Startup Failure

Law Working Paper N° 729/2023
August 2023

Elizabeth Pollman
University of Pennsylvania and ECGI

ECGI Working Paper Series in Law

Startup Failure

Working Paper N° 729/2023
August 2023

Elizabeth Pollman

For valuable comments and conversations, thanks to Emilie Aguirre, Yifat Aran, Geoffrey Berman, Brad Bernthal, Hozefa Botee, Brian Broughman, Abe Cable, John Coyle, Jared Ellias, Joan Farre-Mensa, Elisabeth de Fontenay, Ron Gilson, Scott Hirst, Jeff Gordon, Vincent Lazar, John Mao, Peter Molk, Ed Morrison, Brian Quinn, Dorothy Lund, Mariana Pargendler, Adriana Robertson, Amy Simmerman, David Skeel, Eric Talley, Matt Wansley, Yesha Yadav, and participants at the ABA Private Equity and Venture Capital Section Meeting, National Business Law Scholars Conference, Stanford Law Grey Fellows Forum, BYU Winter Deals Conference, Columbia Law & Economics Workshop, University of Chicago Law and Economics Workshop, Duke Law Faculty Workshop, University of Texas Business Law Seminar, UCLA Faculty Workshop Series, UCLA-Bucerius Corporate Law Workshop, USC Center for Law and Social Science Workshop, USC Corporate and Commercial Law Seminar, University of Washington Faculty Workshop, University of Florida Business Law Conference, Tel Aviv University Corporate Law Workshop, Michigan State University Faculty Workshop Series, Monash University Law & Business Seminar Series, the Oxford Business Law Workshop, and the Private Equity and Venture Capital Transatlantic Law & Finance Debate hosted by ECGI, the London School of Economics, and the Goethe University Center for Advanced Studies on the Foundations of Law and Finance.

Abstract

Venture-backed startups famously aim for a successful "exit" by going public or selling to another company through an acquisition deal and achieving financial return for all equity holders. A different path, however, is vastly more likely to occur—failure. Although high-risk innovative ventures fail at exceedingly high rates, no scholarly account systematically explains what happens to these startups at the end of their life cycle.

This Article provides an original theory of startup failure: how law and culture have shaped a system for dealing with the large number of startups that cannot reach an exit that will produce a financial return for all participants. It makes three central contributions. First, the Article explains why bankruptcy law does not fit the needs of most distressed startups and highlights how their capital structures are indeed designed to avoid bankruptcy except in unusual circumstances. Second, and most critically, the Article reveals how dealing with failure through a variety of alternative means serves a vitally important role in making failure acceptable and sustaining the venture capital ecosystem. In particular, soft-landing acquisitions, acqui-hires, and assignments for the benefit of creditors allow entrepreneurs, investors, employees, and creditors to "fail with honor" and redeploy their talent and capital into other ventures. Third, the Article sheds light on rising challenges for dealing with startup failures amid evolving practices and regulatory agendas, with implications for facilitating efficient failure in corporate, antitrust, and insolvency law.

Keywords: venture capital, startups, entrepreneurship, corporate law, fiduciary duties, M&A, acquisitions, acqui-hire, bankruptcy, liquidation, insolvency, assignment for the benefit of creditors, antitrust

JEL Classifications: G30, G33, G34, G38, G41, J20, K20, K21, K22, M13

Elizabeth Pollman
Professor of Law and Co-Director, Institute for Law & Economics
University of Pennsylvania Law School
3501 Sansom Street
Philadelphia , PA 19104, United States
phone: +1 215 898 4564
e-mail: epollman@law.upenn.edu

University of Pennsylvania Carey Law School

ILE

INSTITUTE FOR LAW AND ECONOMICS

A Joint Research Center of the Law School, the Wharton School,
and the Department of Economics in the School of Arts and Sciences
at the University of Pennsylvania

RESEARCH PAPER NO. 23-31

Startup Failure

Elizabeth Pollman

UNIVERSITY OF PENNSYLVANIA CAREY LAW SCHOOL

STARTUP FAILURE

Elizabeth Pollman*

Forthcoming DUKE L.J. (2023)

Venture-backed startups famously aim for a successful "exit" by going public or selling to another company through an acquisition deal and achieving financial return for all equity holders. A different path, however, is vastly more likely to occur—failure. Although high-risk innovative ventures fail at exceedingly high rates, no scholarly account systematically explains what happens to these startups at the end of their life cycle.

This Article provides an original theory of startup failure: how law and culture have shaped a system for dealing with the large number of startups that cannot reach an exit that will produce a financial return for all participants. It makes three central contributions. First, the Article explains why bankruptcy law does not fit the needs of most distressed startups and highlights how their capital structures are indeed designed to avoid bankruptcy except in unusual circumstances. Second, and most critically, the Article reveals how dealing with failure through a variety of alternative means serves a vitally important role in making failure acceptable and sustaining the venture capital ecosystem. In particular, soft-landing acquisitions, acqui-hires, and assignments for the benefit of creditors allow entrepreneurs, investors, employees, and creditors to "fail with honor" and redeploy their talent and capital into other ventures. Third, the Article sheds light on rising challenges for dealing with startup failures amid evolving practices and regulatory agendas, with implications for facilitating efficient failure in corporate, antitrust, and insolvency law.

* Professor of Law, University of Pennsylvania Carey Law School. For valuable comments and conversations, thanks to Emilie Aguirre, Yifat Aran, Geoffrey Berman, Brad Bernthal, Hozefa Botee, Brian Broughman, Abe Cable, John Coyle, Jared Ellias, Joan Farre-Mensa, Elisabeth de Fontenay, Ron Gilson, Scott Hirst, Jeff Gordon, Vincent Lazar, John Mao, Peter Molk, Ed Morrison, Brian Quinn, Dorothy Lund, Mariana Pargendler, Adriana Robertson, Amy Simmerman, David Skeel, Eric Talley, Matt Wansley, Yesha Yadav, and participants at the ABA Private Equity and Venture Capital Section Meeting, National Business Law Scholars Conference, Stanford Law Grey Fellows Forum, BYU Winter Deals Conference, Columbia Law & Economics Workshop, University of Chicago Law and Economics Workshop, Duke Law Faculty Workshop, University of Texas Business Law Seminar, UCLA Faculty Workshop Series, UCLA-Bucerius Corporate Law Workshop, USC Center for Law and Social Science Workshop, USC Corporate and Commercial Law Seminar, University of Washington Faculty Workshop, University of Florida Business Law Conference, Tel Aviv University Corporate Law Workshop, Michigan State University Faculty Workshop Series, Monash University Law & Business Seminar Series, the Oxford Business Law Workshop, and the Private Equity and Venture Capital Transatlantic Law & Finance Debate hosted by ECGI, the London School of Economics, and the Goethe University Center for Advanced Studies on the Foundations of Law and Finance.

Table of Contents

INTRODUCTION

Venture-backed startups famously aim for "exit." On the path to building great companies, entrepreneurs raise rounds of venture financing and assemble a team to develop an innovative product or service that can grow fast.[1] Success for startups is often framed as reaching a liquidity event, or exit, that provides financial returns and rewards to the investors, founders, and employees. There are two main ways to do this: go public or sell the company.[2]

Each of the two paths to a successful exit—going public or M&A sale—have been the subject of significant scholarly examination and public debate in recent years. The changing trends of initial public offerings ("IPOs") have catalyzed regulatory reform and extensive academic research.[3] Concerns about the power and dominance of large technology companies and their acquisitions such as Facebook's acquisition of Instagram and WhatsApp, and Google's acquisition of YouTube, have generated concern about technology deals, particularly those involving startups on a successful independent trajectory or those that might pose competitive concerns.[4] Further, scholars have explored the governance challenges and fiduciary issues that arise in M&A transactions involving startups.[5]

Most venture-backed startups, however, never reach either of these paths; or if they do, it is in a state of distress.[6] Approximately 75 percent of venture-backed startups fail—the number is difficult to measure, however, and by some estimates it is far greater.[7] In

---

[1] Elizabeth Pollman, *Startup Governance*, 168 U. PA. L. REV. 155, 166–74 (2019).

[2] *Id.* at 164.

[3] *See, e.g.*, Jumpstart Our Business Startups (JOBS) Act, Publ. L. No. 112-106, 126 Stat. 306 (2012); Paul Rose & Steven Davidoff Solomon, *Where Have All the IPOs Gone? The Hard Life of the Small IPO*, 6 HARV. BUS. L. REV. 83 (2016); Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 HASTINGS L.J. 445 (2017).

[4] *See, e.g.*, C. Scott Hemphill & Tim Wu, *Nascent Competitors*, 168 U. PA. L. REV. 1879 (2020); Mark A. Lemley & Andrew McCreary, *Exit Strategy*, 101 B.U. L. REV. 1 (2020); Kevin A. Bryan & Erik Hovenkamp, *Startup Acquisitions, Error Costs, and Antitrust Policy*, 87 U. CHI. L. REV. 331 (2020); Colleen Cunningham, Florian Ederer & Song Ma, *Killer Acquisitions*, 129 J. POL. ECON. 649 (2021); David Pérez de Lamo, *Assessing "Killer Acquisitions": An Assets and Capabilities-Based View of the Start-Up*, CPI ANTITRUST CHRON. 50 (May 2020); Sai Krishna Kamepalli, Raghuram Rajan & Luigi Zingales, *Kill Zone* (Nat'l Bureau of Econ. Rsch., Working Paper No. 27146, June 2022), https://www.nber.org/papers/w27146 [perma.cc/U9BS-C2BB].

[5] *See, e.g.*, Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967 (2006); Brian Broughman & Jesse Fried, *Carrots & Sticks: How VCs Induce Entrepreneurial Teams to Sell Startups*, 98 CORNELL L. REV. 1319 (2013); Robert P. Bartlett, III, *Shareholder Wealth Maximization as Means to an End*, 38 SEATTLE U. L. REV. 255 (2015); Pollman, *supra* note 1, at 189–91, 216–20; Abraham Cable, *Does* Trados *Matter?*, 45 J. CORP. L. 311 (2020); Sarath Sanga & Eric L. Talley, *Don't Go Chasing Waterfalls: Fiduciary Duties in Venture Capital Backed Startups*, https://scholarship.law.columbia.edu/faculty_scholarship/2720 [perma.cc/4P4A-LT5X]; Casimiro A. Nigro & Jörg R. Stahl, *Venture Capital-Backed Firms, Unavoidable Value-Destroying Trade Sales, and Fair Value Protections*, 22 EUR. BUS. ORG. L. REV. 39 (2022).

[6] This Article focuses on innovative, venture-backed startups, which are distinct from companies that are started to pursue existing business models based on replicative products or services and are not typically referred to as startups. Pollman, *supra* note 1, at 163–67, n.40, n.47; DANIEL F. SPULBER, THE INNOVATIVE ENTREPRENEUR 2 (2014); NOAM WASSERMAN, THE FOUNDER'S DILEMMAS: ANTICIPATING AND AVOIDING THE PITFALLS THAT CAN SINK A STARTUP 6 (2012).

[7] Research Briefs, *452 Startup Failure Post-Mortems*, CB INSIGHTS (Apr. 18, 2023), https://www.cbinsights.com/research/startup-failure-post-mortem/ [perma.cc/AEZ5-D7TF]; Faisal Hoque, *Why Most Venture-Backed Companies Fail*, FAST COMPANY (Dec. 10, 2012), fastcompany.com/3003827/why-most-venture-backed-companies-fail [perma.cc/JGS8-3VN5].

general, a startup can be said to fail when it ultimately falls short of reaching product maturity and business metrics suitable for going to public markets and cannot attract an acquirier willing to buy the company at a valuation that would provide a return to all equity holders.[8] This can occur for a wide variety of reasons, such as running out of cash, problems in the team, shortcomings in product development or business model, getting outcompeted, a lack of market need, or changed circumstances.[9] In many instances, the startup never reaches profitability, and thus an inability to raise a new round of venture financing or debt means the end of the road for the startup.[10] The participants may not expressly call this a "failure"—and indeed they may work mightily to find a "soft landing" that allows them to characterize it otherwise—but it is distinctly an end that is not a going-public transaction or M&A sale that results in returns to all equity holders. This third and most common path—startup failure—receives little attention in the scholarly literature,[11] yet it is a critical part of the startup and venture capital ecosystem.

The consequences of startup failure, and how the law facilitates the end of the life cycle for startups, matter for a variety of reasons. First, the ability to withdraw from involvement or recoup some of the investors' capital affects ex ante incentives to invest in a startup. Second, the speed, efficiency, and reputational consequences of startup failure may impact the incentives of entrepreneurs to become founders of new startups, as well as the labor economics of great numbers of entrepreneurs and employees who work in the technology sector. Third, these dynamics affect the flow of talent and technological know-how, as well as the ability and incentives for entrepreneurs to remain connected with the intellectual property assets they developed or start afresh in new ventures. In short, the ability of startups, and their participants, to fail efficiently and "with honor"[12]

---

[8] A similar definition for venture-backed startup failure has been used in business literature for an audience of entrepreneurs and investors. *See* TOM EISENMANN, WHY STARTUPS FAIL: A NEW ROADMAP FOR ENTREPRENEURIAL SUCCESS 25 (2021) ("A venture has failed if its early investors did not—or never will—get back more money than they put in.").

[9] *See id.* at 8–14 (identifying six startup failure patterns); Research Report, *The Top 12 Reasons Startups Fail*, CBINSIGHTS (Aug. 3, 2021), https://www.cbinsights.com/research/startup-failure-reasons-top [perma.cc/WDB9-8DLB] (identifying twelve startup failure patterns).

[10] Startups can sometimes delay or overcome difficult circumstances with "down rounds" or "recapitalizations"—events that bring more capital into the startup, thereby extending the company's lifespan, while establishing a new, lower valuation and capital structure. *See generally* William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891 (2002) (examining the law and economics of downside arrangements in venture capital contracts).

[11] *See, e.g.*, Manju Puri & Rebecca Zarutskie, *On the Life Cycle Dynamics of Venture-Capital and Non-Venture-Capital-Financed Firms*, 67 J. FIN. 2247, 2249 (2012) ("The characteristics and dynamics of failed firms are arguably the least understood aspect of the VC investing process.").

[12] The phrase "fail with honor" is attributed to Sophocles and used in startup circles to describe startup endings that do not result in reputational harm. *See, e.g.*, *Reboot Podcast Episode #10: Fail With Honor – with Derek Bereit & Beth McKeon*, REBOOT (Jan. 25, 2015), https://www.reboot.io/episode/fail-with-honor [perma.cc/UX6L-SD8X]; Alison van Diggelen, *Heidi Roizen: Entrepreneurship, Mentors & Relationships*, FRESH DIALOGUES (Mar. 23, 2015), https://www.freshdialogues.com/2015/03/23/heidi-roizen-entrepreneurship-mentors-relationships [perma.cc/ZK5B-VWYW] (quoting venture capitalist Heidi Roizen: "[I]f you fail in the big picture and your company ends up going out of business, do it with empathy and honor and in Silicon Valley, you will usually get another at-bat"). A variation embraces failure as "a badge of honor." *See, e.g.*, Erika Hall, *How the 'Failure' Culture of Startups Is Killing Innovation*, WIRED (Sept. 11, 2013, 9:29 AM), https://www.wired.com/2013/09/why-do-research-when-you-can-fail-fast-pivot-and-act-out-other-popular-startup-cliches [perma.cc/F6T9-ZVWH] ("[F]ailure now seems to be a sort of badge of honor.").

helps sustain the system out of which also grows some of the largest successes in the history of U.S. business.[13]

This Article provides an original theory of startup failure: why bankruptcy law does not fit the needs of most distressed venture-backed startups, what we can learn from the rare exceptions, and how alternative mechanisms serve a critical role in the startup and venture capital ecosystem. Bankruptcy is often a poor fit for the capital structure of startups and the business model of venture capital, and reputational and cultural factors typically push against its use, but an array of alternative paths for dealing with failed startups has developed. Legal scholarship has provided accounts of various components, such as M&A transactions,[14] acqui-hires,[15] and ABCs,[16] but no prior work has provided a systematic account or theory. Above all, this Article argues that law and culture can facilitate dealing with startup failure at relatively low financial and social cost, and this dynamic is important to sustaining a venture capital system that funds large numbers of innovative entrepreneurs.[17]

Further, this Article sheds light on regulatory and doctrinal opportunities to advance the law's approach to startup failure. For example, recent years have witnessed a number of legislative proposals and arguments to ratchet up antitrust scrutiny on acquisitions by large technology companies.[18] Some have even called for effectively banning Big Tech from making acquisitions.[19] Such proposals raise a concern, however, even beyond

[13] *See* Will Gornall & Ilya A. Strebulaev, *The Economic Impact of Venture Capital: Evidence from Public Companies* 5 (June 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2681841 [perma.cc/H2HD-Z3XB] ("[T]he VC industry is an integral part of the growth engine of the US economy and has played a causal role in the rise of the Apples, Googles, and hundreds of other innovative companies in the US.").

[14] *Supra* note 5.

[15] *See infra* notes 153–155 and accompanying text.

[16] *See infra* note 81 and accompanying text.

[17] A rich literature has explored relationships between formal legal rules, institutions, social norms, and informal dispute resolution or transaction regimes. *See, e.g.*, ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES (1991) (arguing that ranchers and farmers in a region of California rely on informal social norms instead of formal legal rules to resolve boundary disputes); Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992) (identifying the crucial role of social norms in resolving merchant disputes in the diamond trade); Eric A. Feldman, *The Tuna Court: Laws and Norms in the World's Premier Fish Market*, 94 CALIF. L. REV. 313, 316 (2006) (examining "whether, when, [and] why informal norms rather than state-created law prevail in certain settings"); Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine*, 110 COLUM. L. REV. 1377 (2010) (examining how parties "braid" formal and informal mechanisms for enforcing contractual commitments). For explorations of law and culture in Silicon Valley, see *infra* notes 210 and 211. This Article aims to provide an original account in this tradition, focused on startup failure.

