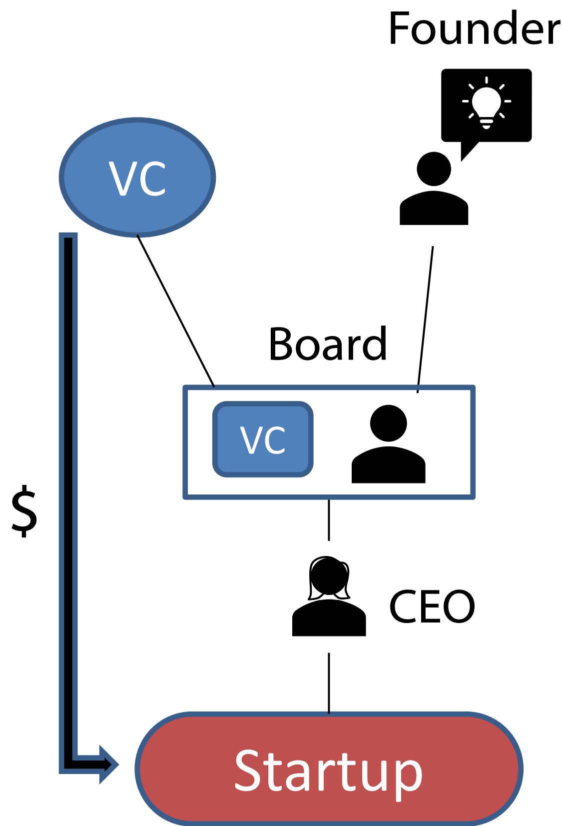
Risk-Seeking Governance

Brian Broughman & Matt Wansley

June 2023

Conventional account of VC Governance



Traditional (Monitoring) model of VC

VC is concerned about
- Adverse Selection
- Moral Hazard

VC solves via Active Governance.
- VCs negotiate for control rights and board seats (Kaplan & Stromberg, 2003, Sahlman, 1990)
- Actively use control to replace founder with outside CEO & professionalize management (Ewens & Marz, 2017, Hellmann & Puri, 2002)

VC governance thought to add value

Yet …

VC Retreat from Active Governance

Bill Gurley

Declining emphasis on governance in recent years (Lerner and Nanda, 2020)

- More founder-friendly contract terms
- Founder control increasing across all dimensions (equity, board seats, & CEO)
- VC-backed dual-class IPOs

Puzzle – why?

- Answer #1 = investor competition *but* if VC-governance adds value – everyone benefits at the right price.
- Alternative Theory = Risk-Seeking Governance

Other explanations:

- Ewens, Nanda, Rhodes-Kropf (2018);
- Pollman (2019);
- Goshen & Hamdani (2016); Goshen & Squire (2017);

"Silicon Valley board rooms have mostly become .. . . . .

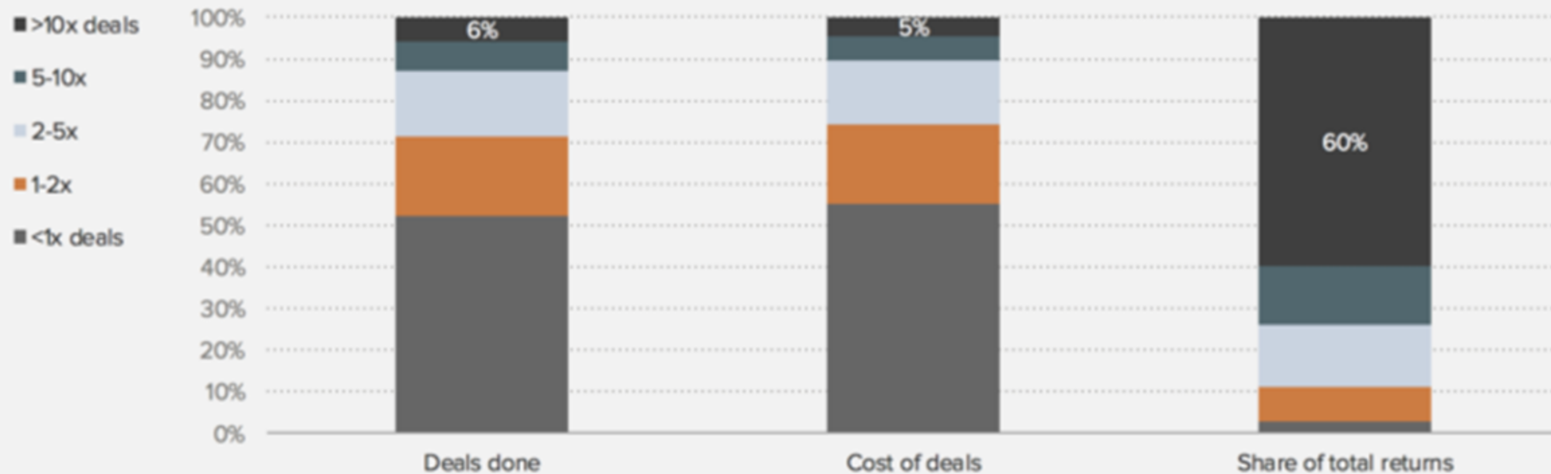
The venture capitalist is afraid of is losing the next big one."

