted at Sentencing?*, FIN. TIMES (Mar. 27, 2024), https://www.ft.com/content/a9fdccbc-e8ff-4c85-ac81-94cf9c2cad8c [https://perma.cc/QSM8-GXSZ].

223. *See* MICHAEL LEWIS, GOING INFINITE: THE RISE AND FALL OF A NEW TYCOON 236–39 (2023).

regulation through enforcement actions, and industry-led technical solutions to enhance verification capabilities.

1. Embracing Regulatory Guidance

One pragmatic approach is for VCs to proactively integrate regulatory guidance from agencies such as the SEC, FTC, and DOJ into their investment frameworks. Regulatory guidance could help address the structural incentives that discourage thorough diligence. As described in Section II.B., in overheated markets, venture investors often feel pressure to move quickly, fearing that deeper scrutiny will slow deal flow or mark them as overly cautious. Clear regulatory expectations can help shift this dynamic, giving investors the mandate, and the confidence, to pause and ask hard questions without risking a competitive disadvantage. To support this, regulators could issue safe harbor guidelines outlining what constitutes "reasonable" due diligence in private market investments.[224] Such guidance might specify baseline expectations—such as verification of financial statements, assessment of governance structures and internal controls, legal compliance checks, and background vetting of founders—while emphasizing that the depth and scope of diligence should be context-dependent.

Regulators should promote a principles-based approach that requires investors to critically assess information and actively follow up on red flags, tailoring their inquiry to each deal's circumstances. Rather than imposing a rigid checklist,[225] the framework would encourage calibration based on a startup's size, sector, and risk profile. Such standards could be modeled as a non-binding VC Due Diligence Code developed in collaboration with industry bodies, which firms could formally adopt—analogous to how corporate governance codes operate—thereby signaling robust practices to LPs and regulators. The NVCA already acknowledges that firms "will engage in reasonable and appropriate due

224. *See, e.g.*, Jennings, *supra* note 112, at 57.

225. *See, e.g.*, Ryan Elmer, *Check-the-Box Mentality Exposes Banks to Big Cyber Risks*, AM. BANKER (Jan. 13, 2015, 10:00 AM), http://www.americanbanker.com/bankthink/check-the-box-mentality-exposes-banks-to-big-cyber-risks-1072117-1.html [https://perma.cc/T9FV-C5UD] (noting that many institutions have "exposed themselves to check-the-box compliance risk," in which they "create governance that meets regulations without understanding the real intent of the guidance or effectively addressing the issues that the regulations are intended to tackle," leading them to be technically "compliant yet still vulnerable to massive liabilities"); Philip J. Weiser, *Entrepreneurial Administration,* 97 B.U. L. REV. 2011, 2057 (2017) (discussing the risk of a check-the-box compliance mentality in the cybersecurity context); *see also* Cheryl L. Wade, *Effective Compliance with Antidiscrimination Law: Corporate Personhood, Purpose and Social Responsibility*, 74 WASH. & LEE L. REV. 1187, 1197 (2017) (describing how a "company that behaves in a socially responsible way will take compliance seriously. One way to do this is to avoid the check-the-box approach to creating and implementing compliance programs. Installation of a program is only the first step. A socially responsible company will make sure that problems are addressed when compliance measures uncover them"); Cristie Ford, *New Governance*, *Compliance, and Principles-Based Securities Regulation*, 45 AM. BUS. L.J. 1, 42–43 (2008) (discussing how prescriptive regulatory mandates can encourage a formalistic, box-checking approach to compliance, detracting from genuine engagement with underlying risks).

diligence" prior to investing;[226] regulatory guidance could build on this by clarifying what such diligence entails in practice.

Contextualized frameworks are essential, as a high-growth crypto exchange managing customer assets demands far more intensive scrutiny—such as verification of asset custody, regulatory registration status, and independently audited financials—than a small B2B software startup with limited exposure to public risk. To reflect this risk variation, regulators could recommend that VC-led deals exceeding a certain dollar threshold or operating in sensitive sectors include independent third-party audits or compliance reviews as a best practice. Scholars have observed that the startup world's "fake it till you make it" ethos, combined with a lack of early oversight—such as failing to require external audits—can create fertile ground for fraud.[227]

Introducing independent audits for late-stage unicorns or startups handling consumer funds would represent a meaningful step toward reducing these risks. Beyond surfacing red flags, this approach could help prevent the kind of "complete absence of trustworthy financial information" that the FTX post-mortem made disturbingly clear.[228]