[18] *See, e.g.*, S. 225, 117th Cong. (2021–2022), Competition and Antitrust Law Enforcement Reform Act of 2021, https://www.congress.gov/bill/117th-congress/senate-bill/225/text?r=56&s=3; H.R. 3826, 117th Cong. (2021–2022), Platform Competition and Opportunity Act of 2021, https://www.congress.gov/bill/117th-congress/house-bill/3826/text?r=1&s=8 [perma.cc/5B8J-GSLQ]; *see also* Lemley & McCreary, *supra* note 4, at 1, 94–97 (arguing that startups' focus on exit is "pathological" and proposing a range of responses including "changing antitrust laws to focus on who is acquiring startups" such as creating a presumption in the merger review process to block dominant firms from acquiring startups with complementary technologies).

[19] *See* S. 1074, 117th Cong. (2021–2022), Trust-Busting for the Twenty-First Century Act (Apr. 12, 2021), https://www.congress.gov/bill/117th-congress/senate-bill/1074/text?r=18&s=7 [perma.cc/G4UJ-D9NH]; *U.S. Senator Wants to Ban Big Tech from Buying Anything Ever Again*, REUTERS (Apr. 12, 2021, 04:15 PM), https://www.reuters.com/technology/us-senator-wants-ban-big-tech-

generally dampening entrepreneurial investment and innovation,[20] that has gotten little attention: they could drain the startup and venture capital ecosystem of an important pressure relief valve that helpfully gives many startups soft landings and recycles talent and technology.[21] Attention should be paid to calibrating regulatory responses so as not to impede the flow of dealing with large numbers of startup failures that do not pose significant competition issues.

Likewise, state laws could promote efficiencies in dealing with failure by adding doctrinal clarity to challenging but commonplace scenarios that startup boards face in fulfilling their fiduciary duties, and by spreading insights from California's state insolvency procedures to growing startup hubs across the country. The value of supporting failure often attracts less regulatory and scholarly attention than the shiny allure of success, but the two are entwined in the larger startup and venture capital ecosystem, which funds high-risk innovative business and has enormous social and economic impact.

This Article proceeds as follows. Part I offers an explanation of why bankruptcy does not fit most startups given their capital structure, the nature of their business, and the ecosystem in which they exist. Further, with examples ranging from the FTX cryptocurrency exchange scandal to solar energy giant Solyndra, it explores how the extraordinary exceptions underscore that formal bankruptcy is not well suited for most startups. Part II sets out the universe of alternatives—that is, the range of options for dealing with failed startups outside of the formal bankruptcy system. Building on this foundation, Part III provides an original theory of the functioning and rationales underlying the system of startup failure, and argues that it plays an important role in the healthy functioning of the venture capital and startup sector. Further, the Part explores developments that are shifting the landscape of venture capital investing and suggests that this system may come under pressure to deal with the size, type, or number of failures. From the exit woes of once high-flying "unicorns" such as WeWork to the collapse of the largest venture lender, Silicon Valley Bank, struggling startups face mounting challenges as well as a changing regulatory environment for technology company acquisitions. The Part concludes by highlighting wide-ranging doctrinal and regulatory implications and opportunities for reform.

I. Startups and Bankruptcy

For many insolvent or financially distressed businesses, bankruptcy provides an important process for dealing with failure and preserving going-concern value or liquidating efficiently under the supervision of a bankruptcy trustee or court. It has long been understood that financial distress can lead to conflicts among creditors that can otherwise spur the inefficient liquidation of a business.[22] The bankruptcy system helps to

---

buying-anything-ever-again-2021-04-12 [perma.cc/C92K-BV9Y] (discussing Senator Josh Hawley's proposed bill that would ban all M&A deals by any company with a market capitalization greater than $100 billion).

[20] *See* D. Daniel Sokol, *Vertical Mergers and Entrepreneurial Exit*, 70 FLA. L. REV. 1357, 1357 (2018) (arguing that vertical merger policy that would unduly restrict firms from undertaking acquisitions "would hurt incentives for innovation in the economy by chilling business formation in start-ups").

[21] *See* Benedict Evans, *When Big Tech Buys Small Tech* (Nov. 12, 2021), https://www.ben-evans.com/benedictevans/2021/11/12/when-big-tech-buys-small-tech [perma.cc/4V8M-8M4A] (noting "the vast majority of Silicon Valley acquisitions, by any company, represent the recycling of talent and capital from ideas that didn't go all the way into new ideas that might").

[22] Douglas G. Baird & Edward R. Morrison, *Serial Entrepreneurs and Small Business Bankruptcies*, 105 COLUM. L. REV. 2310, 2310 (2005).

solve this collective action problem among creditors by allowing for a stay while determining whether the firm is worth saving, and by providing tools and procedures for liquidating or reorganizing.[23] Chapter 7 provides a process to shed assets and obligations and liquidate.[24] Chapter 11 is thought to preserve the going-concern surplus of a financially distressed business, and for small-business owner-operators it is particularly important for providing increased liquidity and a forum for renegotiating debts.[25]

By one count, since 1980, Chapter 11 has been used to reorganize more than $2.6 trillion in inflation-adjusted liabilities.[26] Large public corporations drive a large amount of the assets of these Chapter 11 bankruptcies, and it is also used by a significant number of small businesses.[27]

There is one type of business that rarely uses the formal bankruptcy process, however—venture-backed startups. Despite failing at famously high rates, startups are infrequent bankruptcy filers. This Part offers a novel explanation of why this is so and sheds light on the limited set of unusual circumstances that tend to push startups toward the formal bankruptcy process.

A. Why Bankruptcy Does Not Fit Most Startups

Although a developed bankruptcy system is considered crucial to entrepreneurship and the business environment,[28] venture-backed startups are especially unlikely to turn to the formal bankruptcy process. This is largely by design and a reflection of the system of entrepreneurial financing that has developed to support high-risk business ventures.

First, the typical capital structure of startups does not involve significant commercial liabilities that need to be satisfied.[29] Traditional banks typically do not lend to startups,

---

[23] *See, e.g.*, THOMAS H. JACKSON, LOGIC AND THE LIMITS OF BANKRUPTCY LAW (1986) (discussing the role of bankruptcy as a collective solution); Anthony J. Casey, *Chapter 11's Renegotiation Framework and the Purpose of Corporate Bankruptcy*, 120 COLUM. L. REV. 1709 (2020) (exploring corporate bankruptcy as a framework for ex post renegotiation of incomplete contracts).

[24] 11 U.S.C. §§ 701–84 (2018); Casey, *supra* note 23, at 1711 n.2.

[25] 11 U.S.C. §§ 1101–95 (2018); Baird & Morrison, *supra* note 22, at 2310; *see also* Kenneth M. Ayotte, *Bankruptcy and Entrepreneurship: The Value of a Fresh Start*, 23 J. L. ECON. & ORG. 161, 161 (2007).

[26] Jared A. Ellias, *The Law and Economics of Investing in Bankruptcy in the United States*, forthcoming *in* NACIIL Annual Report 2020 (Eleven Intl. Publishing), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3578170 [perma.cc/8MMZ-UGXZ] (crediting UCLA-LoPucki Bankruptcy Research Database).

[27] *See* Baird & Morrison, *supra* note 22, at 2311 (noting that a large portion of Chapter 11 bankruptcies are small businesses, and for these, "the relevant unit of analysis is the owner and operator of the business, not the business itself"); Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 788 (2002) (discussing how "large corporations no longer fit this paradigm" for the traditional role of Chapter 11, though they account for a substantial amount of the assets in the bankruptcy forum, and small enterprises are more likely to "contain the necessary ingredients for an old-fashioned 'successful' Chapter 11"); Lynn M. LoPucki, *The Nature of the Bankrupt Firm: A Reply to Baird and Rasmussen's* The End of Bankruptcy, 56 STAN. L. REV. 645, 646 (2003) (noting that "[c]orporate reorganizations are booming" and discussing the significant number of reorganizations of large public firms).

[28] *See* D. Gordon Smith & Darian M. Ibrahim, *Law and Entrepreneurial Opportunities*, 98 CORNELL L. REV. 1533, 1565 (2013) ("In modern legal and economic scholarship, bankruptcy is widely regarded as an important legal tool to facilitate entrepreneurship.").

[29] Derek Liu, *Buying Distressed Tech Start-ups*, BLOOMBERG LAW (May 4, 2020), https://www.bakermckenzie.com/-/media/files/insight/publications/2020/05/buyingdistressedtechstartupseco48212.pdf [perma.cc/5EH6-BTJR].

especially in their early stages, because they lack a track record and tangible assets, and have a high failure rate and negative cash flow.[30] Startups can burn through millions of dollars before getting to profitability with a revenue-generating product or service. The most significant asset of many startups is intangible intellectual property in the form of patents or trade secrets, which are more difficult to foreclose on and realize value from.[31] For most banks, the high risks and limited rewards simply do not weigh in favor of lending to startups.[32]

Venture capital arose to fill this financing need for high-risk technology startups.[33] VCs are professional investors who put other people's money to work, typically by acting as general partners of funds organized as limited partnerships that invest in a portfolio of startups.[34] The passive limited partners include wealthy individuals and institutions seeking access to a high-growth alternative asset class, such as pension funds, endowments, foundations, banks, and insurance companies.[35] Venture capital funds have a fixed term, typically ten years, and the venture capital firm makes money by receiving an annual management fee plus a percentage of the profits.[36] Investing in entrepreneurial ventures, particularly those involved in technology, poses a range of well-known challenges, however: uncertainty, incomplete contracting, information asymmetry, and agency costs.[37]

In response to these challenges, VCs seek convertible preferred stock that comes with voting rights, liquidation preferences, and other protective terms.[38] Furthermore, they use staged financing that can incrementally transfer control and threaten abandonment if the company falters.[39] As a result, the big picture of venture capital investors is that they protect themselves through separately allocating cash flow and control rights that can be exercised without incurring the costs of bankruptcy.[40] Venture capitalists are equity

---

[30] Pollman, *supra* note 1, at 170; PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 6–7 (2d ed. 2004).

[31] Darian M. Ibrahim, *Debt as Venture Capital*, 2010 U. ILL. L. REV. 1169, 1175; Ronald J. Mann, *Secured Credit and Software Financing*, 85 CORNELL L. REV. 134, 138–53 (1999) (describing practical and legal obstacles to liquidating software collateral).

[32] Ibrahim, *supra* note 31, at 1175; Xuan-Thao Nguyen & Erik Hille, *Patent Aversion: An Empirical Study of Bank Financing with Patent Collateral, 1980-2016*, 9 UC IRVINE L. REV. 141, 169 (2018).

[33] TOM NICHOLAS, VC: AN AMERICAN HISTORY (2019); Ronald Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1068 (2003).

[34] Gilson, *supra* note 33, at 1068–69 (explaining that VCs are "tailored to the special task of financing [the] high-risk, high-return activities" of startup companies, which are "peculiarly suited to commercializing innovation").

[35] *Id.* at 1070.

[36] *Id.* at 1071–72.

[37] GOMPERS & LERNER, *supra* note 30; Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 282 (2003); Pollman, *supra* note 1, at 172.

[38] D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 345–54 (2005); Bratton, *supra* note 10.

[39] Paul A. Gompers, *Optimal Investment, Monitoring, and the Staging of Venture Capital*, 50 J. FIN. 1461, 1461 (1995) (discussing the staging of capital infusions as a startup control mechanism); *see also* Robert P. Bartlett III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 68 (2006) (discussing staged venture capital financing); Pollman, *supra* note 1, at 173 (describing structure of venture capital financings and governance practices).

[40] *See* Kaplan & Strömberg, *supra* note 37, at 295, 304 (finding that VCs "separately allocate cash flow rights, board rights, voting rights, liquidation rights, and other control rights" such that in many instances "a VC can force a liquidation of badly performing firms" and recoup their investment thorough liquidation preferences or abandon the investment through staging rounds of investment).

holders who contract for *debt-like* protections against downside risk.[41] Likewise, newer entrants such as private equity, mutual funds, sovereign wealth funds, and the like, have participated in venture capital financing rounds using the same practices—and are thus also equity holders of preferred stock that have contracted for downside protections.[42]

The other typical source of financing to startups, particularly in their early stages, are angel investors. These wealthy individuals, often with backgrounds as successful entrepreneurs, are frequently the first source of outside funding to a startup.[43] Angels typically invest relatively small sums and receive common stock, or use convertible notes or similar debt instruments that provide a means of making deferred equity investments with minimal transaction costs.[44] Convertible notes are technically debt, but holders typically have the right under such agreements to convert into convertible preferred stock if the company raises additional capital.[45] These arrangements are often entered into by angel investors who do not expect the notes to be repaid—they hope for the startup's success and will then convert into equity, but otherwise expect that their investment might be worthless.[46] Some forms of convertible notes used by angel investors have even dispensed with maturity dates and do not accrue interest.[47]

Moreover, a startup typically does not take on more than a relatively small number of angel investors and they are commonly a close-knit group of investors who are involved in the governance of the startup or otherwise maintain relationships with the founders-entrepreneurs.[48] Thus, even for startups that have financed the early stages of the venture through angels using debt instruments, they do not typically represent the type of complex debt structures secured by marketable assets for which the formal bankruptcy system would be useful.[49]

---

[41] Bratton, *supra* note 10, at 939–44 (describing why venture capitalists use preferred stock and how they contract for downside protections); *see also* Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1218 (2006) (explaining that a venture capitalist "may want to prevent a business from filing for Chapter 11, but otherwise enjoy all the usual attributes of a creditors" and so "becomes a preferred shareholder and takes steps to ensure that no other creditors of any consequence comes into being").

[42] Pollman, *supra* note 1, at 175; *cf.* Baird & Rasmussen, *supra* note 27, at 755 ("Today's investors allocate control rights among themselves through elaborate and sophisticated contracts that already anticipate financial distress.").

[43] *See* Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1406–10 (2008). A notable alternative or additional source of capital and support for early-stage startups is a startup incubator or an accelerator program, which often use similar financing arrangements as angel investors. *See* Brad Bernthal, *Investment Accelerators*, 21 STAN. J. L. BUS. & FIN. 139, 140–41 (2016).

[44] Pollman, *supra* note 1, at 171; John F. Coyle & Joseph M. Green, *The SAFE, the KISS, and the Note: A Survey of Startup Seed Financing Contract*s, 103 MINN. L. REV. HEADNOTES 42, 43–44 (2018).

[45] Coyle & Green, *supra* note 44, at 44–45.

[46] *Id.* at 45–46.

[47] *Id.* at 46–47 (discussing the Simple Agreement for Future Equity, or "SAFE," and the Keep It Simple Security, or "KISS," and noting they are "best conceptualized as an equity derivative contract by which the investor commits capital to the company today in exchange for the right to receive stock in the company in a future financing if certain contractual conditions are met"); *see also* J. Brad Bernthal, *The Evolution of Entrepreneurial Finance: A New Typology*, 2018 B.Y.U. L. REV. 773, 800–09 (discussing the variety of early-stage startup investment instruments and their terms).

[48] Liu, *supra* note 29, at 2.

[49] *Id.*; *see also* Edward R. Morrison, *Bankruptcy's Rarity: An Essay on Small Business Bankruptcy in the United States*, 5 EUR. CO. & FIN. L. REV. 172, 174 (2008) (noting that "a business with only a handful of major creditors can more easily reach a 'workout' than one with a wide range of creditors" because of a lower cost of coordination, and that firms most likely to use bankruptcy law are "relatively large firms that

Some startups take on what is known as "venture debt"—loans from lenders that specialize in debt financing for startups.[50] Venture debt differs from conventional business loans because it is less contingent on factors like accounts receivable or inventory, and instead is more focused on the relationship with entrepreneurs and the startup's VC backers.[51]

Indeed, venture lenders are a relatively small bunch of specialists in the ecosystem that generally do not lend to a startup unless it has already been funded by VCs.[52] These lenders are most likely to enter the picture as a follow-on source of funding early in a startup's development and in anticipation that the startup will receive successive funding.[53] This practice helps to make venture debt's failure rate relatively low: reports estimate that just 1 to 8 percent of venture debt is written off.[54] Venture lenders often take a mix of debt and equity in the startup and thus make money through interest payments, fees, and warrants—the latter of which allow the holder to participate in the upside by converting into shares during an exit.[55]

Most notably, venture debt is not considered a replacement for venture capital–backed equity rounds.[56] Startups often use it for a quick influx of cash for unanticipated events, extending the cash runway before another venture capital financing round, dealing with short-term market downturns—or as a complementary source of cash that is not as dilutive as venture capital.[57] Facebook, for example, used venture debt to purchase some of its first servers.[58]

Thus, while venture debt exists in a fair number of startups' capital structures, it may not represent a significant amount of the overall source of funds or a large outstanding debt. Startups are often wary of taking on too much venture debt because it can cause difficulty for subsequent attempts at raising venture capital as VCs may balk at funding debt repayment instead of growth opportunities.[59] And startups do often use later rounds of venture capital to pay back venture debt, so it may be ultimately repaid even if the startup later fails.[60]

---

have multiple senior lenders" and "firms that have lost the trust of their creditors, who suspect that the owners have been hiding information").

[50] Ibrahim, *supra* note 31, at 1170; *see also* Xuan-Thao Nguyen, *Lending Innovations*, 86 BROOK. L. REV. 135, 144–45 (2020) ("While more than 99.9 percent of banks shun lending to startups, . . . there are outlier banks. But only four such outlier banks—out of six thousand banks—devote themselves exclusively to serving startups and high-growth companies in the tech industry.").

[51] Research Report, *What Is Venture Debt?*, at 5, CBINSIGHTS, https://www.cbinsights.com/research/report/what-is-venture-debt [perma.cc/Q3D8-ATWZ]; Bernthal, *supra* note 47, at 798–99.

[52] Ibrahim, *supra* note 31, at 1173; *see also* Mann, *supra* note 31, at 137 ("The lender relies primarily on a symbiotic relationship with the venture capitalist . . .").

[53] Ibrahim, *supra* note 31, at 1173, 1186–87.