The Right Tail which Wags an Industry

The
Power Law
Venture Capital
and the Making of
the New Future

Sebastian Mallaby

VC returns are highly skewed (Hall and Woodward, 2010).



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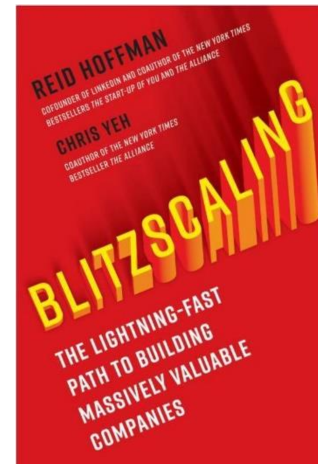
- Not just an issue of deal selection, but governance too

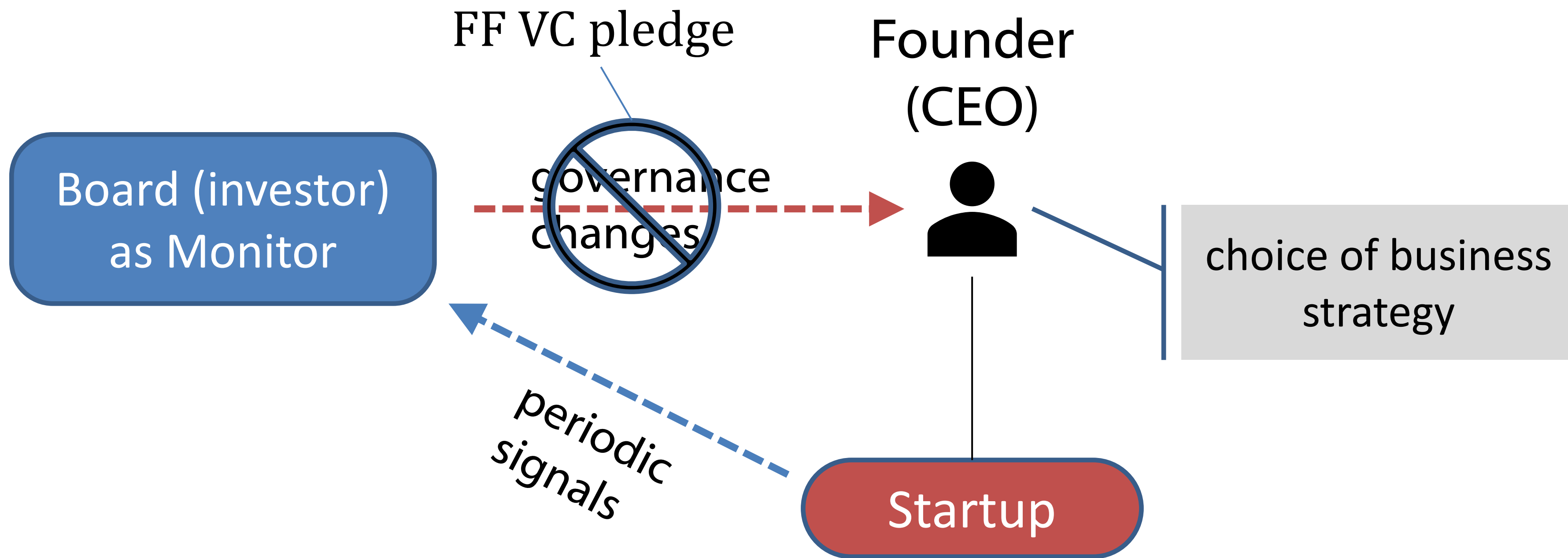
<u>Different Perspectives on Risk</u>:

- Investors in VC fund hold diversified portfolios, *but*
- Founder bears firm-specific (idiosyncratic) risk.