Notably, the SEC has already begun to increase its scrutiny of due diligence practices among private fund advisers, including VC and PE firms.[229] In its 2022 Risk Alert, the SEC highlighted common deficiencies observed in examinations of private fund advisers.[230] These deficiencies included inadequate due diligence processes,[231] misleading disclosures to investors,[232] and failures in valuation practices.[233] The SEC has also adopted new rules that will expand regulation of private fund advisers starting September 2024 and March 2025, imposing additional requirements on exempt reporting advisers, including prohibitions on

226. *Principles for Operating a Venture Capital Fund*, NVCA, https://nvca.org/operating-principles/ (last visited July 17, 2025) [https://perma.cc/25XT-XJP7] ("A venture capital firm will engage in reasonable and appropriate due diligence and legal review prior to making investments or divestments on behalf of the fund.").

227. *See generally* Pollman, *supra* note 110.

228. Georges Ugeux, *The FTX Collapse: Why Did Due Diligence, Regulation, and Governance Evaporate*?, CLS BLUE SKY BLOG (Nov. 30, 2022), https://clsbluesky.law.columbia.edu/2022/11/30/the-ftx-collapse-why-did-due-diligence-regulation-and-governance-evaporate/ [https://perma.cc/KM9T-M7N5].

229. OFF. OF COMPLIANCE & EXAMINATIONS, RISK ALERT: OBSERVATIONS FROM EXAMINATIONS OF INVESTMENT ADVISERS MANAGING PRIVATE FUNDS 2 (June 23, 2020), https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf [https://perma.cc/VB8X-U8AL].

230. DIV. OF EXAMINATIONS, RISK ALERT: OBSERVATIONS FROM EXAMINATIONS OF PRIVATE FUND ADVISERS 1 (Jan. 27, 2022), https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf [https://perma.cc/NRW7-HTWC].

231. *Id.* at 5 ("EXAMS staff observed advisers that did not perform reasonable investigations of investments in accordance with their policies and procedures, including the compliance and internal controls of the underlying investments or private funds in which they invested.").

232. *Id.* at 4 ("EXAMS staff has observed private fund advisers providing to investors or prospective investors misleading track records or other marketing statements that appear to violate Rule 206(4)-8.").

233. *Id.* ("EXAMS staff observed private fund advisers that presented inaccurate performance calculations to investors. For example, the staff observed private fund advisers that used inaccurate underlying data (*e.g.*, data from incorrect time periods, mischaracterization of return of capital distributions as dividends from portfolio companies, and/or projected rather than actual performance used in performance calculations) when creating track records, thereby leading to inaccurate and potentially misleading disclosures regarding performance.").

certain restricted activities and new disclosure requirements around preferential treatment.[234] But these rules are currently subject to ongoing litigation and their implementation under the new administration remains uncertain.[235] Furthermore, the SEC still leaves it to the advisers to determine what constitutes "reasonable" in their specific context, rather than prescribing a universal checklist of due diligence activities.[236]

In parallel, the DOJ has taken more concrete steps in specific areas, particularly through its Evaluation of Corporate Compliance Programs ("ECCP"). Originally in 2017 and updated multiple times since, the ECCP sets out the DOJ Criminal Division's expectations for corporate compliance, including the importance of effective due diligence for informed decision-making in mergers and acquisitions.[237] The most recent update, issued on September 23, 2024, refines the guidance used by prosecutors to assess a company's compliance program during criminal investigations and enforcement actions.[238] While the ECCP is intended primarily for DOJ prosecutors, it also serves as a roadmap for companies seeking to align their internal compliance efforts with the Department's priorities. [239] Firms with robust, well-documented programs are more likely to receive favorable treatment in enforcement proceedings—such as reduced financial penalties or more lenient settlement terms.[240]

In summary, by proactively embracing and shaping regulatory guidance, the VC industry can improve practices before more drastic rules are deemed necessary. This balances the need for innovation-friendly flexibility with a greater measure of accountability and investor protection.

2. *Regulation by Enforcement*

A complementary strategy for improving due diligence in the VC industry is increased regulatory enforcement targeting both entrepreneurs and, where appropriate, investors. This type of "regulation by enforcement" can recalibrate incentives and deter misconduct by signaling that inattention to risk carries

234. DORSEY & ANDERSON, *supra* note 56, at 9.

235. *Id.*

236. DEP'T OF JUST., EVALUATION OF CORPORATE COMPLIANCE PROGRAMS 1 (2024), https://www.justice.gov/criminal/criminal-fraud/page/file/937501/dl [https://perma.cc/GU7C-P2X6].