[54] CBINSIGHTS, *supra* note 51, at 11. Before its collapse in 2023, Silicon Valley Bank (SVB) had been the "800 pound gorilla in the room" in terms of venture debt, with about 70 percent of the market share. Ibrahim, *supra* note 31, at 1177.

[55] *Id.* at 1179.

[56] *Id.*

[57] *Id.* at 1197.

[58] *See id.* at 1177.

[59] *Id.* at 1196. Venture capitalists may also bargain for protective provisions in financing documents that include restrictive covenants about startups taking on debt. Bratton, *supra* note 10, at 943–44, n.157.

[60] Ibrahim, *supra* note 31, at 1187 ("While it is the case that most start-ups fail, lending early in the start-up's development means that follow-on venture capital is usually sufficient to repay loans before VCs stop supporting failing start-ups.").

Perhaps most notably, even if the debt is significant, venture lenders may be few in number for a particular company and first in line in priority before the complex structure of preferred and common equity holders.[61] Furthermore, these venture lenders often have skill at liquidating intellectual property or connections to other specialists who do. Given all of the foregoing, venture lenders often do not have an incentive to push a startup toward formal bankruptcy.[62] Depending on the startup, it may also have real estate leases, cloud-server contracts, or other similar operational expenses—but these often also do not represent significant outstanding debts.[63]

Second, formal bankruptcy is not a fit for most startups for reasons that go beyond their capital structure: they are often, by their very nature, "melting ice cubes."[64] The assets or value in the startup are typically a mix of the team's talent and technological know-how, intellectual property or other intangible assets and, depending on the type of business, network effects of a growing enterprise.[65] These can disappear quickly once it becomes known that the startup is in distress.[66] Startup employees are typically at-will and do not have employment agreements.[67] Talented employees can flee, often unbound by

---

[61] *Id.* at 1189 ("Instead of (or in addition to) security interests, some lenders would enter into contracts with start-ups that entitled them to first priority in the proceeds from the IP's sale.").

[62] A venture lender might take a security interest in the company's intellectual property and seize the collateral upon the company's failure to repay the loan. Assets other than intellectual property could be disposed of quickly through an auction, UCC Article 9 foreclosure sale, or the company could pursue an ABC in which it selects the assignee rather than a randomly appointed bankruptcy trustee. *See, e.g.*, Steve Crowe, *Inside Anki Shutdown: Who Owns IP, Assets Auction, Failed Partnership*, ROBOT REPORT (June 18, 2019), https://www.therobotreport.com/inside-anki-shutdown-who-owns-ip-assets-auction-failed-partnership [perma.cc/J62B-TWCE] (providing an example of a startup that had a loan from SVB subject to a security interest in its intellectual property and auctioned off its remaining assets through Silicon Valley Disposition); *see also* Bob Eisenbach, *Assignments for the Benefit of Creditors: Simple As ABC?*, COOLEY (Mar. 16, 2008) (explaining that a startup board might "prefer[] to avoid a Chapter 7 bankruptcy because it's concerned that a bankruptcy trustee, unfamiliar with the company's technology, would not be able to generate the best recovery for creditors" and instead could choose its own assignee by using an ABC).

[63] *See* Stephen O'Neill & Thomas Hwang, *What Executives Should Know When Their Company Is on the Brink*, at 2, DORSEY (2017), https://www.dorsey.com/-/media/files/uploads/images/11917-resource-guide-for-dos-when-cos-are-on-brink-of-insolvency-handout.pdf [perma.cc/3FXX-EPTT]. Employees are the largest expense for many startups. *Id.* Bootstrapped or distressed startups might be late in making payroll payments, and in that way the employees could become creditors, but in many instances, startups use remaining cash to pay off employees first, and might also do layoffs or refresh equity incentives. Startup directors may be personally liable for unpaid wages and compensation to employees, and thus might be sensitive to risk exposure. *Id.*; *see also* James Wilson, *Shutting Down a Startup: How to Protect Yourself and Your Investors from Liability*, SILICON VALLEY BANK, https://www.svb.com/startup-insights/startup-strategy/startup-shutdown-when-fails [perma.cc/84NY-MD64] (quoting advice to "[p]ay off employees first").

[64] *See* Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862, 865 (2014) (discussing the "melting ice cube" theory of companies in distress).

[65] For a perspective from the dot-com bust era, see Robert Brady, Sean Beach & Karen B. Skomorucha, *Determining and Preserving the Assets of Dot-Coms*, 28 DEL. J. CORP. L. 185, 186 (2003) ("Dot-com companies, however, rarely possess any meaningful base of hard assets.").

[66] Liu, *supra* note 29, at 7 ("Highly skilled tech employees are highly sought after . . . and the spectre of either a failing company or a disappointing exit transaction may cause many to look at other opportunities.").

[67] Startups commonly layoff employees when facing financial distress. *See, e.g.*, Kate Clark, *More Startup Layoffs Are Coming as Investors Push Founders To Conserve Cash*, THE INFORMATION (Apr. 18, 2022),

noncompete agreements.[68] Competitors monitor these situations and actively recruit talent from failing businesses.[69] The stock options, restricted stock units, and common stock often held by employees and founders are usually worthless in distressed situations.[70] Separating founders, in particular, from their intellectual property can destroy potential value,[71] yet they are also not typically locked into the enterprise beyond a sense of moral duty or emotional connection. Furthermore, intellectual property and other intangible assets can be hard to value and asset specific.[72] These qualities make the prospective value of a bankruptcy proceeding even more uncertain than usual, and diminishing as the founders and employees who know how to realize value from the intellectual property leave.

Third, not only is the typical startup a melting ice cube, but it is also embedded in a network of reputational concerns and constraints in a venture capital ecosystem. Angel investors, venture capitalists, and venture lenders are all repeat players in venture lending and investing.[73] Reputational concerns constrain opportunistic conduct. Particularly in a competitive environment for getting into startup deals, and given the "symbiotic" relationship between venture lenders and VCs, it is not worth squeezing the last dollar back from a startup if it affects one's own reputation.[74] Venture lenders can take security interests in assets to protect themselves. VCs and founders "would rather not glorify their failure with an embarrassing public auction."[75] And, as one bankruptcy lawyer noted, "It's pretty taboo in the Valley to use the term Chapter 11."[76]

Finally, VCs typically invest in portfolios of startups with the aim that a small number will deliver home runs that drive much of the returns for the fund. This principle is known

---

https://www.theinformation.com/articles/more-startup-layoffs-are-coming-as-investors-push-founders-to-conserve-cash [perma.cc/5MC8-42CP]; Layoffs.fyi Tracker, http://layoffs.fyi [perma.cc/M8R5-77MY] (tracking tech startup layoffs).

[68] *See* ORLY LOBEL, TALENT WANTS TO BE FREE: WHY WE SHOULD LEARN TO LOVE LEAKS, RAIDS, AND FREE RIDING 64–69 (2013) (describing California's refusal to enforce noncompete agreements and arguing that this is the key to Silicon Valley's success); Ronald J. Gilson, *The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not To Compete*, 74 N.Y.U. L. REV. 575, 603–09 (1999) (describing different employment patterns and polices regarding noncompete clauses between California and Massachusetts).

[69] Liu, *supra* note 29, at 7.

[70] *Id.*; Yifat Aran, Note, *Beyond Covenants Not To Compete: Equilibrium in High-Tech Startup Labor Markets*, 70 STAN. L. REV. 1235, 1269 (2018) (discussing how "out of the money" or "underwater" stock options make an employee more likely to return to the labor market).

[71] *See* Mira Ganor, *Recoupling Founders With Their IP—Improving Innovation by Rationalizing IRC Section 351 (Licensing vs. Assignment of Founders' IP in VC-Backed Startups)*, 44 J. CORP. L. 493 (2019) (discussing how decoupling the intellectual property from founders, who are most apt to exploit it, may hinder innovation and be socially inefficient).

[72] *See* Brady et al., *supra* note 65, at 186 n.2 ("Intellectual property assets usually have a very limited value outside of the business because of the specificity of the intellectual property to the company.").

[73] *See* Pollman, *supra* note 1, at 204 ("VCs and other startup investors are repeat institutional players in a reputation-based market for investments."); Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 254–55 (1998) (arguing that VC opportunism is constrained by reputational concerns).

[74] *See* Steve Blank, *When Founders Go Too Far*, HARV. BUS. REV., Nov.-Dec. 2017, at 99–100 ("Whereas once too many start-ups chased limited amounts of capital from a relatively small number of VC firms, today, some would argue, too much capital is chasing few quality start-ups."); SCOTT KUPOR, SECRETS OF SAND HILL ROAD: VENTURE CAPITAL AND HOW TO GET IT 20–22 (2019) (explaining that VCs "compete for the right to fund entrepreneurs").

[75] Erin Griffith, *Startups Rarely File for Bankruptcy. Could that Change?*, FORTUNE (Apr. 21, 2017), https://fortune.com/2017/04/21/plastc-bankruptcy [perma.cc/E2LM-EV3K].

[76] *Id.*

as the "power law" of venture capital.[77] Once they perceive the company is unlikely to drive such outsized returns, board members affiliated with VC funds may have incentives to shut down startups or find other exit paths that will not require their continued attention.[78] Startups may be unprofitable and have insufficient cash to fund operations going forward through a bankruptcy. Existing investors already account for this possibility by purposely staging rounds of financing at the outset to allow for the possibility of abandonment and may not wish to inject more capital.[79] A long, drawn-out bankruptcy process is often the last thing a VC wants to be involved in given opportunity costs and potential reputational harm.

All of the above explanations go beyond the disadvantages of bankruptcy that generally apply to businesses, such as the costs of administering the case and the long time frame[80]—although these too may certainly contribute to why startups are unlikely to use the formal bankruptcy system. In sum, for most failing startups the bankruptcy system is not a good fit because of the nature of their capital structure and business, and even when it might hold value, there are reputational and cultural factors that push against its use.

B. When Startups Use Bankruptcy

Although startups rarely use the formal bankruptcy process, it occasionally happens nonetheless. Under what circumstances does this tend to occur?

Scholarly research on venture-backed startups in bankruptcy is sparse. The legal literature contains one notable study, by Professor Ronald Mann, who collected a data set

---

[77] PETER THIEL, ZERO TO ONE: NOTES ON STARTUPS, OR HOW TO BUILD THE FUTURE 86–87 (2014) (discussing the "power law" and noting that "the best investment in a successful fund equals or outperforms the entire rest of the fund combined"); Bob Zider, *How Venture Capital Works*, HARV. BUS. REV., Nov.-Dec. 1998, at 131, 136 ("Given the portfolio approach and the deal structure VCs use, . . . only 10% to 20% of the companies funded need to be real winners to achieve the targeted return rate . . . . In fact, VC reputations are often built on one or two good investments.").

[78] Abraham J.B. Cable, *Opportunity-Cost Conflicts in Corporate Law*, 66 CASE W. RES. L. REV. 51, 53 (2015) ("An opportunity-cost conflict arises when corporate fiduciaries operate under strong incentives to withdraw human and financial capital for redeployment into new investment opportunities."). Startups that continue to operate after reaching a point in which big exits have become unlikely are sometimes referred to as "zombie" companies or "the walking dead." *See* Rory Carroll, *Silicon Valley's Culture of Failure . . . and 'The Walking Dead' It Leaves Behind*, GUARDIAN (June 28, 2014), https://www.theguardian.com/technology/2014/jun/28/silicon-valley-startup-failure-culture-success-myth [perma.cc/RK8E-TT8G].

[79] *See* Eisenbach, *supra* note 62 (explaining that a Chapter 11 bankruptcy might be "problematic" for a startup when "there is insufficient cash to fund operations going forward, no significant revenues are being generated, and debtor in possession financing seems highly unlikely unless [a] buyer itself would make a loan"); *see also* Bratton, *supra* note 10, at 893 (explaining that VCs defend against downside risk ex ante by "staging the drawdowns of funds over time and conditioning the funding commitment on performance targets").

[80] Dov R. Kleiner, *Non-Bankruptcy Alternatives to Chapter 11 Restructurings and Asset Sales*, THOMSON REUTERS PRACTICAL LAW (2017), https://www.kkwc.com/wp-content/uploads/2017/06/Non-Bankruptcy-Alternatives-to-Chapter-11-Restructurings-and-Asset-Sales....pdf [perma.cc/LN8Q-3748]; Morrison, *supra* note 49, at 176. The Small Business Reorganization Act of 2019 added a new Subchapter V to Chapter 11 of the Bankruptcy Code that aims to provide a quicker, more streamlined process, with reduced expenses for qualifying small businesses that could be helpful for lessening the impact of cost and timing challenges. *See* Michael Goldstein et al., *A New Bankruptcy Lifeline for Startup, Early Stage and Emerging Growth Companies?*, GOODWIN (2021), https://www.goodwinlaw.com/-/media/files/publications/attorney-articles/2021/top-10-questions-about-subchapter-v-reorganization.pdf [perma.cc/N3NX-KCXM].

of firms, from a wide range of geographies, that had received a venture-capital investment between 2000 and 2002—during or shortly after the dot-com bust—and were "out of business" by 2004. Professor Mann found that 22 percent of the failed firms had bankruptcy filings.[81] He found startups had filed for bankruptcy to redeploy assets to a more productive use, facilitate a sale of the firm, or resolve litigation,[82] and California tech firms "systematically use bankruptcy less than firms in other states," because the state offers a streamlined alternative process for an assignment for the benefit of creditors ("ABC").[83]

Building on these intriguing findings from around the dot-com bust era, this Section canvasses media reporting and recent filings to report on current drivers for venture-backed startups to use the formal bankruptcy process.[84] Together, the various categories that this new examination sheds light on—legal issues, rebirth or pivot to a new business model or owner, debt problems, and the big "startup"—reflect the evolving startup landscape and underscore that choosing bankruptcy is still not the norm.

1. Legal Issues

One set of venture-backed startups that have made formal bankruptcy filings in recent years have involved significant legal issues. While it is certainly not new for startups to face legal difficulty, innovative startups of the twenty-first century have frequently made headlines for their entanglements with the law and aggressive regulatory stances.[85] More generally, startup culture has fostered a growth-at-all-costs mentality and a willingness to take legal risks or potentially even engage in fraud.[86] All of these various developments can land startups in legal hot water that is difficult to resolve, particularly if they have not gained enough traction to have collected a war chest to fight legal battles outside of bankruptcy. In these circumstances, a formal bankruptcy process provides value by

---

[81] Ronald J. Mann, *An Empirical Investigation of Liquidation Choices of Failed High Tech Firms*, 82 WASH. U. L. Q. 1375, 1384–85 (2004) ("Out of the 161 bankruptcy filings, there were 68 firms (42%) in Chapter 11 at some point in the process and 93 firms (58%) that were exclusively in Chapter 7.").
[82] *Id.* at 1420–37.
[83] *Id.* at 1377.
[84] This Part draws on information available from bankruptcy proceedings involving: 38 Studios, LLC; A123 Systems LLC; Abound Solar, Inc.; Aero, Inc.; Alliance of American Football, LLC; Altrec.com Outdoors; Amp'd Mobile Inc.; Aquion Energy, Inc.; Aura Financial LLC; Avaya Inc.; BCause LLC; BrewPublik, Inc.; Celsius Network LLC; CloudMine; CODA Automotive, Inc.; Crescent Dunes Solar Energy Project; Crosscode, Inc.; Dart Music, Inc.; Earth Class Mail, Inc.; Evergreen Solar, Inc.; Fisker Automotive; FTX Trading Ltd. (and affiliated entities); Gawker Media LLC; Immune Pharma Ltd.; ImmunSYS Inc.; Julep Beauty, Inc.; Jumio; Juno USA, LP; Knotel Inc.; Leap Transit Inc.; Lily Robotics, Inc.; Metricom, Inc.; Mobile Gallop LLC; MoviePass Inc.; Munchery; Nasty Gal; NeuroproteXeon, Inc.; NovaSom Inc.; NS8 Inc.; OneWeb Global Limited; OptiScan Biomedical Corp.; Poler Inc.; Proteus Digital Health, Inc.; ProtoStar; Quirky, Inc.; Sandbox VR; Satcon Technology Corp.; Scoobeez Global, Inc.; Searchmetrics GmbH; Sienna Biopharmaceuticals, Inc.; Sinemia, Inc.; Sizmek, Inc.; Solyndra; SpectraWatt Inc.; Sugarfina USA LLC; Suitable Technologies Inc.; SunEdison, Inc.; TerrAvion, Inc.; The Loot Company; uBiome, Inc.; Unlockd Media, Inc.; Vector Launch, Inc.; WiseWear Corp.; XFL.
[85] *See* Elizabeth Pollman, *The Rise of Regulatory Affairs in Innovative Startups*, *in* HANDBOOK OF LAW AND ENTREPRENEURSHIP IN THE UNITED STATES (D. Gordon Smith, Christine Hurt & Brian Broughman eds., 2022) (describing developments contributing to the rise of regulatory affairs in innovative startups); Elizabeth Pollman & Jordan M. Barry, *Regulatory Entrepreneurship*, 90 S. CAL. L. REV. 383 (2017) (describing "regulatory entrepreneurship," or pursuing a line of business in which changing the law is a significant part of the business plan).
[86] Pollman, *supra* note 85; Elizabeth Pollman, *Private Company Lies*, 109 GEO. L.J. 353 (2020).

offering a venue for verifying a debtor's assets and liabilities and facilitating the sale of assets to buyers who might otherwise have concerns about outstanding claims.[87]

Consider FTX, a venture-backed cryptocurrency exchange that at one time reached a $32 billion private valuation but suddenly collapsed in late 2022 when news reporting stoked fears about the company's capital reserves and triggered a selloff akin to a bank run before FTX halted customer withdrawals.[88] Amid rising concern, a financial regulator in the Bahamas froze the assets of FTX and the Securities and Exchange Commission and the Department of Justice began to investigate allegations that customer funds were mishandled.[89] The company quickly filed for Chapter 11 bankruptcy, and its founder was subsequently charged by federal prosecutors and arrested on a claim of defrauding investors.[90] The company owes its fifty biggest creditors nearly $3 billion, and the blowup has left a million customers and other investors facing uncertain losses as novel legal questions regarding the ownership of digital currencies remain unsettled.[91]

Other recent examples beyond FTX highlight that a range of legal issues might drive a startup into using a formal bankruptcy process, from losing a single "bet-the-company" legal issue[92] to facing a string of lawsuits that drain resources and spark concern about whether the company was using imprudent or wrongful business practices.[93]

2. Rebirth or Pivot to a New Business Model or Owner

Another theme that emerges from recent startup bankruptcies is that formally filing can serve as a fail-safe device when a company hits the rocks and other options are unavailable. For companies that were heavily funded or have promising technology, filing

---

[87] *See* Edward R. Morrison, *Bargaining around Bankruptcy: Small Business Workouts and State Law*, 38 J. LEGAL STUD. 255, 270–71 (2009) (discussing how federal bankruptcy law serves an auditing function and bankruptcy courts provide a venue for verifying a debtor's assets and liabilities); Baird & Rasmussen, *supra* note 27, at 787 (discussing how "Chapter 11 provides a mechanism for selling assets free and clear of all claims even before a plan of reorganization is put in place" and how it might be used "not to rehabilitate a failing enterprise but rather to dispose of it").