<u>Implicit Bargain</u>: VC offers private benefits – early liquidity, job protection & soft landings – to encourage founders to take risks.



BoD Monitoring vs Risk Taking



Problem: Risky strategies increase likelihood of negative signal

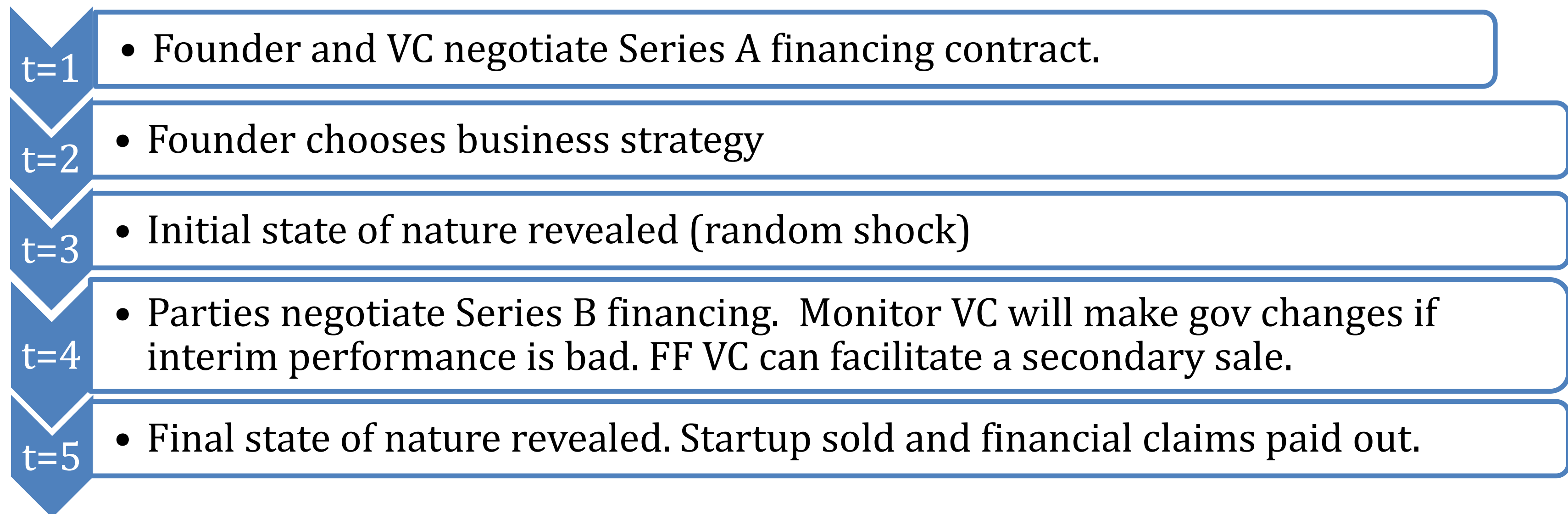
Financing Contract -- Setup

Founder can choose between two types of VCs (contracts):