237. *Id.* at 9.

238. *Id.* at 1.

239. *See id.*

240. Andrew M. Good, Avia M. Dunn & Zaneta Wykowska, *Key Updates to the DOJ's Evaluation of Corporate Compliance Programs*, HARV. L. SCH. F. ON CORP. GOV. (Oct. 7, 2024), https://corpgov.law.harvard.edu/2024/10/07/key-updates-to-the-dojs-evaluation-of-corporate-compliance-programs/ [https://perma.cc/7ZV3-L3RU] (stating that "[t]he DOJ has consistently emphasized that the existence of an effective compliance program can lead to significant benefits, including reduced fines under the U.S. Sentencing Guidelines and more favorable charging decisions").

consequences.[241] Notably, the SEC's inquiry into FTX's backers raised the question of whether those firms met their fiduciary duties to their own investors.[242]

To date, however, enforcement actions have primarily focused on startup founders rather than investors. For example, the FTC has stepped up efforts to combat deceptive practices in emerging technologies, including artificial intelligence ("AI"). In September 2024, the agency launched a broad crackdown on companies making exaggerated or misleading AI claims, citing its authority under the FTC Act, which prohibits "unfair or deceptive acts or practices in or affecting commerce.[243] While VCs are unlikely to face direct liability unless they knowingly participate in or facilitate deceptive conduct, regulators have begun to examine how investors might contribute to, or fail to prevent, fraudulent behavior.[244]

The DOJ has gone further in certain sectors, especially healthcare. In February 2024, Brian Boynton, then acting head of the DOJ's Civil Division, explicitly identified "investors, such as private equity firms or venture capital firms" as a source of "influence [on] patient care" and warned that the DOJ "will not hesitate to pursue them for their roles in defrauding the government."[245] Consistent with this position, the DOJ has argued that healthcare investors may be held liable under the False Claims Act ("FCA") for failing to identify or address illegal conduct during the due diligence process.[246] These developments suggest

241. *See, e.g.*, Chris Brummer, Yesha Yadav & David T. Zaring, *Regulation by Enforcement*, S. CAL. L. REV. 1, 2 (2023) ("This approach, popularly termed 'regulation by enforcement,' prompted fierce critiques from commentators and the marketplace, often from the standpoint of fairness—and based on an implicit assumption that such regulatory conduct might be illegal, or at the very least, politically motivated."); James J. Park, *The Competing Paradigms of Securities Regulation*, 57 DUKE L.J. 625, 635–37 (2007) (describing how regulation by enforcement happens when agencies or regulators use interpretive letters to create a rule that otherwise does not actually clearly exist); Donna M. Nagy, *Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework*, 83 CORNELL L. REV. 921, 937 (1998) (explaining interpretive letters as the letters which agencies send in response to a request for guidance on the applicability of a particular regulation); Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation by Enforcement: A Look Ahead at the Next Decade*, 7 YALE J. ON REG. 149, 155 (1990) (describing that many agencies have not maintained a highly-visible, and successful enforcement profile).

242. Lang & Prentice, *supra* note 8.

243. *See* FED. TRADE COMM'N, *supra* note 196; 15 U.S.C. § 45(a)(1).

244. Sarah Wynn, *SEC Subpoenaed Three Venture Capital Firms This Year: DL News*, BLOCK (Aug. 9, 2024, 12:37 PM), https://www.theblock.co/post/310496/sec-subpoenaed-three-venture-capital-firms-this-year-dl-news [https://perma.cc/HS65-4MDV] (reporting increased regulatory scrutiny of VCs' roles in potential securities violations involving their portfolio companies); Dan Primack, *Venture Capital May Have a Liability Problem*, AXIOS (Jan. 10, 2023), https://www.axios.com/2023/01/10/venture-capital-may-have-a-liability-problem [https://perma.cc/P92Y-2WTZ] (noting that regulatory agencies are beginning to scrutinize VC firms for potential liability in the fraudulent activities of their portfolio companies, indicating increased regulatory focus on the role of VCs in overseeing and possibly overlooking misconduct); *see* also Jennings, *supra* note 112.