[88] Max Zahn, *A Timeline of Cryptocurrency Exchange FTX's Historic Collapse*, ABC NEWS (Dec. 13, 2022), https://abcnews.go.com/Business/timeline-cryptocurrency-exchange-ftxs-historic-collapse/story?id=93337035 [perma.cc/6LJQ-2HAH].

[89] *Id.*

[90] *Id.* Formal bankruptcy also enables issuing Chapter 11 subpoenas for cofounders and executives. Vince Sullivan, *FTX Wants Ch. 11 Subpoenas for SBF, His Family and Execs*, LAW360 (Jan. 26, 2023, 5:44 PM), https://www.law360.com/delaware/articles/1569724 [perma.cc/WH59-XQAL].

[91] *Collapsed FTX Owes Nearly $3.1 Billion to Top 50 Creditors*, REUTERS (Nov. 21, 2022, 5:12 AM), https://www.reuters.com/business/finance/collapsed-ftx-owes-nearly-31-bln-top-50-creditors-2022-11-20 [https://perma.cc/AP78-KXHD]; Andrew Scurria, *FTX Collapses into Bankruptcy System That Still Hasn't Figured Out Crypto*, WALL ST. J. (Nov. 16, 2022, 5:30 AM), https://www.wsj.com/articles/ftx-collapses-into-bankruptcy-system-that-still-hasnt-figured-out-crypto-11668550688 [perma.cc/8T3P-7YEY].

[92] *See, e.g.*, Emily Steel, *Aereo Concedes Defeat and Files for Bankruptcy*, N.Y. TIMES (Nov. 21, 2014), https://www.nytimes.com/2014/11/22/business/aereo-files-for-bankruptcy.html [perma.cc/JUL4-7HEX] (discussing how television-streaming startup Aereo litigated its business model all the way up to the Supreme Court and lost before filing for bankruptcy).

[93] *See, e.g.*, Valeriya Safronova, *Nasty Gal's Path to Bankruptcy*, N.Y. TIMES (Nov. 11, 2016), https://www.nytimes.com/2016/11/11/fashion/nasty-gal-sophia-amoruso-bankruptcy.html [perma.cc/Z7RK-U6EM] ("[T]he picture that's emerging is one of rapid growth, built largely around the personality of Nasty Gal's founder and undercut by mismanagement and legal stumbles.").

for bankruptcy might effectively buy the company some additional runway to find a new business model or owner to give the company a rebirth.[94]

Consider, for example, Aquion Energy. The company raised nearly $200 million from Bill Gates, the prominent venture capital firm Kleiner Perkins, the oil-and-gas giant Shell, and other investors, to work on developing an inexpensive saltwater battery for renewable energy sources.[95] Despite progress on technology development, the business was unusually capital-intensive, struggled to raise enough financing, and faced competition from large industry players that aggressively pushed for market share.[96] In the face of these challenges, the company concluded that it needed to find an exit—likely by selling to a multinational company that had an interest in putting Aquion's technology into their own product line or system.[97] But the company was running out of cash before it could find and close such a deal, so it turned to the bankruptcy system to extend its time to find an exit or pivot.[98] Before filing, the company reportedly fired most of its workforce and ceased its operations.[99] Aquion spent the next several months restructuring, shedding some of its debts, and finding a buyer for $9.2 million that was willing to invest millions more to put the company on a new track with a new business strategy of selling directly to big grid operations in China.[100] After the bankruptcy and sale concluded, the founder of Aquion reflected that through the process it had become "a very different company, and one better positioned to succeed in the brutal storage business."[101]

A similar example is Earth Class Mail, an Oregon-based startup that originally started with the name Document Command and a business model of digitizing users' paper mail by hand: "taking over the post office of the world."[102] It did not take long before digitizing thousands of pieces of physical mail became an untenable business model and the company's funding dried up.[103] Eventually the company filed for bankruptcy, from which it pivoted with a new buyer—a technology investment firm—that transitioned the company to a B2B business model with business customers and new technological support.[104]

---

[94] Startups could similarly pivot through an ABC process, as illustrated by consumer electronics startup Jawbone, once valued at $3 billion, which used well-known startup liquidators Sherwood Partners. *See* Reed Albergotti, *Jawbone to Be Liquidated as Rahman Moves to Health Startup*, THE INFO (July 6, 2017, 1:45 PM), https://www.theinformation.com/articles/jawbone-to-be-liquidated-as-rahman-moves-to-health-startup [perma.cc/3YEN-RFZX].

[95] James Temple, *Inside the Fall, and Rebirth, of a Bill Gates-Backed Startup*, MIT TECH. REV. (Aug. 8, 2017), https://www.technologyreview.com/2017/08/08/150080/inside-the-fall-and-rebirth-of-a-bill-gates-backed-battery-startup [perma.cc/QDS6-48B2].

[96] *Id.*

[97] *Id.*

[98] *Id.*

[99] James Ayre, *Aquion Energy Files for Chapter 11 Bankruptcy*, CLEAN TECHNICA (Mar. 15, 2017), https://cleantechnica.com/2017/03/15/aquion-energy-files-chapter-11-bankruptcy [perma.cc/F3P8-QRHN]; *see also* Matt Chiappardi, *Bankrupt Aquion Energy Hit With WARN Complaint*, LAW360 (Mar. 31, 2017), https://www.law360.com/articles/908646/bankrupt-aquion-energy-hit-with-warn-complaint [perma.cc/6P2J-U6U8].

[100] Temple, *supra* note 95.

[101] *Id.*

[102] Research Briefs, *11 Lessons from Startup Chapter 11s*, CBINSIGHTS (June 6, 2019), https://www.cbinsights.com/research/bankruptcy-startup-lessons [perma.cc/VBL9-WJXQ].

[103] *Id.*

[104] *Id.*

3. Debt Problems

Although many startups take on relatively little debt or use lenders that are repeat players in Silicon Valley, some startups are not so lucky and can be forced into bankruptcy when the business falters. Examples in this category may be a sign of the times with newer entrants into startup founding, investing, and lending, and geographies beyond California and its thick network of players and norms against taking disputes to court.

For example, 38 Studios, a video game startup founded by a retired Red Sox pitcher, accepted a $75 million loan from the state of Rhode Island to fund its development of an ambitious multiplayer online role-playing game.[105] The state gave the large loan to the startup in exchange for the company's promise to create 450 jobs in Rhode Island.[106] Taking public money instead of traditional venture capital put the company in an unusually difficult position, because it was required to add jobs in the state even as it ran low on cash and had taken on the special obligation of paying home mortgages for relocated employees.[107] Moreover, once it hit financial distress, 38 Studios faced an even bigger problem—it had over one thousand creditors, including workers who were collectively owed more than $150 million.[108] The company said it was "unable to find a solution" to the "stalemate" reached in negotiations with the state, investors, and others—and it laid off hundreds of employees and filed for Chapter 7 bankruptcy to liquidate its assets and figuratively throw in the towel.[109]

Another example of a startup's debt problems leading to bankruptcy is Cloudmine, a Philadelphia-based startup that raised approximately $15.6 million to develop a cloud-based healthcare platform.[110] The business model was capital-intensive in its early stages with a long lag-time before the promise of becoming highly profitable.[111] The company took on venture capital, primarily from East Coast–based firms, as well as debt from lender Comerica Bank, which later "declared a default and swept the company's bank account," pushing the company to file for Chapter 7 bankruptcy to liquidate its assets—likely intellectual property related to its software.[112] The company's capital-intensive business model, combined with its particular mix of financiers, may have contributed to its difficulty in staying afloat and its turn to bankruptcy once the lender declared a default.[113]

---

105 Todd Wallack, *38 Studios Files for Bankruptcy*, BOSTON.COM (June 8, 2012), https://www.boston.com/news/technology/2012/06/08/38-studios-files-for-bankruptcy [https://perma.cc/DHQ8-5QFS].

106 *Id.*

107 *Id.*

108 *Id.*

109 *Id.*

110 Michelle Caffrey, *CloudMine, Startup That Raised $15.6M, Files for Chapter 7 Bankruptcy*, PHILA. BUS. J. (Nov. 5, 2018), https://www.bizjournals.com/philadelphia/news/2018/11/05/cloudmine-startup-that-raised-15-6files-for.html [perma.cc/93ZX-UYXA].

111 *Id.*

112 *See id.*

113 An interesting twist on this theme may be instances in which customers file an involuntary petition seeking to push a startup into Chapter 7 bankruptcy. *See, e.g.*, Keith Harris, *Customers Try To Push Bitcoin Startup into Chapter 7*, 2014 WL 1924102 (May 15, 2014) (noting that customers filed an involuntary petition in an attempt to force a Bitcoin-mining hardware startup into Chapter 7 bankruptcy).

4. The Big "Startup"

Finally, the last main category or trend that emerges is distress in large startups that raised mega rounds of funding. In previous times, it was unusual for a startup to raise hundreds of millions or even $1 billion or more while private. Such levels of fundraising for venture-backed startups have occurred more often in recent years as companies stay private longer and raise larger rounds of financings.[114] These behemoth companies strain the label "startup," and when they encounter financial difficulty, many of the typical pathways for dealing with failure for smaller startups, such as an acqui-hire or ABC, are ill-suited to the circumstances.

OneWeb is an example of this phenomenon. Founded in 2012, the company aims to use a large network of broadband communication satellites to provide "high-speed services capable of connecting everywhere, to everyone."[115] The company raised—and burned through—$3.4 billion from Airbus, SoftBank Group, and the government of Rwanda, among other investors.[116] The company faced enormous regulatory and operational challenges, as well as competition from SpaceX, led by Elon Musk, which has a similar worldwide internet concept.[117] After failing to obtain new funding from investors during the early days of the COVID-19 pandemic, OneWeb laid off about 85 percent of its workforce and filed for Chapter 11 bankruptcy to "pursue a sale of its business in order to maximize the value of the company."[118] The company emerged from its bankruptcy protection status several months later, owned by a new consortium of investors consisting of the U.K. government and Indian conglomerate Bharti Enterprises.[119]

Solyndra provides another example. Founded in 2005, Solyndra sought to deliver less expensive, polysilicon-free, cylindrical solar panels.[120] By 2009, Solyndra had raised over $681 million of venture capital financing and $119 million of debt financing before receiving a $535 million conditional loan guarantee from the U.S. Department of Energy.[121] Although Solyndra began 2010 with momentum and hosted President Obama at its Fremont, California, factory, by the end of the year it was apparent that the company faced enormous competition and market pressures and would not be able to repay the

---

[114] NAT. VENTURE CAP. ASSOC. (NVCA), 2019 YEARBOOK 5, 32 (2019), https://nvca.org/wp-content/uploads/2019/08/NVCA-2019-Yearbook.pdf.

[115] Stanley Reed, *Britain Gambles on a Bankrupt Satellite Operator, OneWeb*, N.Y. TIMES (July 10, 2020), https://www.nytimes.com/2020/07/10/business/britain-oneweb.html [perma.cc/2CP2-677A].

[116] *Id.*

[117] *Id.*

[118] Lauren Muskett, *SoftBank-Backed Satellite Startup Files for Bankruptcy*, CFO (Mar. 30, 2020), https://www.cfo.com/bankruptcy/2020/03/softbank-backed-satellite-startup-files-for-bankruptcy/#:~:text=Lauren%20Muskett,of%20the%20COVID%2D19%20pandemic [perma.cc/V9D9-DWJ7].

[119] Reed, *supra* note 115; Darrell Etherington, *OneWeb Emerges From Bankruptcy, Aims To Begin Launching Satellites Again on December 17*, TECHCRUNCH (Nov. 20, 2020, 8:56 AM), https://techcrunch.com/2020/11/20/oneweb-emerges-from-bankruptcy-aims-to-begin-launching-satellites-again-on-december-17 [perma.cc/W9Q7-3PQJ]; Jonathan O'Callaghan, *U.K. Government Wins Controversial Bid for Bankrupt Mega Constellation Firm OneWeb*, FORBES (July 3, 2020, 7:43 AM), https://www.forbes.com/sites/jonathanocallaghan/2020/07/03/uk-government-wins-controversial-bid-for-bankrupt-mega-constellation-firm-oneweb/?sh=7f85c0435b9d [perma.cc/98PC-M3DV].

[120] Matthew L. Wald & Michael Kanellos, *F.B.I. Raids Solar Firm That Got U.S. Loans*, N.Y. TIMES (Sept. 8, 2011), https://www.nytimes.com/2011/09/09/business/solar-company-is-searched-by-fbi.html [perma.cc/4PTG-SZXY].

[121] Company Profile of Solyndra, PITCHBOOK, https://my-pitchbook-com.proxy.library.upenn.edu/profile/40658-59/company/profile#insights (last visited May 17, 2021).

federal loan.[122] Despite efforts to restructure, the company eventually defaulted and laid off over a thousand employees.[123] By 2011, Solyndra filed for Chapter 11 bankruptcy.[124] The filing was quickly followed by an FBI raid of Solyndra's Fremont headquarters, as well as Congressional investigations.[125] The unusual size and source of Solyndra's funding, with a significant public dimension and political implications, likely contributed to its turn to the formal bankruptcy process.

* * * * *

Exploring these examples of startup bankruptcies in many ways provides a study of the exceptions that prove the rule: failed startups typically do not favor using the formal bankruptcy process. Legal issues are often dire when they drive a decision to file for bankruptcy. Startup participants often say they have exhausted all other options to find a new buyer or an extended runway to pivot before they will use the bankruptcy system for this purpose. Debt problems that drive startups to bankruptcy may involve unusually large loans or outsiders to traditional venture capital. And companies that have raised nearly a billion dollars or more are barely still "startups"—or at least are not representative of the bulk of the startup world. Yet these examples—with newcomer investors and lenders, and larger sums at stake—may portend shifts in the startup bankruptcy landscape, a topic that will be further explored after turning to the current system of alternatives.

II. A System for Dealing with Startup Failures

The vast majority of startups fail to reach a "successful" exit of an IPO or M&A deal that provides returns to all equity holders, and yet few startups use the formal bankruptcy system. What happens to these great numbers of startups that are failing to achieve their founding dreams?

This Part sets out the various pathways to get rid of a startup that is struggling to raise more funding or that has lost its early hopes or promise for a big exit. A range of options exists and has not before been explored in the big picture—as a system for dealing with the large number of failed startups that our venture capital ecosystem produces. Scholars have long theorized bankruptcy as a system and recognized its critical contribution to the institutional framework for business.[126] This Article argues that the alternatives to bankruptcy that venture-backed startups commonly use—such as M&A sales, acqui-hire

---

[122] Saqib Rahim & Peter Behr *How Well Did DOE Know Solyndra's Technology – and Its Market Vulnerabilities?*, N.Y. TIMES (Sept. 15, 2011), https://archive.nytimes.com/www.nytimes.com/cwire/2011/09/15/15climatewire-how-well-did-doe-know-solyndras-technology-a-88462.html [perma.cc/8DJH-3V4W]; Wald & Kanellos, *supra* note 120.

[123] Wald & Kanellos, *supra* note 120.

[124] Tom Hals, *Solyndra Bankruptcy Plan Approved over U.S. Objections*, REUTERS (Oct. 22, 2012, 2:25 PM), https://www.reuters.com/article/us-solyndra-bankruptcy-approvalenv/solyndra-bankruptcy-plan-approved-over-u-s-objections-idUSBRE89L15L20121022 [perma.cc/87D2-L767].

[125] *See* Wald & Kanellos, *supra* note 120.

[126] *See, e.g.*, Johan Eklund, Nadine Levratto & Giovanni B. Ramello, *Entrepreneurship and Failure: Two Sides of the Same Coin?*, 54 SMALL BUS. ECON. 373, 374 (2020) ("In other words, the institutional framework sets up part of the incentives affecting entrepreneurial action and is thus relevant not only for failed entrepreneurs but for the whole market. Today, the evolution of the legal system that characterizes bankruptcy has a profound impact on the dynamics of the creation of a firm and its life cycle, and finally, the economic system.").

transactions, and assignments for the benefit of creditors—can be understood in a similar way and are vitally important to sustaining the system of venture capital and startups.