- Monitor VC
- Founder Friendly VC

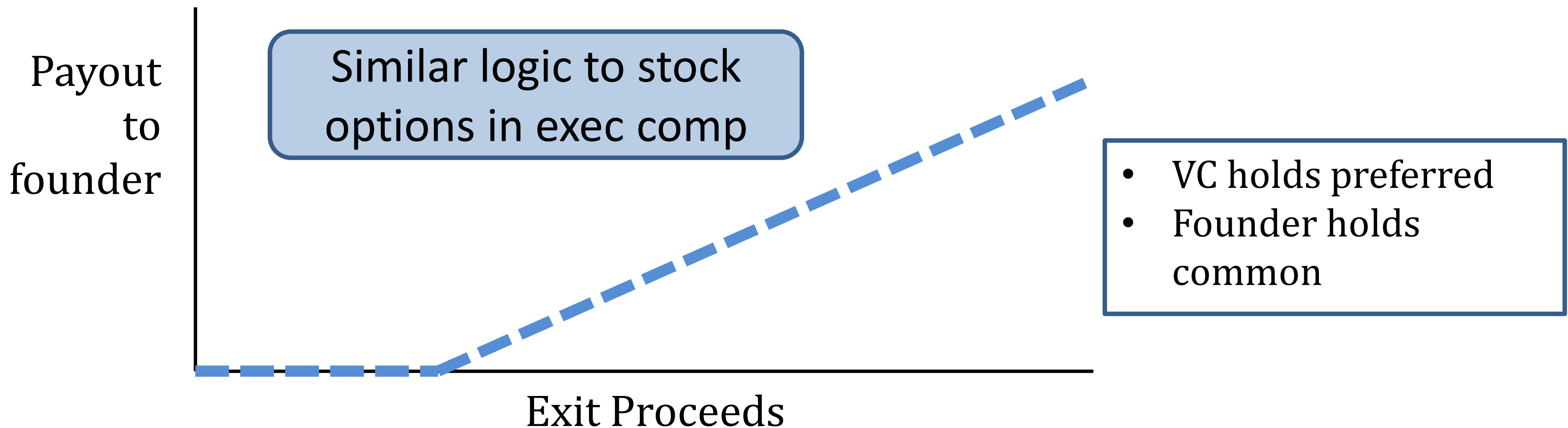
Parties negotiate two rounds of financing (incomplete contract)

Timeline:



Ex Post Incentives (Capital Structure)

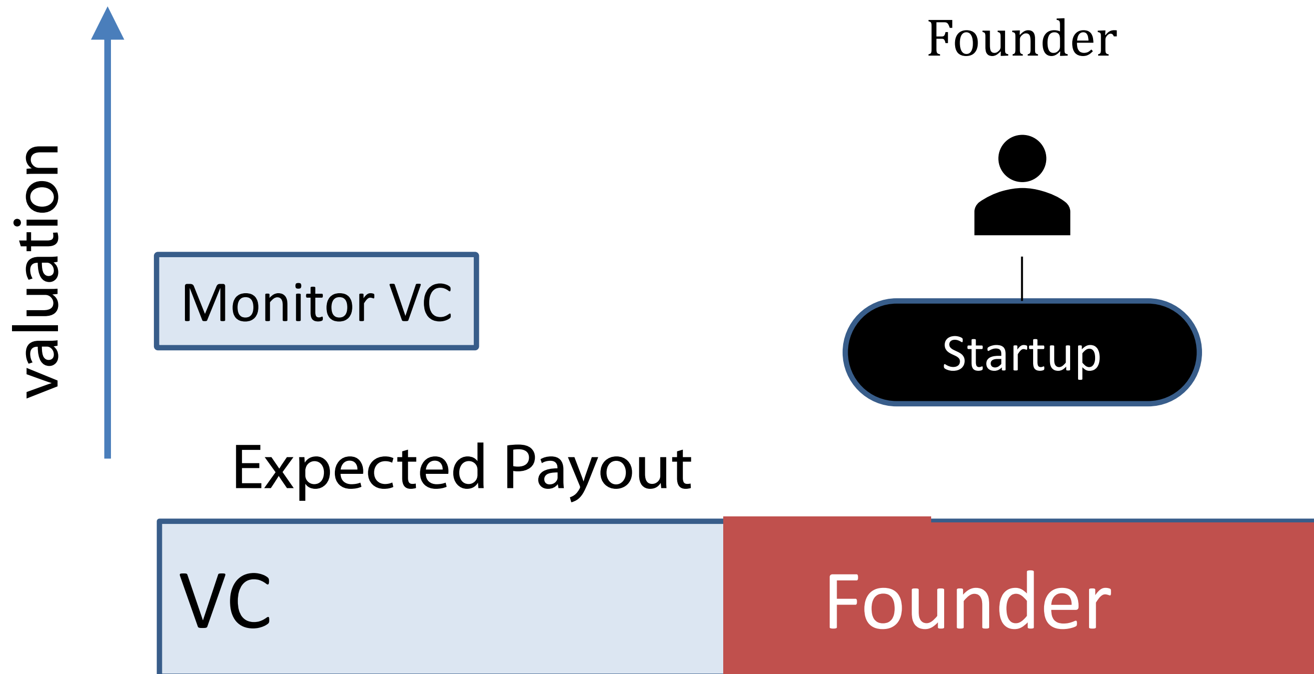
A capital structure where VC holds preferred stock (with a liquidation preference) encourages founder to take risks