245. Jaime L.M. Jones, Brenna E. Jenny & Lauren McBride, *DOJ Ramps Up Scrutiny of Health Care Investors*, REUTERS (June 14, 2024, 8:47 PM), https://www.reuters.com/legal/legalindustry/doj-ramps-up-scrutiny-health-care-investors-2024-06-14/ [https://perma.cc/JR9V-DJET].

246. United States ex rel. Medrano v. Diabetic Care RX, LLC, No. 15-62617-CIV, 2018 WL 6978633, at *1 (S.D. Fla. Nov. 30, 2018). This case, also known as the Patient Care America case, involved allegations that a pharmacy, its PE fund owner, and two executives violated the False Claims Act by engaging in an illegal

a trend towards stricter scrutiny of investor conduct, particularly in highly regulated industries such as healthcare, fintech, and cryptocurrency. Still, the extent to which this trend will continue remains uncertain under the new Trump administration, as regulatory priorities may shift.

In the meantime, the legal landscape has shifted considerably following the Supreme Court's decision in *Loper Bright Enterprises v. Raimondo*,[247] which overturned the long-standing *Chevron* doctrine. This ruling is expected to curtail the SEC's ability to define and enforce due diligence standards through enforcement actions.[248] Without presumptive deference to agency interpretations, courts may more readily question whether specific requirements exceed statutory authority. The SEC's reliance on regulation by enforcement[249]—effectively creating norms through case-by-case actions—may now face greater judicial resistance, even in rapidly evolving sectors like fintech and AI, where flexible oversight has traditionally been favored.[250]

Compounding this challenge is the limited investigatory capacity of the SEC and similar agencies. The sheer number of early-stage companies and the complexity of venture investment structures make comprehensive oversight difficult.[251] Limited public resources constrain these agencies' ability to pursue every instance of potentially suspected startup-related fraud.[252] The efficient allocation of scarce public enforcement resources is crucial for maximizing social welfare.[253] This allocation strategy is rational from a welfare-maximization

kickback scheme. *Id.* The DOJ argued that the PE firm exercised substantial control over the pharmacy's operations, including compliance decisions, and therefore could be held accountable for the misconduct. *See id.* at *10. The case ultimately settled in 2019, with the PE fund agreeing to pay $21.36 million to resolve the allegations. *See Compounding Pharmacy, Two of Its Executives, and Private Equity Firm Agree to Pay $21.36 Million to Resolve False Claims Act Allegations*, U.S. DEP'T OF JUST. OFF. OF PUBLIC AFF., https://www.justice.gov/opa/pr/compounding-pharmacy-two-its-executives-and-private-equity-firm-agree-pay-2136-million (Feb. 5, 2025) [https://perma.cc/639K-9HL4]; *see also* K&L Gates, *Legal Trends Health Care Investors Should Know: Q&A with K&L Gates Partners*, Bos. Bus. J. (Oct. 1, 2024), https://www.bizjournals.com/boston/news/2024/10/01/legal-trends-health-care-investors.html [https://perma.cc/28N7-2VVJ].

247. 603 U.S. 369, 412 (2024) (overruling Chevron U.S.A., Inc. v. Nat. Res. Def. Council, Inc., 468 U.S. 837 (1984)); *see also* Lisa Schultz Bressman, *Lower Courts After Loper Bright*, 31 GEO. MASON L. REV. 499, 500 (2024).

248. Alex Ortolani, *SEC Inspector General Warns of More Lawsuits After Loper Bright*, PLANSPONSOR (Nov. 7, 2024), https://www.plansponsor.com/sec-inspector-general-warns-of-more-lawsuits-after-loper-bright/ [https://perma.cc/G963-K5U2].

249. *See, e.g.*, Brummer et al., *supra* note 241.

250. For such focus on the emerging technology space, see, e.g., Nizan Geslevich Packin & Hadar Yoana Jabotinsky, *Blacklisting or Banning Technologies that Scare Us: AI, Cryptocurrencies, and More*, 73 AM. U. L. REV. 1467 (2024); Yuliya Guseva, *The SEC, Digital Assets, and Game Theory*, 46 J. CORP. L. 629 (2021).

251. Primack, *supra* note 244.

252. Pollman, *supra* note 110, at 353 (arguing that the "explosive growth of private markets has left [significant] portions of U.S. capital markets with [minimal] securities fraud scrutiny and enforcement," allowing large private companies to operate in environments of "extreme information asymmetry" that "foster misconduct and deception").