A. M&A Sales

Once a startup founder, CEO, or board realizes that its current path is not working, it will often consider pivoting to a new business model or raising a round of funding from new investors.[127] If those are not viable, a startup will often try to find a buyer.[128]

Selling the company through an M&A deal is generally the first preference for most startup participants in a venture that does not have a likelihood of continued lifespan as an independent venture-backed startup. As the company begins to search for a deal, there might still be some hope for success and a payout for founders and employees. Even if the company cannot find a deal that will bring financial success for all participants, founders and employees might at least be enticed by some deal "carrots,"[129] employment at the acquiring company, or the ability to craft a narrative of success for their individual career paths.[130] Investors might be able to recoup at least some of their investment and redeploy their time and capital into more promising ventures.[131]

M&A deals can be difficult to parse as successes or failures—participants often characterize them as a successful or at least semi-successful exit even if the company is sold for a fraction of the amount of money raised and burned, and some equity holders do not get a return or any of the deal proceeds. Achieving an M&A exit might understandably be appreciated not only because it recovers some capital for investors, but also as a validation that the startup produced something of value.[132] These deals can pose difficult situations for startup boards navigating their fiduciary duties.[133] The tensions and disputes that these exits raise between the different startup participants often arise because perceptions of success vary, and financial or personal interests may not align.[134]

---

[127] EISENMANN, *supra* note 8, at 250–54.

[128] *Id.* at 254; Marina Temkin, *'Put Up the For-Sale Sign,' More VCs Tell Founders As Market Sours*, PITCHBOOK (June 29, 2022), https://pitchbook.com/news/articles/mergers-acquisitions-vc-startups-sale-falling-valuations [perma.cc/BW38-GHUM] (noting that after trying to cut expenses or raise more capital, investors are encouraging startups to find a "soft landing" by "try[ing] to sell to a strategic buyer at a discount rather than risk going out of business").

[129] *See* Broughman & Fried, *supra* note 5, at 1325.

[130] *See id.* (finding that in 45 percent of trade sales, VCs give at least one type of carrot, such as sale bonuses or carve-outs, to common shareholders); EISENMANN, *supra* note 8, at 255–56 (discussing founder perspectives on M&A deals when a startup is failing).

[131] *See* EISENMANN, *supra* note 8, at 263–64; Cable, *supra* note 78, at 53.

[132] *See, e.g.*, Puri & Zarutskie, *supra* note 11, at 2276 (finding that "[t]here is no significant difference in the size of VC- and non-VC-financed firms at acquisition or IPO" and "[t]hus, it does not appear that venture capitalists are disguising failures as acquisitions"); Jacob Hellman, *Big Tech's 'Voracious Appetite,' or Entrepreneurs Who Dream of Acquisition? Regulation and the Interpenetration of Corporate Scales*, 31 SCI. AS CULTURE 149, 152 (2022) (explaining that the prestige of an exit is touted on résumés and portfolio lists as "[a]n entrepreneur or employee at a subsequently acquired company, or an investor who financed one, typically attaches the parenthetical suffix '(acquired by Google)' to the company's name in such documents, as a sign of their validation").

[133] *See supra* note 5; Steven E. Bochner & Amy L. Simmerman, *The Venture Capital Board Member's Survival Guide: Handling Conflicts Effectively While Wearing Two Hats*, 41 DEL. J. CORP. L. 1, 11–13 (2016).

[134] *See* EISENMANN, *supra* note 8, at 256 (explaining that founders may not want a deal that yields little or no personal financial upside and requires working for the acquirer); Pollman, *supra* note 1, at 160–61 (describing how vertical and horizontal conflicts or misalignments between startup participants grow over time).

The typical choice of deal structures is either: (a) a purchase of the equity of the startup company (either via a stock purchase or a merger), or (b) an asset purchase.[135] A stock purchase or merger can potentially be done quickly—assuming internal shareholder approvals are in place and the deal falls below the threshold for antitrust filings, a deal could even close on the same day that it is signed.[136] This can minimize employee and customer flight away from the startup.[137] As one startup lawyer explained, "This speed becomes an incredible advantage in the melting ice-cube situation of a distressed startup: the management teams can negotiate without any publicity regarding the financial distress, and the transaction can be presented to the world as a fait accompli."[138]

Asset purchases are, by contrast, typically slower to negotiate and execute, but they allow for customizing the assets and liabilities to be transferred.[139] Some asset purchases that do not keep much of the company intact might resemble liquidations and wind-downs. A vivid example of this is the recent failure of Quibi, the streaming video-service startup that rapidly torched nearly a billion dollars to launch the service and then realized that it had crashed and burned when it could not get enough subscribers to use the service after the free trial ended.[140] In a written statement, cofounders Jeffrey Katzenberg and Meg Whitman explained: "Quibi was a big idea and there was no one who wanted to make a success of it more than we did. We exhausted all options and came to the difficult decision to wind down the business."[141] Quibi returned some of the cash left on hand to its investors, and then sold its content rights to Roku,[142] after reportedly finding no other deals to sell the company as a whole.[143] This example highlights the difficulty of finding buyers and how they often drive the choice of deal structure.

As a sign of the need for a systematic way to efficiently sell startups that have in some sense failed but still have some value, online marketplaces have sprung up that let companies list themselves for sale.[144] While big startup exits grab news headlines, sites like Acquire provide a "quiet world of tiny acquisitions,"[145] ranging from "tens of thousands to complex, multimillion-dollar deals."[146] In just the first year of operation, the site had 25,000 potential buyers sign up, and it facilitated the acquisition of over one hundred

---

135 Liu, *supra* note 29, at 2; *see also* Cable, *supra* note 5, at 328 (noting acquirers "have a strong preference for mergers or asset sales . . . rather than acquiring stock from individual shareholders").
136 Liu, *supra* note 29, at 2–3.
137 *Id.* at 3.
138 *Id.*
139 *Id.* (explaining that asset purchases are subject to successor liability and fraudulent conveyance laws).
140 Benjamin Mullin & Lillian Rizzo, *Quibi Was Supposed to Revolutionize Hollywood. Here's Why It Failed.*, WALL ST. J. (Nov. 2, 2020), https://www.wsj.com/articles/quibi-was-supposed-to-revolutionize-hollywood-heres-why-it-failed-11604343850 [perma.cc/NDP3-ESKZ].
141 *Id.*
142 Todd Spangler, *Roku Acquires Global Rights to 75-Plus Quibi Shows, Will Stream Them for Free*, Variety (Jan. 8, 2021, 6:20 AM), https://variety.com/2021/digital/news/roku-acquires-quibi-shows-free-streaming-1234881238 [perma.cc/K3FK-P4J9].
143 Mullin & Rizzo, *supra* note 140; Amol Sharma, Benjamin Mullin & Cara Lombardo, *Roku Nears Deal To Buy Rights to Quibi's Content*, WALL ST. J. (Jan. 3, 2021), https://www.wsj.com/articles/roku-nears-deal-to-buy-rights-to-quibis-content-11609725389 [perma.cc/7TD4-B4VJ]
144 Kia Kokalitcheva, *MicroAcquire's Marketplace Helps Small Businesses Get Acquired*, AXIOS (Oct. 9, 2020), https://www.axios.com/microacquire-small-business-acquisition-dfdcd6cf-58d0-4fdc-9030-2de81a507084.html [perma.cc/3VZS-YZQM].
145 *Id.*
146 Andrew Gazdecki, *Why We're Dropping the Micro to Become Acquire.com*, ACQUIRE (Jan. 5, 2023), https://blog.acquire.com/becoming-acquire-com/.

startups.[147] The startups listed for sale are usually four to five years old, and their names are not publicly disclosed until they have fielded interest from buyers.[148] Acquire is not the only marketplace—others like Flippa and Empire Flippers serve a similar function.[149]

Regardless of how a company might search for a buyer, the process of trying to sell the company may be contentious and risky, particularly past the early stage of a startup. Some potential acquirers will express interest to learn more about the startup's strategy, intellectual property, or performance and subsequently will waste the startup's remaining time and money, potentially dooming it to a worse fate.[150] If the process is not successful at finding a buyer, the startup may be perceived as "damaged goods" in the market.[151] Raising bridge financing to fund the company while it searches for a buyer can put the existing investors in conflict over "down round" terms that significantly dilute non-participating investors and raise issues for VC board members wearing two hats as "dual fiduciaries."[152] Despite these challenges, selling the company is generally the best outcome for a failed startup to make a graceful exit.

B. Acqui-hire Transactions

Some companies cannot find a buyer for a traditional M&A deal but do find a different option available: an "acqui-hire." An acqui-hire is an acquisition that is predominantly carried out to hire a team of talent.[153] In a sense it is "an extreme form of an asset sale."[154] In many of these transactions, the buyer has little interest in the assets or projects of the startup—the target is instead the people.[155]

By way of context, although economic downturns occasionally occur, competition for engineering talent has often been fierce in Silicon Valley and in the technology sector more broadly.[156] With an acqui-hire, the acquirer/employer not only gets the benefit of bringing new talent on board, but also an experienced team that already knows how to work together on technology development and the possibility of including an enforceable

---

[147] Kokalitcheva, *supra* note 144.
[148] *Id.*
[149] *Id.*
[150] EISENMANN, *supra* note 8, at 255.
[151] *Id.* at 256.
[152] A "down round" refers to a financing at a lower valuation of the company than was used in the previous round of financing. Down rounds can significantly dilute existing investors and raise conflicts for VC directors who stand on both sides of the financing. *Id.* at 257; Bochner & Simmerman, *supra* note 133, at 3, 13–15.
[153] John F. Coyle & Gregg D. Polsky, *Acqui-Hiring*, 63 DUKE L.J. 281, 283–84 (2013).
[154] Liu, *supra* note 29, at 4.
[155] Coyle & Polsky, *supra* note 153, at 283; *see also* Cable, *supra* note 5, at 328 ("In Silicon Valley, acquisitions are often focused on acquiring talent rather than hard assets or specific technology—'the buyer wants the team.'"); Geoffrey Parker, Georgios Petropoulos & Marshall Van Alstyne, *Platform Mergers and Antitrust*, 30 INDUS. & CORP. CHANGE 1307, 1316 (fig. 3) (2021) (charting percentage of M&A deals that are acquihires for talent acquisition for Google, Amazon, Facebook, Apple, and Microsoft).
[156] *See, e.g.*, ANNALEE SAXENIAN, REGIONAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE 128, at 35 (1996) (describing vigorous competition for engineering talent in Silicon Valley as early as the 1970s); Ronald J. Gilson, *The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not To Compete*, 74 N.Y.U. L. REV. 575, 593 (1999) (describing the legal infrastructure of California's longstanding policy rendering noncompetes unenforceable and its culture of "open social and professional relations" that foster job networking and talent acquisition); LOBEL, *supra* note 68, at 11–26 (discussing "the talent wars" in the technology sector).

covenant not to compete.[157] Hiring a team with particular expertise can also help an acquirer move quickly into a new space of innovation.[158] For example, when Apple was building its cloud-based music service, it bought Lala, a startup that had been an early pioneer in music streaming.[159] Shortly after, Lala's founder left Apple and many fellow former Lala engineers followed him to start a new company related to video- and photo-sharing technology, which eventually failed.[160] For a small fraction of the reported Lala deal price, Apple acqui-hired the team back and got nearly two dozen employees, seasoned at working together, all at once.[161] For the acquirer/employer, the opportunity to enter into an acqui-hire transaction is at core a "make-or-buy" decision for engineering and entrepreneurial talent.[162]

For a startup without a better M&A deal on the table, an acqui-hire can represent a soft landing for founders and employees. For founders, an acqui-hire can provide the optics of an acquisition and thus an "exit" on their résumé.[163] The value of having a transaction that can be characterized as an exit can be of personal benefit in terms of psychic reward or relief, but also in terms of reputation that could be of potential monetary value in the future should founders or employees wish to become entrepreneurs again.[164] Depending on the acquirer and the level of incentive compensation allocated for the founders and employees, these individuals may or may not find the employment opportunity particularly attractive. They might prefer to join another startup or company rather than work for the acquirer, which is often a large technology company, but for some the lure of a juicy pay package or at least a relatively good story to tell about what happened to the startup is enough to push toward an acqui-hire. For investors, if a traditional M&A deal is not available, and the founders and employees are not formally locked in, an acqui-hire may be the only path available to potentially recoup some capital and be able to say the portfolio company had an exit.[165]

Notably, there is no universal structure for acqui-hires.[166] They are commonly done as an asset purchase with offers of employment to the target employees that the buyer wants, together with a relatively small amount of consideration to the target entity itself.[167]

---

[157] Coyle & Polsky, *supra* note 153, at 294. Federal and state courts typically enforce noncompetes executed in connection with the sale of a business, even in California through a narrow exception to its statutory bar against noncompetes. *See* Jonathan M. Barnett & Ted Sichelman, *The Case for Noncompetes*, 87 U. CHI. L. REV. 953, 982–83 (2020).

[158] Coyle & Polsky, *supra* note 153, at 294.

[159] Alex Heath, *The Inside Story of How Apple Bought Music Startup Lala, and Then Bought It Again*, CULT OF MAC (Jan. 18, 2013), https://www.cultofmac.com/211126/the-inside-story-of-how-apple-bought-music-startup-lala-and-then-bought-it-again [perma.cc/CQ24-54T9].

[160] *Id.*

[161] *Id.*; *see also* Anthony Wing Kosner, *Apple to Buy Bill Nguyen's Failed Color Labs for Patents to Bolster Facetime*, FORBES (Oct. 18, 2012), https://www.forbes.com/sites/anthonykosner/2012/10/18/apple-to-buy-bill-nguyens-failed-color-labs-for-patents-to-bolster-facetime/?sh=347162e97345 [perma.cc/9ML8-TFGC] (noting Apple's interest in failed startup Color was for its engineering talent from the previously acquired Lala team).

[162] EISENMANN, *supra* note 8, at 267; *cf.* Baird & Rasmussen, *supra* note 27, at 773 (noting that "[t]he synergy of the team makes it valuable, but the value may be independent of any firm").

[163] Coyle & Polsky, *supra* note 153, at 320–21 (discussing the "social status that entrepreneurs derive from being able to claim that they sold their company").

[164] *Id.* at 314–17.

[165] *Id.* at 321–22 ("From the perspective of an angel investor or a VC . . . it is better to be able to say that a portfolio company was acquired by Google than to say that it failed, even if the economics between the two outcomes are not materially different.").

[166] *Id.* at 296.

[167] Liu, *supra* note 29, at 4.

On the small side, an acqui-hire could be as simple as a cash payment in consideration for the startup's covenant not to sue the buyer and incentive packages for the employees being brought on board.[168] On the larger side, the deal could be structured as a stock purchase or merger and might involve some intellectual property.[169] The distinctive feature of the acqui-hire is that the main target asset is talent—thus the deal structure will include two pools of compensation, one for compensating the employees being hired and one for deal consideration in the form of cash or buyer's stock.[170] The allocation of the aggregate consideration between the two pools is the "key economic issue," with the buyer and target employees typically aligned in preferring to allocate more to the compensation pool.[171] After closing, typically the buyer redeploys the newly hired employees onto its own projects, and the startup liquidates and distributes any deal consideration.[172]

Sometimes an acqui-hire will include only part of a startup's team. This reality evidences the diverging interests among startup participants that must be navigated to resolution. As entrepreneurs at ChangeCoin, a startup that let people tip each other with Bitcoin, explained: "We've explored dozens of options [to stay in business] thoroughly over the past few months, and came up empty. It's time."[173] Citing potential legal liabilities and the costs of maintaining servers and services as prohibitive for continued survival, it accepted Airbnb's offer to acqui-hire the majority of its team.[174] The acqui-hire did not include any intellectual property or assets, and the company explained that it would subsequently shut down.[175] This example highlights the space that an acqui-hire often occupies in the system of options for dealing with a failed startup—often worse than a traditional M&A deal but better than a liquidation, and sometimes featuring aspects of either or both.

C. Assignment for the Benefit of Creditors

If a startup without a viable runway for continued lifespan cannot find an M&A deal or does not have an offer for an acqui-hire transaction, it faces the hard prospect of a liquidation or wind down. Despite the inherent challenges for a startup in this unfortunate position, it has options outside of formal bankruptcy.

An assignment for the benefit of creditors ("ABC") is a state law insolvency proceeding in which a debtor's assets are assigned by contract "to an assignee acting like a trustee over those assets."[176] ABCs can be faster, cheaper, less public, less work for

---

[168] Coyle & Polsky, *supra* note 153, at 296.
[169] *Id.*
[170] *Id.* at 297–98.
[171] *Id.* at 299.
[172] *Id.* at 296–99.
[173] ChangeTip Founder, *ChangeTip Shutting Down*, REDDIT (2016), https://www.reddit.com/r/changetip/comments/5dn3rc/changetip_shutting_down [perma.cc/F87A-8NVX] [hereinafter ChangeTip Founder Statement].
[174] *Id.*; Biz Carson, *Airbnb Just Brought on a Team of Bitcoin Experts from a Tiny Startup*, BUS. INSIDER (Apr. 12, 2016, 4:48 PM), https://www.businessinsider.com/airbnb-buys-bitcoin-startup-changecoin-2016-4 [perma.cc/4LRU-KW7K].
[175] Carson, *supra* note 174; ChangeTip Founder Statement, *supra* note 173173 ("In the spring of 2016, ChangeTip's employees were acqui-hired by Airbnb, where most of us work today. Since then, we've been searching for the best outcome for ChangeTip, and unfortunately the only remaining option is to shut it down.").
[176] Kleiner et al., *supra* note 80, at 1, 5.

corporate directors and officers, and less subject to oversight compared to a formal bankruptcy proceeding for a liquidation.[177]

ABCs are generally carried out under a state statutory scheme—but not all states have them, and those that do vary widely.[178] As a general matter, the process involves the company choosing an ABC firm as its assignee, and then the ABC firm liquidates the assets for the benefit of creditors.[179] The company debtor in an ABC does not continue its operations or reorganize—and, notably, it does not receive a discharge of its debts.[180] Board and shareholder consent is typically required.[181] As usual in startup matters, the potential for diverging interests among startup participants lurks, and concerns can arise about abuse of the process or misaligned interests between the ABC firm's priorities and those of other startup participants.[182] The assignee serves as a fiduciary to all creditors.[183] Once the assignee is selected, it is effectively like turning over the keys to the company—the assignee manages the liquidation process, not the board or officers.