Contrary to caselaw – VC and founder holding different classes of equity helps *align* incentives

Ex Ante: Risk-bearing & bargaining over price

VCs compete on valuation (i.e. price/share)



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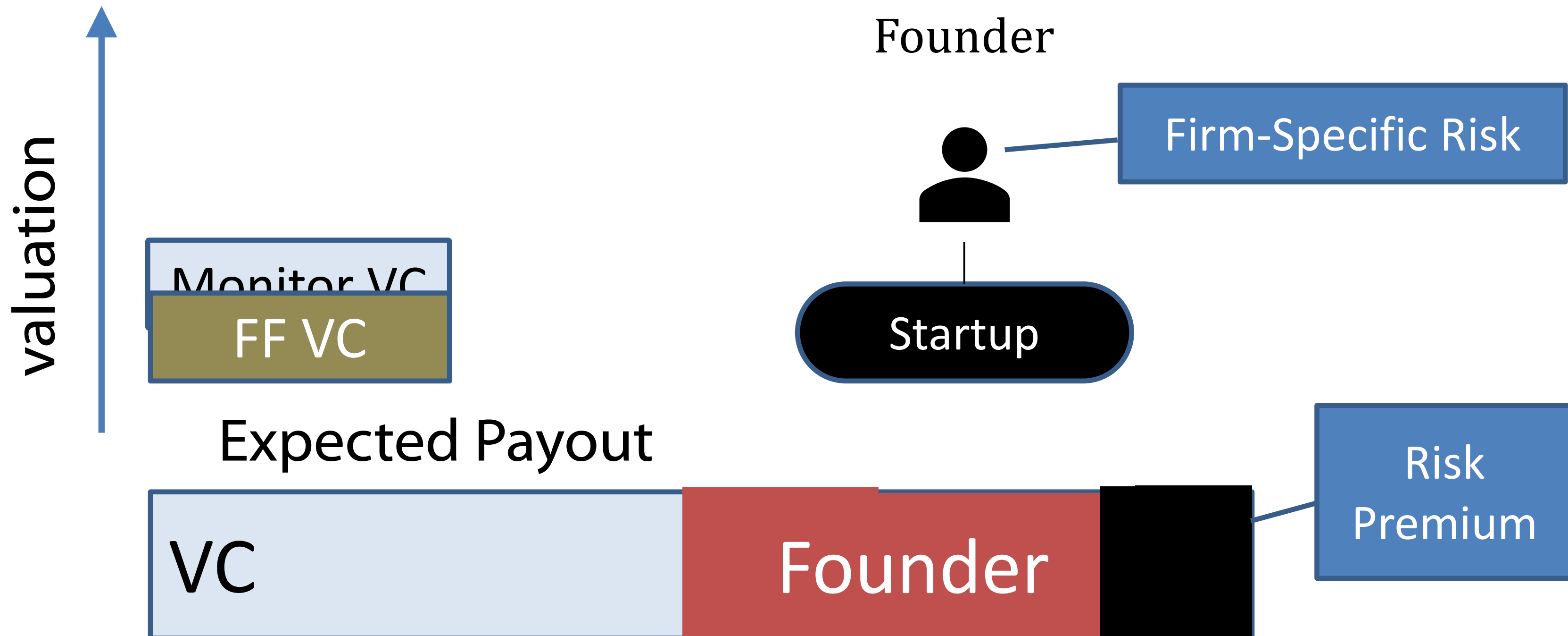


The VC's Implicit Bargain

Early Liquidity (Secondary Sales)

- VC led secondary sales
  - Inconsistent with monitoring (asym info and moral hazard)
- Scenario for empirical testing -- Startup receives acquisition offer from strategic acquirer

Job Protection

- Pledge to not replace founders (a16z, founders fund, …)

Soft Landings

- Facilitating carveouts or management bonuses in underwater M&A sales [Broughman & Fried (2010)]
- Acqui-hires and Failures [Pollman (2023)]
- helping founder start next company, …

Caveats & Implications

Caveats:

- Early-stage investing vs. Growth capital
- What caused the change?