253. *See* A. Mitchell Polinsky & Steven Shavell, *The Economic Theory of Public Enforcement of Law*, 38 J. ECON. LITERATURE 45, 50–51 (2000) (discussing how optimal enforcement strategies allocate resources to maximize social welfare by balancing the costs of enforcement with the benefits of deterrence).

standpoint but leaves large swaths of the private market under-scrutinized.[254] In effect, enforcement gaps in the venture sector widen just as legal tools for informal rulemaking are contracting, creating a regulatory vacuum that neither courts nor agencies are well-equipped to fill.

Generative AI intensifies this vacuum. Founders armed with large language models (LLMs) can now fabricate investor decks, auto-generate "live" websites, and even script fake user-engagement data in a single afternoon—transforming the appearance of traction into a purchasable commodity.[255] The collapse of 11x AI, which falsely touted Fortune 500 clients and displayed unauthorized logos, shows how LLM-enabled puffery can metastasize into outright fraud before any regulator notices.[256] In a similar vein, the DOJ has indicted Albert Saniger—the former chief executive officer of e-commerce app Nate—for securities and wire fraud after investigators discovered that transactions the company advertised as "AI-powered" were in fact completed by hundreds of human contractors in the Philippines and Romania.[257] More broadly, "vibe-coding" tools such as Cursor let engineers ship superficially polished products on day one, eroding the signaling value of early demos.[258] Taken together, these developments blur the line between authentic traction and AI-manufactured momentum. When AI-generated signals look indistinguishable from genuine market validation, traditional ex-post enforcement by the SEC, the DOJ, or the FTC arrives only after capital, jobs, and public trust have already been misallocated.[259]

254. Rachel E. Barkow, *Institutional Design and the Policing of Prosecutors: Lessons from Administrative Law*, 61 STAN. L. REV. 869, 880–81 (2009) (noting that enforcement agencies prioritize cases based on resource constraints and the potential impact on public welfare, often targeting egregious or high-profile violations to maximize deterrent effects).

255. Daniel Lee, *LLMs + Fraud: How Criminals Use Large Language Models to Commit Fraud*, PERSONA (Feb. 26, 2025), https://withpersona.com/blog/llm-fraud [https://perma.cc/L6J9-75HR] (explaining how LLMs can fabricate listings and reviews); Jason Tabeling, *LLMs Are Driving Referral Traffic – but What About Engagement?*, SEARCH ENGINE LAND (Apr. 2, 2025, 9:00 AM), https://searchengineland.com/llms-referral-traffic-engagement-453798 [https://perma.cc/LE7X-3B7F] (explaining how LLM-generated content distorts engagement metrics).

256. Dominic-Madori Davis & Marina Temkin, *a16z- and Benchmark-backed 11x Has Been Claiming Customers It Doesn't Have*, TECHCRUNCH (Mar. 24, 2025), https://archive.ph/i7U68 [https://perma.cc/LB86-28RX] (explaining misrepresentation of client relationships and revenue figures).

257. Chris Morris, *A Tech CEO Has Been Charged with Fraud for Saying His E-Commerce Startup Was Powered by AI, When It Was Actually Just Using Manual Human Labor*, FORTUNE (Apr. 11, 2025, 11:01 AM), https://fortune.com/2025/04/11/albert-saniger-nate-shopping-app-fraud-ai-justice-department/ [https://perma.cc/YFS6-DYZZ] (explaining DOJ indictment of Nate's CEO for misrepresenting AI capabilities).

258. *Maker of AI "vibe coding" App Cursor Hits $9bn Valuation*, FIN. TIMES (May 5, 2025), https://www.ft.com/content/a7b34d53-a844-4e69-a55c-b9dee9a97dd2 (explaining the rise of AI-generated code and "vibe coding").

259. *See* Ting Cheung, John McKnight & Savannah Shepherd, *Fraud in Startup Land: When the Unicorn Horn is Plastic*, SANFORD HEISLER SHARP MCKNIGHT, LLP (Feb. 25, 2025), https://sanfordheisler.com/blog/2025/02/fraud-in-startup-land/ [https://perma.cc/5GT7-QBFK].