For startups, there are well-known professionals who are in the business of serving as ABC assignees. One firm in particular, Sherwood Partners, has handled ABCs, receiverships, and bankruptcies of startups for almost thirty years.[184] The firm has been called the "undertakers of Silicon Valley"—and one of its partners, "the Terminator of startups."[185] In his words, they are not undertakers, but an ABC is like "a private funeral" in which the company is quietly shut down.[186] Venture lenders are also experienced repeat

[177] *See* Morrison, *supra* note 87, at 263 (noting that state procedures are generally cheaper, faster, and more private than federal bankruptcy procedures, but can be less transparent and subject to coordination costs and holdup problems).
[178] *See* Kleiner et al., *supra* note 81, at 5–6; *see also* Mann, *supra* note 81, at 1377, 1398 (discussing the startup-favorable ABC law in California).
[179] *See* Kleiner et al., *supra* note 80, at 5–6 (noting that the debtor usually selects its assignee).
[180] *Id.* at 5. There is no automatic stay or "free-and-clear sale order" as in a bankruptcy court, and litigation could continue against the debtor-assignor. Andrew De Camara, *The 1, 2, 3s of ABCs*, TURNAROUND MGMT. ASS'N (July/Aug. 2018), at 2; *see also* Liu, *supra* note 29, at 4 (noting that "because the technical sale occurs between the assignee and the buyer, the buyer is often stuck with very limited representations to the assets and little if no post-closing recourse").
[181] Notably, buyers cannot assume secured debt without the secured creditor's consent, nor is there the possibility for a cramdown, as in a Chapter 11 bankruptcy.
[182] *See, e.g.*, Berg & Berg Enters., LLC v. Boyle, 100 Cal. Rptr. 3d 875, 880–81 (Cal. Ct. App. 2009) (holding that creditor failed to plead a cognizable claim for breach of fiduciary duty against startup directors who decided to do an ABC instead of pursuing the creditor's bankruptcy plan to protect net operating losses through a Chapter 11 reorganization); EISENMANN, *supra* note 8, at 270 (providing example of a bank lender that retained an ABC firm for a startup and noting the founder's concern that the liquidation prioritized paying back the bank loan but not trying to obtain more to pay back all vendors and return capital to shareholders). In light of the potential for abuse, Bankruptcy Code § 303(h)(2) permits creditors to file an involuntary bankruptcy petition within 120 days after an ABC has been commenced. 11 U.S.C. § 303(h)(2).
[183] Kleiner et al., *supra* note 80, at 6; *see also* Credit Managers Ass'n of S. Cal. v. Nat'l Indep. Bus. All., 209 Cal. Rptr. 119, 121 (Cal. Ct. App. 1984) (quoting Francisco v. Aguirre, 94 Cal. 180, 183 (1892)) ("Under the common law of assignments, the assignee stands in the place of the assignor.") The court added, "[A]s trustee for all the creditors, [assignee] was charged with the duty to defend the property in its hands against all unjust adverse claims." *Id.* at 123.
[184] Adrian Daub, *The Undertakers of Silicon Valley: How Failure Became Big Business*, THE GUARDIAN (Aug. 21, 2018, 4:00 AM), https://www.theguardian.com/technology/2018/aug/21/the-undertakers-of-silicon-valley-how-failure-became-big-business [perma.cc/KX8M-TLJT].
[185] *See id.*
[186] *Id.* ("The clean-up crew stays deliberately out of sight.").

players at foreclosing on startup assets and working with liquidators like Sherwood Partners.[187]

The existence of specialized players in the startup ecosystem to facilitate ABCs underscores the need for efficient ways to get rid of failing startups. An ABC process is less time consuming for founders, directors, and officers, who might otherwise have to engage in an out-of-court workout or formal bankruptcy—instead, with an ABC, they can hire a specialized firm to handle the liquidation process and devote their attention to other ventures and new opportunities.[188] It is usually quicker than a bankruptcy, and the specialized players have industry expertise and connections that may enable them to recover more value than would be recaptured by a bankruptcy trustee assigned by a court.[189]

One potential downside of an ABC as compared with a formal bankruptcy is that assets are generally sold "as is," and there are a lack of bankruptcy protections for buyers.[190] The reputation of established ABC firms can help give buyers some confidence to fill this gap.[191] Moreover, a recent development has arisen to further close the gap between ABCs and bankruptcy in terms of protections for buyers: "ABC 2.0 Insurance."[192] This product bears some similarity to another recent phenomenon of private insurance: representations and warranty insurance in private M&A deals, which "allows sellers to minimize risk at exit and allows buyers to mitigate risk aversion in selecting investments."[193] ABC insurance focuses instead on "fill[ing] the risk gaps and provid[ing] a menu of analogous protections to a bankruptcy for buyers."[194] That is, insurance in the ABC context allows private players to provide buyers a substitute for bankruptcy protection from liability risk. The development evidences private-ordering solutions to replicate the benefits from a formal legal process and help position ABCs as a more complete and efficient solution for liquidation.

D. Wind Downs, Turnarounds, and Additional Alternatives

For a startup that has so little of value that it is not even worth an ABC, the company may simply sell off any assets directly and shut down the business and carry out a voluntary dissolution.[195] A corporate dissolution is a formal process under state corporate law to

---

187 There are also specialists in monetizing patent portfolios and customer lists, such as Hilco Streambank. *See* Fiona M. Scott Morton & Carl Shapiro, *Strategic Patent Acquisitions*, 79 ANTITRUST L.J. 463, 469 (2014) ("Increased opportunities for patent monetization, particularly in the information technology sector, have resulted in the rise of institutions to facilitate the sale of patents.").
188 EISENMANN, *supra* note 8, at 270.
189 *Id.*
190 *ABC 2.0*, SHERWOOD, [hereinafter ABC 2.0], https://www.shrwood.com/Users/Documents/Default/ABC_20.pdf [perma.cc/X6FK-K7PD] (describing key points of ABC 2.0 insurance as "an added benefit to the ABC").
191 As evidence of this perception, ABC firms and bankruptcy courts are sometimes discussed in equivalent terms in this regard. *See, e.g.*, EISENMANN, *supra* note 8, at 270 ("[S]ophisticated buyers of expensive assets will typically prefer to work with either an ABC firm or a bankruptcy court . . . [t]he buyers want to avoid legal complications that will ensue if the assets they acquire are secured by another claim; ABC firms and bankruptcy courts take care to ensure that assets aren't encumbered in this way.").
192 *See* ABC 2.0, *supra* note 190.
193 *See* Sean J. Griffith, *Deal Insurance: Representation and Warranty Insurance in Mergers and Acquisitions*, 104 MINN. L. REV. 1839, 1847 (2020).
194 ABC 2.0, *supra* note 190.
195 *See* O'Neill & Hwang, *supra* note 63, at 7 (discussing pros and cons of formal dissolution pursuant to § 280 under the Delaware General Corporation Law, and informal wind down).

end the corporation's legal existence after winding up its affairs.[196] It typically requires board and shareholder approval,[197] and subsequently continues to involve at least one director to supervise the process and someone to manage the operational tasks of wind down and liquidation, though professional firms can sometimes serve in this role.[198] When properly conducted, the dissolution of the corporation can provide directors with protection from personal liability once it has been completed.[199]

Finally, startups that are navigating choppy waters in search of an exit might have a few additional alternative paths available: recapitalizations and distressed turnarounds, and going public via a special purpose acquisition company ("SPAC").[200] Neither of these paths have been heavily used for startup failures, but bear brief discussion as they add to a full picture.

On the first, there is a small but growing group of investors that do "turnaround" or "distressed venture capital" that reflects the influx of private equity players and specialized VC funds in recent years into the venture ecosystem.[201] Often when these distressed investors enter the startup, they aim to buy a majority stake from incumbent shareholders, and then recapitalize the company and restructure its operations.[202] Thus, although often accomplished through a secondary transaction in which the startup maintains continued existence, the deal may be regarded as an offramp for startup participants in a distressed venture.

Regarding SPACs, while the transaction structure is an alternative to an IPO, it is one that is sometimes used for companies that otherwise struggle to get to the public markets and may not be an exit that provides returns to all equity holders. In this way, not all SPACs are startup failures, but it may be a potential pathway for dealing with some failed startups that might not otherwise be able to exit via a traditional IPO on favorable terms. For instance, shared workspace company WeWork engaged in a botched attempt at an

---

[196] *See, e.g.*, Bob Eisenbach, *Running Out of Cash? Your Duties and Options for Winding Down*, COOLEYGO (Feb. 26, 2021, last reviewed Mar. 23, 2023), https://www.cooleygo.com/running-out-of-cash-your-duties-and-options-for-winding-down [perma.cc/9HV8-D9RH] (noting corporate dissolution as a wind down option for insolvent startups or those running out of cash).

[197] *See, e.g.*, 8 DEL. CODE ANN. § 275(a)–(c) (2023) (providing procedures for dissolution).

[198] Bob Eisenbach, *You Say You Want a Dissolution: An Overview of the Formal Corporate Wind Down*, IN THE (RED) (Feb. 24, 2015), https://bankruptcy.cooley.com/2015/02/articles/the-financially-troubled-company/you-say-you-want-a-dissolution-an-overview-of-a-formal-corporate-wind-down [perma.cc/379D-86A6].

[199] *Id.* The dissolution and winding up of Delaware corporations may be done with or without court supervision. 8 DEL. CODE ANN. §§ 280, 281 (2010). Once a Delaware corporation has dissolved, it may prosecute and defend suits for a period of three years, or longer pursuant to court order, after which time the corporation can no longer sue or be sued in its corporate capacity. *Id.* § 278 (2010).

[200] For a discussion of SPACs, see Michael Klausner, Michael Ohlrogge & Emily Ruan, *A Sober Look at SPACs*, 39 YALE J. ON REG. 228 (2022).

[201] Julian Giessing, *Distressed Venture Capital*, MEDIUM (Jan. 27, 2020), https://medium.com/@julian.giessing/distressed-venture-capital-38c6be0e186e [perma.cc/4BWL-5EHP].

[202] *Id. See* Russ Garland, *Guggenheim Looks to Capitalize on Distressed VC Deals*, WALL ST. J. (Aug. 24, 2009), https://www.wsj.com/articles/BL-VCDB-2998 [perma.cc/RVU5-KJYV]; *Alara Capital Spins Off From Guggenheim Partners*, VC NEWS DAILY (Aug. 1, 2011), https://www.vcnewsdaily.com/alara-capital-spins/venture-capital-funding/wpwvsjtpkq [perma.cc/GM4R-8BQW]. On washout financings, see *In re Nine Sys. Corp. S'holder Litig.*, Consol. C.A. No. 3940-VCN, 2014 WL 4383127, at *30 (Del. Ch. Sept. 4, 2014); Kalashian v. Advent VI Ltd. P'ship, No. CV-739278, 1996 WL 33399950, at *1–2 (Cal. App. Dep't Super. Ct. Oct. 4, 1996); José M. Padilla, *What's Wrong With a Washout?: Fiduciary Duties of the Venture Capitalist Investor in a Washout Financing*, 1 HOUS. BUS. & TAX L.J. 269, 276–78 (2001).

IPO, followed by a bailout from private investors, layoffs, and litigation.[203] It subsequently entered into a de-SPAC deal at a reported equity valuation of $7.9 billion, which was less than the amount invested by one its main investors, and far less than its hopes of going public at a valuation of $47 billion.[204] The SPAC sector has attracted regulatory scrutiny and controversy, however, and the continued use of this structure faces an uncertain fate.[205]

* * * * *

This Part has provided a holistic account of the variety of paths and options for dealing with startups that are not going to reach successful exits with big returns for participants. Through M&A deals, acqui-hires, ABCs, and other arrangements, we observe in the real world the "ex post" bargaining theorized to be a critical part of dealing with problems in venture capital contracting.[206]

Stepping back, we can see that giant startup successes are relatively straightforward insofar as creditors are fully paid back and all equity holders share in the gains.[207] It is the vast number of startups that instead reach a middling level of success or failure, depending on one's perspective, that pose some of the greatest complexities, as they are less amenable to advance specification by contract.[208] Failure may also be more challenging than it appears at first sight—although security interests and liquidation preferences may clearly spell out priorities and obligations,[209] the startup board must decide when it is time to pull the plug and how to do so, whether in the form of a formal, potentially drawn out, and public proceeding, or through a discretely managed "private funeral" in which directors, founders, and employees can quietly disperse.

---

[203] Sarah E. Needleman & Eliot Brown, *WeWork to Cut Around 17% of Workforce*, WALL ST. J. (Nov. 21, 2019, 2:17 PM), https://www.wsj.com/articles/wework-to-cut-around-17-of-workforce-11574355656 [perma.cc/RK68-CU2S]; Nicholas Rizzi, *Investors Sue WeWork Over Botched IPO*, COMMERCIAL OBSERVER (June 4, 2020, 11:03 AM), https://commercialobserver.com/2020/06/investors-sue-wework-over-botched-ipo/ [perma.cc/CS4M-N4KV].

[204] Peter Eavis & Lauren Hirsch, *After Failed I.P.O., WeWork Will Go Public Through a Merger*, N.Y. TIMES (Mar. 26, 2021), https://www.nytimes.com/2021/03/26/business/WeWork-Spac-ipo.html [perma.cc/MH3A-N9V4]; Alex Sherman, *WeWork's $47 Billion Valuation Was Always a Fiction Created by SoftBank*, CNBC (Oct. 22, 2019, 5:26 PM), https://www.cnbc.com/2019/10/22/wework-47-billion-valuation-softbank-fiction.html [perma.cc/FJ58-J6ST].

[205] *See, e.g.*, Dave Michaels, Amrith Ramkumar & Alexander Osipovich, *SPAC Hot Streak Put on Ice by Regulatory Warnings*, WALL ST. J. (Apr. 16, 2021, 5:38 PM), https://www.wsj.com/articles/spac-hot-streak-put-on-ice-by-regulatory-warnings-11618565403 [perma.cc/7XZ2-F9KL].

[206] *See* Bratton, *supra* note 10, at 896 (theorizing that venture capitalists bargain for governance processes to address contracting difficulties in the startup context).

[207] *See id.* (noting that "fabulous success" in startups "present[] . . . no questions respecting the entrepreneur's control of the assets in the future"). On navigating governance challenges and conflicts in mature, late-stage startups, see Pollman, *supra* note 1, at 209–16.

[208] Bratton, *supra* note 10, at 896.

[209] *See id.* ("Total failure is similarly cut and dried – the contracts trigger liquidation for the benefit of the venture capitalist subject to the constraints of the bankruptcy system."); *see also* Richard M. Hynes, *Reorganization as Redemption*, 6 VA. L. & BUS. REV. 183, 212 (2011) (noting that venture capital investment "comes with real options" because "the early investment allows the firm to expand to meet new demand, or the firm can shut down if business is failing").

III. A Theory of Startup Failure

Building on the previous discussion, this Part offers an original theory of the law and culture facilitating failure and argues that it serves an important role in the startup and venture capital ecosystem.[210] The low cost, speed, potential for private ordering, and light level of legal formality allow startup participants to "fail fast" and for assets and talents to be absorbed or redeployed without significant reputational harm. Further, the discussion examines how recent developments may spell trouble for the existing system to deal with the size, type, and number of failures ahead in the same ways that it has in the past. The discussion concludes by considering a wide range of policy implications in corporate law, state insolvency procedures, bankruptcy, and antitrust to advance the goal of facilitating efficient failure.

A. The Advantages of Silicon Valley's Approach to Failure

Since legal scholars, sociologists, and historians began studying startups and venture capital, a common theme that has emerged is the presence of strong social and cultural norms that reflect thick networks, reputational concerns, and awareness of repeat player interactions.[211] In addition, as described in Part I, venture capitalists use a "power law" business model that is based on investing in a portfolio of high-risk startups with the potential for growth, and the understanding that a small number of home-run successes will likely drive the returns for the fund.[212] Even VC firms with top performances and reputations do not know ex ante which companies will be the home runs, and so they take a portfolio approach to investing, look for companies with the potential for extremely high growth, and expect some failures.

Adding these two themes together reveals the modus operandi of Silicon Valley's approach to startup failures: normalize and redeploy. Venture capital firms do not generally sweat an individual failure—that is part of their business model.[213] To find companies with high potential payoff, they need entrepreneurs with big ideas willing to take risks.[214] They typically expect multiple failures in a fund, and it could still be wildly successful overall. Furthermore, to be a top-tier venture capital firm, it must be able to raise successive funds over time. Reputation matters. It is important not to burn bridges with other venture capital firms that may invest again alongside in a syndicate, with venture

---

[210] For big-picture explorations of other aspects of the venture capital industry and its "power law" business model, startup communities, and innovative regions, see, e.g., SAXENIAN, *supra* note 156; BRAD FELD, STARTUP COMMUNITIES: BUILDING AN ENTREPRENEURIAL ECOSYSTEM IN YOUR CITY (2d. ed. 2020); SEBASTIAN MALLABY, THE POWER LAW: VENTURE CAPITAL AND THE MAKING OF THE NEW FUTURE (2022); NICHOLAS, *supra* note 33; MARGARET O'MARA, THE CODE: SILICON VALLEY AND THE REMAKING OF AMERICA (2019).

[211] *See, e.g.*, MARK C. SUCHMAN, ON ADVICE OF COUNSEL: LAW FIRMS AND VENTURE CAPITAL FUNDS AS INFORMATION INTERMEDIARIES IN THE STRUCTURATION OF SILICON VALLEY 1 (1994); Mark C. Suchman & Mia L. Cahill, *The Hired Gun as Facilitator: Lawyers and the Suppression of Business Disputes in Silicon Valley*, 21 LAW & SOC. INQUIRY 679, 679 (1996); NICHOLAS, *supra* note 33, at 3–5; Gilson, *supra* note 33, at 1069, 1078.

[212] *See supra* note 77 and accompanying text.

[213] Daub, *supra* note 184 ("By the time one venture crashes and burns, everyone is already on to their next one.").