Apparent tension with Delaware case law:

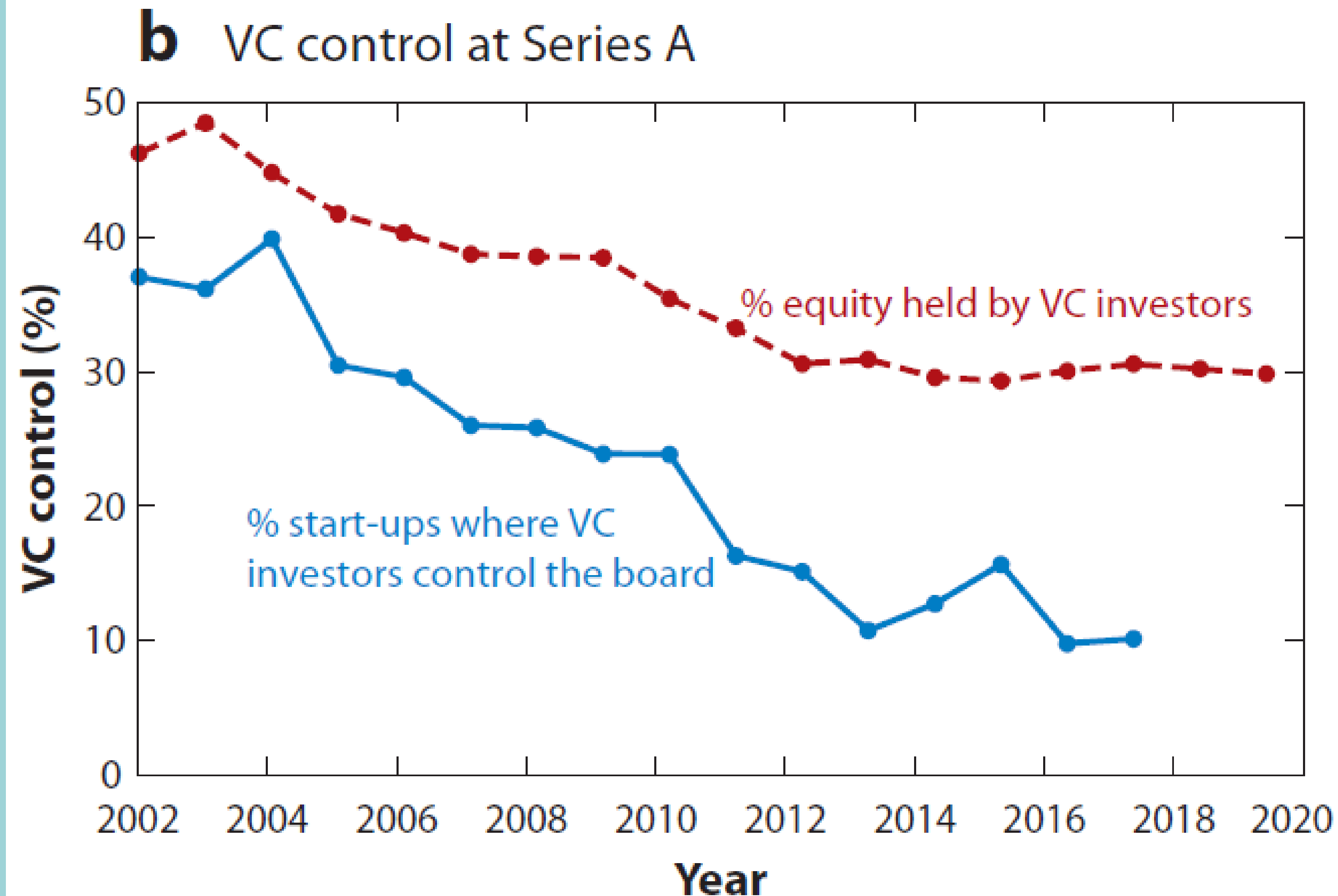
- *Trados*
- But see *In re Good Technology Corporation*

Broader Welfare Analysis Complicated

- Closed world with no spillover effects. Some of the gains from Risk-Seeking may come at expense of 3rd parties (e.g. employees, communities, consumers, …). VC-Founder bargain excludes many.