3. *Technology-Based Solutions and RegTech*

A third potential solution to the due diligence dilemma lies in deploying regulatory technology ("RegTech") solutions to streamline due diligence processes.[260] These technologies can automate tasks traditionally performed manually, such as financial analysis, background checks, and compliance assessments, enabling VC firms to conduct faster and more rigorous evaluations.[261] For instance, machine learning algorithms can identify anomalies in historical financial or transaction data that may signal misrepresentation or emerging risk.[262] LLMs and natural language processing ("NLP") models such as GPT-based classifiers and tools can scan unstructured data—such as news coverage, litigation records, or social media content—for red flags involving founders or company conduct,[263] and even assess whether hype-driven manipulation is at play.[264] AI and blockchain can offer real-time visibility into a startup's financial health or build transparent ledgers of contractual and transactional information.[265] For example, Sequoia Capital reports using AI to streamline investment analysis, automate diligence protocols, and significantly reduce manual workload.[266] Thus, RegTech tools can reduce the incentive to rely on "proxy due diligence" by enabling each investor to independently verify a company's representations—even in fast-moving deals.

260. *See generally* Nizan Geslevich Packin, *Regtech, Compliance and Technology Judgement Rule*, 93 CHI.-KENT L. REV. 193, 194 (2018).

261. Mayuri Jain, *Why Finance Is Deploying Natural Language Processing*, FINEXTRA (Sept. 30, 2024), https://www.finextra.com/blogposting/26254/why-finance-is-deploying-natural-language-processing [https://perma.cc/WVU7-SJYD].

262. *From Data to Defense: The Role of Machine Learning in Fraud Prevention*, ACI WORLDWIDE, https://www.aciworldwide.com/machine-learning-fraud-detection-prevention [https://perma.cc/WNL2-VTRW] (last visited July 17, 2025); *see also* Cary Coglianese & David Lehr, *Regulating by Robot: Administrative Decision Making in the Machine-Learning Era*, 105 GEO. L.J. 1147, 1168–70 (2017) (noting that reliance solely on algorithms can overlook context-specific factors better assessed by human judgment); Douglas W. Arner, Janos Barberis & Ross P. Buckley, *FinTech, RegTech, and the Reconceptualization of Financial Regulation*, 37 NW. J. INT'L L. & BUS. 371, 424–26 (2017) (emphasizing that technology aids in regulation but cannot fully substitute for human expertise in detecting complex risks).

263. Jain, *supra* note 261.

264. For more on NLP, see generally Leon Anidjar, Nizan Geslevich Packin & Argyri Panezi, *The Matrix of Privacy: Data Infrastructure in the AI-Powered Metaverse*, 18 HARVARD L. POL. REV. (2023).

265. *See, e.g.*, Khowanas Saeed Qader & Kemal Ceka, *Influence of Blockchain and Artificial Intelligence on Audit Quality: Evidence from Turkey*, 10 HELIYON, April 2024, at 1, 1, https://www.ncbi.nlm.nih.gov/pmc/articles/PMC11076863/ [https://perma.cc/C53K-LETK] (providing empirical evidence of these emerging technologies potential to enhance audit accuracy, efficiency, and transparency); Hongdan Han, Radha K. Shiwakoti, Robin Jarvis, Chima Mordi & David Botchie, *Accounting and Auditing with Blockchain Technology and Artificial Intelligence: A Literature Review*, 48 INT'L J. ACCT. INFO. SYST., April 2024, at 1, 2 (offering an overview of the impacts of blockchain and AI in accounting and auditing); Arystanbek Aitkazinov, *The Role of Artificial Intelligence in Auditing: Opportunities and Challenges*, 6 INT'L J. RSCH. ENG'G, SCI. & MGMT. 117, 114 (2023) (exploring AI's potential to revolutionize auditing, possibly reflecting on how AI can enhance audit quality by automating complex processes).

266. Josipa Majic Predin, *Venture Capital's New Era: AI's Journey from Enhancing Operational Efficiency to Alpha Generation*, FORBES (Jan. 16, 2024, 8:03 AM), https://www.forbes.com/sites/josipamajic/2024/01/16/venture-capitals-new-era-ais-journey-from-enhancing-operational-efficiency-to-alpha-generation [https://perma.cc/TSQ4-SWYJ].

However, AI tools are not only a resource for investors but also for deceptive founders. Builder.ai—a Microsoft- and QIA-backed startup—was recently forced to revise its financials after revelations that it had inflated reported sales by up to 25%. The company has since hired external auditors.[267] The case illustrates both the need for AI-aided diligence and the risks posed when founders themselves exploit AI and investor trust to exaggerate traction. It also highlights the importance of integrating third-party audits into RegTech workflows—especially for startups scaling rapidly with the aid of generative tools.