[214] *See, e.g.*, Puri & Zarutskie, *supra* note 11, at 2248 (finding that "the key firm characteristic on which VC focuses is scale or potential for scale").

lenders that might be helpful to another portfolio company, and with entrepreneurs who might talk with other founders or turn around and start the next hot startup.[215]

Entrepreneurs and many employees also benefit from being able to take a swing and miss. Failure might result from a lack of luck or other factors beyond an entrepreneur's control.[216] Research suggests that investors to high-growth ventures understand that past entrepreneurial failure does not necessarily indicate a lack of skill, and they can use informational cues to evaluate the merits of future investments.[217] A large number of failed founders try again.[218] One study observed that founders routinely received attractive opportunities after their startup failed and did not experience significant stigmatization or rejection.[219]

A common refrain among insiders in the startup ecosystem is that it is important for founders to treat others well and execute a "graceful" exit or shutdown to preserve relationships.[220] With relational contracting and a dense network of professional ties, the threat of reputational harm and soft mechanisms of accountability might help to enforce norms that encourage prosocial behavior.[221]

---

[215] *See* Daub, *supra* note 183 ("Sure, a 24-year old can run his company into the ground—but he's still a 24-year old, with time and energy for another startup, and then another. And any one of those could pan out and make everybody fantastically rich."); Ola Bengtsson, *Relational Venture Capital Financing of Serial Founders*, 22 J. FIN. INTERMEDIATION 308, 309 (2013) (on serial entrepreneurship); Bratton, *supra* note 10, at 944–45 (discussing VCs as "reputational intermediaries" and their contracts as "relational"); Brian Broughman, *Relational Contracting and Business Norms in Entrepreneurial Finance* 4 (Ind. Leg. Studs. Rsch. Paper No. 402, Oct. 12, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3196033 [perma.cc/24Q8-ZANT] (explaining how "relational bolstering" embeds entrepreneurs into investors' networks).

[216] Diego Zunino, Gary Dushnitsky & Mirjam van Praag, *How Do Investors Evaluate Past Entrepreneurial Failure?: Unpacking Failure Due to Lack of Skill Versus Bad Luck*, ACAD. MGMT. J., Aug. 2022, at 1, 3 (arguing "that past failure is not always a negative cue of entrepreneurial skill; rather, it is a noisy cue [because] . . . failure may result not from a lack of skill but sometimes simply because of a lack of luck").

[217] *Id.* at 39 (reporting findings from experimental studies in the equity crowdfunding setting). Although past failure may be a noisy signal, research suggests that entrepreneurs who successfully start a company that goes public have a higher chance of succeeding in their next venture (30 percent) than first-time entrepreneurs (21 percent) and those who have previously failed (22 percent chance of success). *See* Paul A. Gompers, Josh Lerner, David Scharfstein & Anna Kovner, *Performance Persistence in Entrepreneurship and Venture Capital*, 96 J. FIN. ECON. 18, 18, 26 (2010).

[218] *See* EISENMANN, *supra* note 8, at 282 (reporting survey finding that 48 percent of first-time entrepreneurs launched another venture within five years of failure).

[219] *Id.* (discussing study by Jason Cope); *see also* Rajarishi Nahata, *Success Is Good but Failure Is Not So Bad Either: Serial Entrepreneurs and Venture Capital Contracting*, 58 J. CORP. FIN. 624, 625 (2019) (finding that "previously unsuccessful founders are able to float another startup in a reasonable timeframe and also obtain VC backing").

[220] *See, e.g.*, EISENMANN, *supra* note 8, at 282 ("For most founders—especially those who preserved relationships with team members and investors by engineering a graceful shutdown—the problem [of failure] doesn't appear to be as acute as many of them feared.").

[221] David Lee, *Quick Thoughts on Acquihires/"Soft Landings"* (Aug. 18, 2012), https://daslee.me/quick-thoughts-on-acquihiressoft-landings [perma.cc/93D8-HCWF]. Lee observes that:

> As [prominent VC and angel investor] Ron Conway once told me . . . how a founder conducts herself during either an acquihire or soft landing can determine if they get funding [again]. For example, founders who don't think of their team's welfare first in a soft landing probably won't get funding from their prior investors.

Id.

Knowing that failing will not harm one's ability to get a "regular" job or try again at entrepreneurship, so long as one aims to treat others well, may help to motivate the decision to launch an innovative startup or go work for one.[222] In many instances, venture capitalists can provide implicit insurance to spread the risk of individual failure by being willing to make introductions to other portfolio companies, early-stage investors, and "soft landing" opportunities.[223] Companies and their investors might even facilitate these opportunities for employees of a failed startup as a group.[224] More broadly, because buttressing entrepreneurs' willingness to take on risk is integral to venture capital, it often redounds to a VC firm's benefit to cultivate a reputation for supporting entrepreneurs in this way—whether in good times or in bad.[225]

This is not to say that "founder friendly" approaches writ large are optimal,[226] that bad behavior should go unpunished,[227] or that all startup founders and employees receive

---

[222] It might also have other potential positive effects, such as reducing the risk of fraud by providing an off-ramp instead of last-period agency costs. *See* Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 694 (discussing how fraud can arise as "a product of agency costs between owners and managers in circumstances where the managers fear themselves to be in their last period of employment").

[223] *See* Carmen Nobel, *Why Companies Fail—and How Their Founders Can Bounce Back*, HARV. BUS. SCH. (Mar. 7, 2011) , https://hbswk.hbs.edu/item/why-companies-failand-how-their-founders-can-bounce-back [perma.cc/FJD6-MHLA] (discussing research by Shikhar Ghosh finding that "savvy entrepreneurs know that running a company that eventually fails can actually help a career" and "failed businesses yield future networking opportunities with venture capitalists and relationships with other entrepreneurs whose companies are succeeding").

[224] For example, one company reportedly held a "career fair" for its employees at the company office just days after they announced the company was going out of business, and large tech firms such as Apple, Google, and Microsoft attended to meet with employees. *See* Crowe, *supra* note 62.

[225] The wide influence of the "founder friendly" approach pioneered by prominent VC firm Andreessen Horowitz for its own competitive advantage evidences this dynamic. *See generally* Blank, *supra* note 74 (describing the characteristics of the "founder friendly approach"); *see also* Stephanie Gleason & Ted Mann, *Invention Startup Quirky Files for Bankruptcy*, WALL ST. J. (Sept. 22, 2015), https://www.wsj.com/articles/invention-startup-quirky-files-for-bankruptcy-1442938458 [perma.cc/A5JW-5Z8G] (quoting an Andreessen Horowitz partner about failed startup Quirky, noting it was a "great idea" and "we stand firmly behind the employees of Quirky and will do everything we can to help them find their next job"). For a model of VC founder-friendly strategies to persuade risk-averse founders to pursue high-risk strategies, see generally Brian J. Broughman & Matthew Wansley, *Risk-Seeking Governance*, 76 VAND. L. REV. (forthcoming 2023).

[226] *See, e.g.*, Pollman, *supra* note 1, at 205–09 (discussing challenges related to founder-friendly governance); Renee M. Jones, *The Unicorn Governance Trap*, 166 U. PA. L. REV. ONLINE 165, 169 (2017) (highlighting "emerging governance problems presented by persistent Unicorns").

[227] *See* Nobel, *supra* note 223 (explaining that "enterprise failure" is "a learning experience that can lead to future opportunities," but an individual entrepreneur's "personal failure" of violating a fiduciary duty, committing a crime, or violating notions of morality and fair play can "damn a career"). This analysis highlights that unethical or illegal conduct should be addressed directly, so as not to perpetuate or amplify the activity in the startup and venture capital ecosystem. *See, e.g.*, Connie Loizos, *SoFi Founder Mike Cagney Is Back With a New Startup and $50 Million in Funding*, TECHCRUNCH (Apr. 30, 2018), https://techcrunch.com/2018/04/30/sofi-founder-mike-cagney-is-back-with-a-new-startup-and-50-million-in-funding-too [perma.cc/S8N2-9AG8] (noting that SoFi's founder received new venture funding after being ousted following a sexual harassment lawsuit and allegations of a toxic workplace culture); Rani Molla, *Why Does the WeWork Guy Get to Fail Up?*, VOX (Aug. 17, 2022), https://www.vox.com/recode/2022/8/17/23309756/wework-adam-neumann-flow-andreessen-venture-capital [perma.cc/36WY-NZBC] (discussing how venture capitalists funded WeWork founder Adam Neumann in a new venture instead of penalizing him for wild behavior and mismanagement). Further, efforts to make startups and venture capital firms more diverse and inclusive are important to

soft landings and take a rosy view of failure.[228] Rather, the existence of thick connections in venture capital and startup communities, and a culture that normalizes failure and redeploys talent, helps to lower risk and encourage founders and employees to engage in entrepreneurship.[229]

Viewed in this light, the alternative system discussed in Part II can be understood as producing certain efficiencies for serial entrepreneurship and investment. Legal and cultural factors allow startups to fail relatively quickly, quietly, and at low cost, with the potential for assets and talents to be absorbed or redeployed without stigma. As one observer commented:

> Silicon Valley thinks it has failure figured out. . . . [A] tolerance for things not going quite right is baked into the tech industry. People take jobs and lose them, and go on to a new job. People create products that no one likes, and go on to create another product. People back companies that get investigated by the SEC, and go on to back other companies. . . . In Silicon Valley, it seems, there is no such thing as negative experience.[230]

The range of options for failed startups, and their distinctive features, reflects the value of this approach for startup participants and for the optimal production of innovative ventures more generally. M&A trade sales frequently include deal "carrots" to the common shareholders to get the deal done, even when there is no contractual obligation on the preferred shareholders to share deal proceeds.[231] Acqui-hires, which at first appear a puzzle because employees could simply obtain employment on their own, make sense when understood as a means of avoiding the informal social sanctions of defection and providing cultural cachet to claim exit.[232] Acquiring companies may even learn from

---

ensuring equity of opportunity. *See* Carlos Berdejó, *Financing Minority Entrepreneurship*, WISC. L. REV. 41, 45, 85–99 (2021) (discussing the lack of diversity in private equity and venture capital's management and possible pathways to reducing racial disparities in financing entrepreneurship); Benjamin P. Edwards & Ann C. McGinley, *Venture Bearding*, 52 U.C. DAVIS L. REV. 1873, 1881–82 (2019) (discussing the disproportionate VC funding of male entrepreneurs); Jennifer S. Fan, *Innovating Inclusion: The Impact of Women on Private Company Boards*, 46 FLA. ST. U. L. REV. 345, 391–412 (2019) (exploring gender-related initiatives in Silicon Valley).

[228] *See, e.g.*, Carroll, *supra* note 78 (describing "the psychic toll of unrelenting failure" that some tech entrepreneurs experience); EISENMANN, *supra* note 8, at 249 (discussing how the decision to shut down a failed startup is "fraught with strong emotions").

[229] When the cost of failing is relatively low, the level of "overconfident" individuals willing to engage in entrepreneurship despite the large chance of failure may be stable and benefit society. *See* Antonio E. Bernardo & Ivo Welch, *On the Evolution of Overconfidence and Entrepreneurs*, 10 J. ECON. & MGMT. STRAT. 301, 305, 325 (2004) (providing a "group selection" theory that posits that overconfidence can persist when the cost to the irrational entrepreneur is low and the benefit to society is high). Questions remain, however, regarding the ability of venture capital to advance substantial technological change in areas of social need and the social welfare impact of venture capital more generally. Josh Lerner & Ramana Nanda, *Venture Capital's Role in Financing Innovation: What We Know and How Much We Still Need to Learn*, 34 J. ECON. PERSPS. 237, 238 (2020).

[230] Daub, *supra* note 184; *see also* EISENMANN, *supra* note 8, at 272 ("Those who've invested in many other startups will see the failure as part of the 'circle of life' and most won't be bitter."); *cf.* Carroll, *supra* note 78 (noting that "[v]enture capitalists and angel investors tolerate failure only up to a point").

[231] *See* Broughman & Fried, *Carrots and Sticks*, *supra* note 5, at 1347–52; Cable, *Does* Trados *Matter?*, *supra* note 5, at 334–36.

[232] *See* Coyle & Polsky, *supra* note 153, at 286; Hellman, *supra* note 132, at 152–53 (explaining that exits produce "cachet in the industry" and acqui-hires can confer status in the new workplace for engineers

experience and improve their ability to integrate newly acquired teams.[233] California ABCs and their relatively light level of regulation, with no public court filing and allowance for assets to be sold without court approval, compare favorably to other states that maintain rigid formalities.[234]

By contrast, bankruptcy does not quickly or quietly mitigate failure for startups.[235] M&A deals, acquihires, and ABCs are significantly more efficient in that sense. As we have seen, Chapter 7 can be particularly ill-suited for many startups because it does not keep the people together with the intellectual property to maximize the sale. It does not allow the company to choose its trustee for liquidating the assets, so it cannot select a sophisticated repeat player who has specialized experience with liquidating intellectual property and will act in a relationship-based manner.[236] Perhaps most importantly, it does not keep the failure quiet. The stigma of filing for bankruptcy may be perceived as the opposite of "failing with honor" that many participants in the startup ecosystem, from investors and founders to employees, seek for their reputations and career trajectories.[237] A private sale or acqui-hire allows the startup participants to take responsibility and craft their own narrative of success.[238] An ABC "allows them to fly under the radar" and quickly move on.[239]

Chapter 11, even a 363 sale, presents a major tradeoff in terms of visibility, cost, and timing.[240] The upside is that this process provides a federal forum for dealing with complex litigation, and so it might be a useful option for companies like OneWeb, which raised over a billion dollars and had non–Silicon Valley–type investors, and FTX, which had extraordinary legal fiascos and large numbers of creditors. To date, however, it has not been viewed as a viable solution for the masses of startups. The time, expense, and visibility have made it "taboo" for many years—and meanwhile, participants have embraced other pathways of dealing with the end of the startup's life.[241]

In sum, the venture capital business model prioritizes investing in high-risk and potentially high-growth innovative startups—a large number of failures is to be expected. Startups are much more likely to go to zero than traditional businesses, but they also have

---

who were targeted and compensated through an acquisition process rather than the conventional hiring and salary packages).

[233] J. Daniel Kim, *Startup Acquisitions as a Hiring Strategy: Worker Choice and Turnover* 25 (Mar. 1, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3252784 [perma.cc/FMF6-P8EM].

[234] *See* Mann, *supra* note 81, at 1398.

[235] Stigma associated with bankruptcy is socially constructed but may impact use of the bankruptcy system. *See, e.g.*, Rafael Efrat, *The Evolution of Bankruptcy Stigma*, 7 THEORETICAL INQUIRIES L. 365, 374–85, 393 (2006) (discussing studies attempting to measure bankruptcy stigma and its impact on the number of bankruptcy filings and finding that stigma has had a "limited influence"); Michael D. Sousa, *The Persistence of Bankruptcy Stigma*, 26 AM. BANKR. INST. L. REV. 217, 217 (2018) (finding that "stigma surrounding personal bankruptcy has actually increased over time").

[236] *See* Mann, *supra* note 81, at 1442–43.

[237] *See supra* notes 75–76 and accompanying text.

[238] *See* Daub, *supra* note 184 ("'None of this litigation happens in this industry, because nobody wants to be blackballed,' one anonymous lawyer says. Or, as an angel investor puts it, it's important that even a failed venture 'facilitates the founder's story.'"); EISENMANN, *supra* note 8, at 282 (noting that founders can take responsibility for failure and "own the narrative" or "spin" their story).

[239] Daniel Fisher, *The Latest Craze in Silicon Valley: Bankruptcy*, FORBES (Mar. 15, 2017), https://www.forbes.com/sites/danielfisher/2017/03/15/the-latest-craze-in-silicon-valley-bankruptcy/?sh=64542ea11664 [perma.cc/8QND-AALP] (quoting a startup lawyer).

[240] For a discussion of going-concern bankruptcy sales accomplished through a Chapter 11 plan or a 363 sale, see Jacoby & Janger, *supra* note 64, at 892–910.

[241] *See supra* note 76 and accompanying text.

enormous potential to produce something very big on the upside.[242] As one tech expert astutely noted, "Silicon Valley is a machine for running experiments, and most of the experiments don't work[.]"[243] The theory of startup failure advanced in this Article shows that this activity is normalized and a rich culture has developed to protect the reputation of entrepreneurs, alongside a variety of legal and private ordering mechanisms outside of bankruptcy that ease the absorption or redeployment of talent and capital into other ventures. The smooth functioning of this activity is crucial to encourage entrepreneurs to take the leap in launching a startup, to help them try again in a new venture or find productive use of their human capital, and to ensure the health of the venture capital ecosystem out of which blockbuster successes also arise.

B. The Changing Landscape of Startup Failure

Several developments are shifting the landscape of venture capital investing and suggest that the system may come under pressure to deal with the size, type, or number of failures. New entrants to venture-backed startup investing, longer timelines of staying private, higher valuations and amounts raised, and looming increased antitrust scrutiny of technology acquisitions all point to change that might test the adaptability of the existing law and culture of startup failure that aims to normalize and redeploy at low social and financial cost.