The End

VCs Are Taking Less Equity, Gaining Control Later



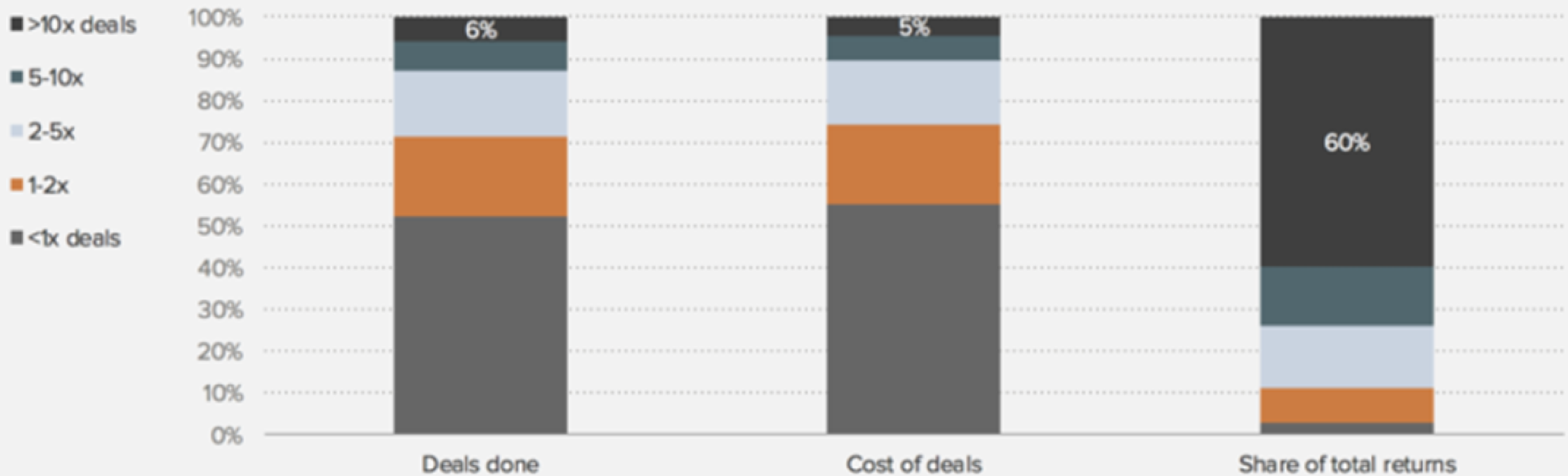
Ewens & Farre-Mensa
2022

Founders Are Being Replaced Less Frequently

Technology matters, but so do teams.

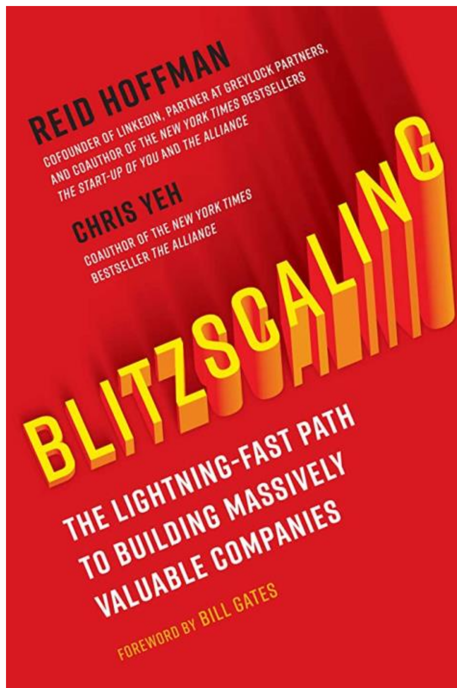
A curious point: companies can be mismanaged, not just by their founders, but by VCs who kick out or overly control founders in an attempt to impose 'adult supervision.' VCs boot roughly half of company founders from the CEO position within three years of investment. FOUNDERS FUND has never removed a 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.

Venture Returns Follow A Power Law



VCs Seem to Fail at Monitoring Often

Risky Strategies: Blitzscaling



"As part of blitzscaling at Uber, managers would ask a newly hired engineer, 'Who are the three best engineers you've worked with in your previous job?' And then they'd send those engineers offer letters. No interview. No reference checking. Just an offer letter."

Hoffman (2016)

Risky Strategies: Underwater Expansion