Importantly, technology can also support a shift from static, one-time diligence to ongoing risk monitoring. Some VC firms now explore software that interfaces directly with portfolio company systems—with permission—to track compliance indicators, cash flows, or governance changes in real time. This kind of "continuous diligence" could serve as a failsafe for catching deterioration in controls or the emergence of red flags between funding rounds. While potentially enhancing due diligence efficiency, RegTech tools face inherent limitations in detecting subtle fraud indicators that often require contextual understanding.[268] These systems tend to excel at identifying standardized compliance or financial inconsistencies but may struggle with the contextual or qualitative nuances that characterize early-stage fraud. While large VC firms may be able to train AI models on broad datasets and refine them over time to improve accuracy, such investments are often out of reach for smaller funds. Moreover, automation may encourage over-reliance: the assumption that "the system would have caught it" can easily foster complacency. To mitigate this risk, regular audits of automated tools and integration of human judgment at critical junctures remain essential.

Regulators and industry groups could play a supporting role in promoting adoption and reducing barriers. Regulators can encourage standardized reporting formats for startup diligence data, which would make it easier for VC tools to ingest and compare data across startups. In parallel, industry groups could fund shared utilities or open-source tools for basic diligence tasks—such as cap table verification or founder background checks.[269] Lastly, RegTech tools can aid in internal training and cultural change. Interactive modules that simulate fraud detection scenarios or gamify the identification of red flags can sharpen the instincts of junior analysts and partners alike, especially in a world where misconduct may be subtle and relational rather than overt. Over time, such practices may help entrench a culture of proactive vigilance within VC firms.

Taken together, these developments suggest that technology can play a valuable—but not decisive—role in addressing the due diligence dilemma. It can

267. *See* Mark Bergen, Newley Purnell & Yazhou Sun, *Microsoft-Backed Startup Builder.ai Hires Auditors to Investigate Inflated Sales*, BLOOMBERG (Mar. 31, 2025), https://archive.ph/gnTSE [https://perma.cc/4GSB-XE9B].

268. *See* Packin, *supra* note 260.

269. Yifat Aran, *A New Coalition for "Open Cap Table" Presents an Opportunity for Equity Transparency*, TECHCRUNCH (Aug. 29, 2021), https://techcrunch.com/podcast/a-new-coalition-for-open-cap-table-presents-an-opportunity-for-equity-transparency/ [https://perma.cc/MRY8-Q2GX].

amplify human capacity, reduce the time-cost tradeoff that plagues diligence in fast-moving markets, and create infrastructure for shared oversight.

B. Alternatively—Accepting the Price of Innovation?

While technological solutions offer promise, some argue that occasional failures in VC due diligence are an acceptable "price of innovation." This argument, which warrants serious consideration, emphasizes the need to preserve a delicate balance between regulatory oversight and entrepreneurial freedom. According to this view, the VC ecosystem flourishes precisely because of its reliance on flexible legal norms and private ordering,[270] suggesting that minimal regulatory intervention in due diligence is not a bug but a feature of an innovation-driven economy.

Modern corporate and securities laws, particularly in the U.S., have largely taken an enabling rather than restrictive approach toward startups and venture financing.[271] This private realm of contracting has been integral to the growth of startups.[272] Furthermore, VC's reliance on trust networks and reputation serves where formal regulation recedes.[273] In short, a flexible legal regime accommodates the unique risk profile and innovation cycle of high-growth ventures, treating occasional failures as an expected cost in a sector where the potential upsides are transformative.[274]

Comparative evidence strengthens the case for minimal intervention. Countries attempting to replicate Silicon Valley through heavily regulated "public venture capital" exchanges like Germany's Neuer Markt and London's AIM imposed public-company style requirements, yet still suffered widespread fraud before collapsing.[275] By contrast, the U.S. system's reliance on private venture funding, with informal vetting by sophisticated angels and VCs rather than statutory prospectus mandates, has yielded far better outcomes.[276] The lesson is that transplanting a public-company regulatory model onto early-stage ventures is a poor fit; it can neither cure the inherent uncertainties of startups nor replicate the

270. *See, e.g.*, Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1069 (2003) ("[T]he keystone of the U.S. venture capital market is private ordering."); Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CALIF. L. REV. 261, 263–64 (1985) ("We argue that the very benefits of the state's efforts to imply and standardize widely useful terms create hitherto overlooked barriers to innovative forms of contractual agreement.").

271. *See* Elizabeth Pollman, *Adventure Capital*, 96 S. CAL. L. REV. 1341, 1356 (2024) (describing how securities regulations have evolved to favor venture capital with deregulatory measures that transformed private markets).

272. *See, e.g.*, John F. Coyle & Joseph M. Green, *Contractual Innovation in Venture Capital*, 66 HASTINGS L.J. 133, 155 (2014) (exploring the process of contractual innovation in early-stage financing).

273. *See* Gilson, *supra* note 270, at 1067 ("The braiding of the venture capital fund-portfolio company contract with the investor-venture capital fund contract supports a reputation market that constrains opportunistic behavior by the venture capital fund.").

274. *See* Pollman, *supra* note 271, at 1369 (warning that additional mandatory verification would "impinge on the valuable space for maneuvering in the private realm" essential for startups).

275. *See* Darian M. Ibrahim, *Public or Private Venture Capital?*, 94 WASH. L. REV. 1137, 1151–59 (2019).

276. *Id.*; *see also* Gilson, *supra* note 270, at 1086–87.

nuanced due diligence that experienced venture investors perform as a matter of course.

By this view, preemptive regulation risks doing more harm than good in the VC context. Mandating detailed due diligence requirements ex ante could freeze a fast-moving, judgment-driven investment process into rigid bureaucratic routines. VC depends on speed, discretion, and a tolerance for uncertainty—qualities poorly served by standardized compliance checklists. Regulatory mandates risk being both redundant and counterproductive since existing antifraud rules, such as Rule 10b-5, already provide a framework for punishing misconduct. Imposing a generalized legal duty of exhaustive diligence may simply incentivize risk-averse behavior—deterring investment in precisely the kinds of ventures that drive innovation: those built on unproven science, unorthodox founders, or nontraditional business models. In this view, the presence of risk is not a regulatory defect to be eliminated but a defining feature of the innovation economy.

Moreover, research shows that financial regulation often follows a predictable pattern of crisis-driven overreaction that fails to account for market cycles.[277] Major financial reforms tend to be enacted in the immediate aftermath of market downturns, leading to the adoption of provisions ill-suited to normal market functioning. This pattern of reactive regulation risks imposing permanent constraints based on temporary conditions, particularly problematic for VC's long-term innovation horizon.

Given these considerations, our policy recommendations deliberately favor light-touch interventions that preserve the dynamism and flexibility of venture markets. We advocate for maintaining the current approach of reserving public enforcement actions for the most egregious cases of fraud or misconduct, while encouraging industry-led improvements in due diligence practices. This balanced approach acknowledges that while some oversight is necessary, heavy-handed regulation could undermine the very innovation ecosystem it seeks to protect.

V. CONCLUSION

The VC industry's cyclical approach to due diligence—thorough during downturns, cursory during booms—creates significant mismatches between stakeholder expectations and actual practices, as demonstrated by failures like FTX. The current legal framework, which relies on private ordering, frequently fails to incentivize adequate due diligence, enabling moral hazard to harm a broad range of stakeholders. While mandatory due diligence requirements might seem appealing, they risk creating a checkbox mentality that could hinder innovation. Instead, market-based solutions centered on transparency, best practices,

277. *See, e.g.*, Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1591 (2005) (demonstrating how crisis-driven financial regulation often produces suboptimal governance requirements that persist beyond their usefulness).

and reputational incentives may prove more effective. RegTech solutions can enhance these processes, though technology should complement rather than replace human judgment in detecting nuanced risks.[278] A balanced policy approach should promote thorough due diligence while preserving the VC industry's ability to support high-risk ventures. Through market-driven standards and improved practices, VCs can better align private incentives with market integrity, enabling continued technological advancement while protecting stakeholder interests.

278. *See* Cary Coglianese & David Lehr, *Regulating by Robot: Administrative Decision Making in the Machine-Learning Era*, 105 GEO. L.J. 1147, 1168–70 (2017) (noting that reliance solely on algorithms can overlook context-specific factors better assessed by human judgment); Douglas W. Arner, Janos Barberis & Ross P. Buckley, *FinTech, RegTech, and the Reconceptualization of Financial Regulation*, 37 NW. J. INT'L L. & BUS. 371, 387–88 (2017) (emphasizing that technology aids in regulation but cannot fully substitute for human expertise in detecting complex risks).

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