Recent years have witnessed the explosive growth of the private markets.[244] In 2021, U.S. investments in venture capital exceeded $300 billion for the first time, nearly doubling the previous year's figure.[245] A significant driver of this growth is the entrance of nontraditional investors to the venture capital space: hedge funds, mutual funds, private equity, and sovereign wealth funds.[246] This development has introduced players into the venture capital system that may not follow the same norms and are not averse to litigation and the formality and visibility of bankruptcy. This potential for different approaches may become particularly visible during an economic downturn, when a greater number of startups struggle to find success.[247]

Further, with regulatory changes and an unprecedented influx of private capital, startups have increasingly stayed longer in the private market.[248] During the dot-com era, startups that survived to exit would typically be acquired or go public within about five years.[249] By 2021, the median age of companies at IPO stretched to eleven years.[250] With

[242] Venture capitalists are known to bemoan their missed opportunities more than their failures. *See* MAHENDRA RAMSINGHANI, THE BUSINESS OF VENTURE CAPITAL 248–51 (2021) (discussing venture capitalists' "agony of missed opportunities" and how some firms such as Bessemer Venture Partners showcase them in an "anti-portfolio" of companies they declined to invest in).
[243] Evans, *supra* note 21.
[244] Pollman, *Private Company Lies*, *supra* note 86, at 370–73.
[245] Jessica Hamlin, *U.S. Venture Capital Shattered Records in 2021*, INSTITUTIONAL INVESTOR (Jan. 6, 2022), https://www.institutionalinvestor.com/article/b1w6kyc497hzrt/us-venture-capital-shattered-records-in-2021 [perma.cc/VS8Q-UVKW].
[246] *Id.*
[247] Marina Temkin, *Startup Life Expectancy Expected to Fall*, PITCHBOOK (Jan. 11, 2023), https://pitchbook.com/news/articles/startup-shutdowns-failure-VC [perma.cc/GR6Z-8RVF].
[248] de Fontenay, *supra* note 3, at 460; Pollman, *Private Company Lies*, *supra* 86, at 371.
[249] Jay R. Ritter, *Initial Public Offerings: Median Age of IPOs Through 2021* (Dec. 23, 2021) (unpublished tabular data), at tbl.4 (tracking the median age of venture-backed companies at IPO from five years in 1999 to eleven years by 2021), https://site.warrington.ufl.edu/ritter/files/IPOs-Age.pdf [perma.cc/8HNH-3ZPW].
[250] *Id.*

longer timelines of startups staying private, we may also start to see more of the large, late-stage startup failures like WeWork. The alternative system may strain to deal with these kinds of failures.[251] There may not be buyers for a distressed trade sale, or such deals might only be available at fire sale valuations. These startups are generally too big to acqui-hire. Aiming to scale over a long period of time means these startups often have large numbers of employees who are not engineers and do not have the technological skill and tacit knowledge that are highly prized in the labor market for talent. Companies that have stayed private for a long period may also have too many potential assets and liabilities for an acqui-hire or ABC to be a good fit.[252] The white-hot market for SPACs seen in 2021 has cooled, and the SEC has set its sights on increased enforcement.[253]

Another dimension of these changing trends is that startups are reaching higher valuations and raising larger amounts while on the private market. "Unicorns," or startups that have raised a venture financing round with a post-money valuation of $1 billion or more, increasingly attract attention in the venture capital industry and beyond through media coverage.[254] Relatively rare just a decade ago, there are now over 1,400.[255] Recent years have also seen record-setting median deal sizes of venture capital financing.[256] In 2021, there were more than 1,500 "mega"-rounds of $100 million or more.[257] These "mega"-rounds made up less than five percent of global venture deals, but accounted for 59 percent of total dollars—reflecting the market shift toward funding large startups.[258]

Although more mature, late-stage startups may be less likely to fail, when they cannot find a successful M&A deal or IPO, they face a particularly challenging situation to navigate.[259] It is harder to get rid of these big "startups" in a low-profile manner, and they might have larger amounts of debt or complex capital structures that lead to a greater

---

[251] Partial liquidity before exit and post-secondary sale failures like WeWork might also impact the dynamics in late-stage startups. Depending on the timing of investment and secondary liquidity, investors in the same company may be winners or losers.

[252] ABCs generally operate on property in the jurisdiction where the assignment is made, and so startups with property spread across jurisdictions may also find ABCS a poor fit. *See* Carly Landon, Note, *Making Assignments for the Benefit of Creditors as Easy as A-B-C*, 41 FORDHAM URB. L.J. 1415, 1462 (2014) (discussing choice of law and jurisdiction over property in ABCs).

[253] *See* Amrith Ramkumar, *The SPAC Ship Is Sinking. Investors Want Their Money Back*, WALL ST. J. (Jan. 21, 2022), https://www.wsj.com/articles/the-spac-ship-is-sinking-investors-want-their-money-back-11642761012 [perma.cc/V962-YQL5]; Alex Wyman, Colleen Smith & Kristin Murphy, *SPAC-Related Enforcement and Litigation: What to Expect in 2022*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Apr. 13, 2022), https://corpgov.law.harvard.edu/2022/04/13/spac-related-enforcement-and-litigation-what-to-expect-in-2022 [perma.cc/E6RX-SCBS].

[254] *See, e.g.*, *The Crunchbase Unicorn Board*, CRUNCHBASE, https://news.crunchbase.com/unicorn-company-list [perma.cc/ZY8N-P9DR] (recognizing 1,454 unicorns with $865 billion raised and $6.9 trillion total value); *cf.* Will Gornall & Ilya A. Strebulaev, *Squaring Venture Capital Valuations with Reality*, 135 J. FIN. ECON. 120, 121 (2020) (discussing the rise of unicorns and explaining that post-money valuation does not equate with fair valuation).

[255] *Crunchbase Unicorn Board*, *supra* note 254.

[256] RESEARCH REPORT, STATE OF VENTURE 2021, at 41 (2021), CBINSIGHTS, https://www.cbinsights.com/research/report/venture-trends-2021 [perma.cc/FLZ9-L6BV].

[257] *Id.* at 8.

[258] *Id.*

[259] Pollman, *supra* note 1, at 209–16 (discussing increasing governance tensions and liquidity pressure in late-stage startups, particularly once they reach the ten-year mark). Exits at the late stage might also involve investors, founders, and employees with highly variable outcomes depending on how early they invested in or joined the startup and the terms of their participation. For an examination of the outcomes of the first thirty-two startups to reach the "unicorn" moniker, see generally Abraham J.B. Cable, *Time Enough for Counting: A Unicorn Retrospective*, 39 YALE J. ON REGUL. BULL. 23 (2021).

likelihood of using the bankruptcy system.[260] With a downturn in the technology sector and the collapse of Silicon Valley Bank, once the largest venture lender, the speed in which the environment for financings and exits can go from frothy to cool has also become readily apparent, further increasing the difficulty level of finding a good ending for large startups.

In addition to new entrants to venture capital investments and major changes in startup timelines, sizes, and valuations, a different development also looms large: increased antitrust scrutiny and regulatory enforcement of large technology company acquisitions. Amid wide-ranging concerns about the power of large technology companies, including so-called "killer acquisitions" in which big companies scoop up nascent competitors, the Department of Justice, the Federal Trade Commission, and several states attorneys general have brought major antitrust cases against Big Tech companies, and policymakers have proposed a variety of bills that would clamp down on the acquisition of startups.[261]

Although regulatory reform and its potential impact are uncertain, M&A transactions are a key pathway to exit for venture-backed startups. M&A exits have long outnumbered IPOs, with recent years often reaching a nearly 10-to-1 ratio or more.[262] As the above discussion has shown, venture-backed startups that reach M&A exits run the gamut in terms of "success" and "failure": some are home runs, which generate large returns for all equity participants, and some are less favorable, with not all equity holders getting a payout. Thus, to the extent that Big Tech slows down its acquisitions due to concerns of government scrutiny or breakups,[263] or if government becomes even more active in constraining these acquisitions, regulatory reform may be closing or tightening an important means by which startups are finding an off-ramp to fail with honor and quickly redeploy talent, technology, and tacit knowledge.[264]

---

[260] Fisher, *supra* note 239.

[261] *See* Herbert Hovenkamp, *Antitrust Remedies for Big Tech*, REGUL. REV. (Jan. 18, 2021), https://www.theregreview.org/2021/01/18/hovenkamp-antitrust-remedies-big-tech [perma.cc/G85K-SPCU] (discussing litigation against Facebook and Google); Katherine McKeen, *A Modern Antitrust Law for Tech Tycoons*, REGUL. REV. (Apr. 15, 2021), https://www.theregreview.org/2021/04/15/mckeen-modern-antitrust-law-tech-tycoons [perma.cc/SHG3-8AE7] (discussing antitrust proposals).

[262] Nat'l Venture Cap. Ass'n, 2021 NAT'L VENTURE CAP. ASS'N Y.B. 7 (2021), https://nvca.org/wp-content/uploads/2021/03/NVCA-2021-Yearbook.pdf [perma.cc/6NQB-TJDW] (noting a ratio of M&A exits to IPOs of 8.6 to 1 in 2020); Nat'l Venture Cap. Ass'n, 2020 NAT'L VENTURE CAP. ASS'N Y.B. 35–36, https://nvca.org/wp-content/uploads/2020/03/NVCA-2020-Yearbook.pdf [perma.cc/Y93J-RAX7] (reporting on M&A and IPO exits with a ratio approximating 10 to 1 in 2019); Jeff Farrah, *Restrictions on Acquisitions Would Stifle the US Startup Ecosystem, Not Rein in Big Tech*, TECHCRUNCH (May 19, 2021, 12:08 AM) https://techcrunch.com/2021/05/19/restrictions-on-acquisitions-would-stifle-the-us-startup-ecosystem-not-rein-in-big-tech [perma.cc/K78U-5ZTT] (noting "the average acquisition-to-IPO ratio since 2004 is approximately 15:1").

[263] *See, e.g.*, Vishal Persaud, *Alphabet's M&A Activity Declines as US Files Antitrust Suit*, PITCHBOOK (Oct. 20, 2020), https://pitchbook.com/news/articles/alphabets-acquisition-activity-declines-as-us-files-antitrust-suit [perma.cc/S3Y2-UVDH] (describing how Alphabet has slowed down its acquisition activity in recent years in response to increased regulatory scrutiny).

[264] Combined, four of the large technology companies, Amazon, Apple, Facebook (Meta), and Google, have made nearly 500 acquisitions since the start of 2010. Kevin Dowd, *10 Big Things: Potential Fallout from a Big Tech Backlash*, PITCHBOOK (Aug. 2, 2020), https://pitchbook.com/news/articles/potential-fallout-big-tech-backlash [perma.cc/XAA6-N3B8].

C. Applications and Policy Implications

Although startups and venture capital have experienced significant changes in the past decades, they have only grown in importance as an engine of the U.S. economy and innovation. U.S. venture-backed startups employ 3.8 million workers.[265] Among U.S. public companies founded since 1968, venture-backed companies account for 77 percent of total U.S. market capitalization, 41 percent of total employees, and 92 percent of research and development spending.[266] Many of the world's largest companies by market capitalization started in the proverbial garage or dorm room and raised venture capital to develop an innovative product or service and bring it to market.[267] By any measure, startups are a key piece of the dynamic life cycle of business and the U.S. economic landscape.

As this Article has explored, the law and culture of dealing with failure plays an underappreciated role in supporting this system. The vast majority of startups fail to reach an exit with a return for all equity holders, and participants in the ecosystem generally understand that this is the nature of the business model that also produces the biggest business successes. Given the importance of dealing with large numbers of failed startups, and recent developments potentially adding tension to our system, this final subsection explores a variety of avenues for bolstering the law assisting startup failure.

A natural starting place for inquiry is corporate law. This Article shows that once a startup is getting low on cash and sees signs of trouble, the company will typically take measures to extend its runway, such as by raising a new round of financing or cutting expenses, or it will try to find a buyer (or both). Eventually, the startup might be faced with the decision to liquidate. Along this path, two key doctrinal areas related to fiduciary duties can be implicated:[268] (1) the "insolvency" line of case law,[269] and (2) the case law dealing with conflicts between the preferred and common shareholders in M&A deals.[270]

---

[265] Devin Miller, *Record Year for U.S. Venture Capital Industry Despite Pandemic and Economic Downturn*, NAT'L VENTURE CAP. ASS'N (Mar. 25, 2021), https://nvca.org/pressreleases/record-year-for-u-s-venture-capital-industry-despite-pandemic-and-economic-downturn/#:~:text=In%202020%2C%20U.S.%20venture%2Dbacked,represented%20about%202.5%20million%20employees [https://perma.cc/937W-NTBF].

[266] Gornall & Strebulaev, *supra* note 13, at 17.

[267] *See* Pollman, *supra* note 1, at 156 ("The world's largest companies in 2019 by market capitalization—Alphabet, Microsoft, and Amazon—all began as venture-backed startups.") (citation omitted).

[268] This discussion focuses on Delaware corporate law as most venture-backed startups incorporate in Delaware. Other state corporate law could be examined for similar opportunities for increased doctrinal clarity for boards navigating startup failure. *See* Gregg Polsky, *Explaining Choice-of-Entity Decisions by Silicon Valley Start-Ups*, 70 HASTINGS L.J. 409, 411 (2019) ("[H]ighly sophisticated lawyers, . . . who advise start-ups in Silicon Valley and other hotbeds of start-up activity, stubbornly prefer C corporations."); Cable, *supra* note 5, at 322 n.88 and accompanying text (discussing startup lawyers mostly forming and representing Delaware corporations).

[269] *See, e.g.*, N. Am. Cath. Educ. Programming Found. v. Gheewalla, 930 A.2d 92, 94 (Del. 2007) (holding that the creditors of an insolvent Delaware corporation "have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against the corporation's directors" but have standing to bring derivative actions); Quadrant Structured Prods. Co. v. Vertin, 102 A.3d 155, 176 (Del. Ch. 2014) (explaining that insolvency "marks a shift" in which creditors gain "derivative standing to enforce . . . the fiduciary duties that directors owe to the corporation to maximize its value for the benefit of all residual claimants").

[270] *See, e.g.*, *In re* Trados S'holder Litig., 73 A.3d 17, 39–40 (Del. Ch. 2013) (explaining that "[p]referred stockholders are owed fiduciary duties only when they do not invoke their special contractual rights and rely on a right shared equally with the common stock").

Additional doctrinal clarity in each of these areas could be beneficial for startup boards navigating the challenges of financial distress or finding an exit.

First, the twenty-first century shift away from the "zone of insolvency" doctrine has moved toward greater precision in defining the parameters of when creditors can bring fiduciary claims against directors.[271] Instead of uncertainty around when a company enters a "zone" or state of "deepening insolvency," which could trigger a shift of fiduciary duties being owed to creditors,[272] Delaware courts have drawn a bright line at insolvency and "eliminated any notion of creditor rights to bring direct fiduciary claims."[273] Current doctrine provides that once a corporation becomes insolvent, creditors gain standing to assert derivative claims for breach of fiduciary duty.[274] Although this doctrinal move to sharpen the line at insolvency might give rise to concerns about "bankruptcy hardball" and opportunism against creditors,[275] it helps to mitigate the cost of ambiguous fiduciary law and reduce litigation abuse against startup directors,[276] thereby contributing to efficiencies in dealing with failing startups and reinforcing business judgment protection for startup boards that face complexity and distress.

One important related area that could be further clarified, however, is the test for insolvency itself and, more specifically, how to understand this in the context of venture-backed startups.[277] Delaware corporate law does not use a bright-line test for insolvency and has not defined the "balance sheet" and "cash flow" tests uniformly.[278] Although insolvency tests commonly pose difficulty in application, startups raise particularly vexing issues given how frequently they exist in precarious financial positions with uncertain valuations of assets and forward-looking cash flows. That is, unlike other closely held corporations, or public corporations, venture-backed startups distinctively operate in a continual mode of raising staged financing and running down cash reserves, often while having assets that are difficult to value and questions about the "reasonable prospects" of

---

[271] *See* Jared Ellias & Robert J. Stark, *Delaware Corporate Law and the "End of History" in Creditor Protection*, *in* FIDUCIARY OBLIGATIONS IN BUSINESS 207, 214–20 (Arthur B. Laby & Jacob Hale Russell eds., 2021) (tracing Delaware corporate law's evolution away from the "deepening insolvency" and "zone of insolvency" case law).

[272] *See id.* at 215–16 (discussing Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm. Corp., No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991)).

[273] *Id.* at 218.

[274] *Quadrant*, 102 A.3d at 172 (citing *Gheewalla*, 930 A.2d at 101–02).

[275] Jared A. Ellias & Robert J. Stark, *Bankruptcy Hardball*, 108 CAL. L. REV. 745, 745, 750 (2020) (arguing that "*Gheewalla* and its progency relieved corporate decision-making of important guiding principles, and, in the vacuous space that now exists, remarkable instances of control opportunism are observable and increasingly common place").

[276] It does this by removing the uncertainty created by case law that had introduced concepts of a "zone" of insolvency or "deepening" insolvency. *See, e.g.*, Stephen M. Bainbridge, *Much Ado About Little? Directors' Fiduciary Duties in the Vicinity of Insolvency*, 1 J. BUS. & TECH. L. 335, 363 (2007) (explaining that *Credit Lyonnais* "introduced uncertainty into the law, depriving directors of the *ex ante* guidance on which Delaware corporate law appropriately prides itself").

[277] Scholars and practitioners have identified the difficulty of applying insolvency tests and the lack of uniformity of tests at common law, but they have not focused on how these issues could be particularly challenging in the context of venture-backed startups. *See, e.g.*, Robert J. Stearn, Jr. & Cory D. Kandestin, *Delaware's Solvency Test: What is it and Does it Make Sense? A Comparison of Solvency Tests Under the Bankruptcy Code and Delaware Law*, 36 DEL. J. CORP. L. 165, 165 (2011). On the uncertainty of valuing emerging companies and the high variance in their potential results, see James J. Park, *Investor Protection in an Age of Entrepreneurship*, 12 HARV. BUS. L. REV. 107, 118–22 (2022).

[278] Stearn & Kandestin, *supra* note 277, at 165–66 ("[U]nlike federal bankruptcy law, which uses uniform statutory tests to determine solvency, Delaware corporate law has no uniform tests . . . . Delaware case law on solvency is confusing and can lead to inconsistent results.").

continuing.[279] This utterly commonplace factual scenario opens up the regular possibility of creditor suits for breach of fiduciary duty, and thus also complexity for startup boards making decisions when it may not be clear which path would maximize firm value versus value for common shareholders. It appears to be only a matter of time before a significant case involving a venture-backed startup and creditor's claim for breach of fiduciary duty will come before Delaware courts, and this opportunity will be a valuable one for providing guidance and giving startup boards the wide discretion they often need in these circumstances.[280]

Second, this Article's observations about the law and culture of startup failure sheds new light on the *Trados* doctrine about the preferred-common shareholder conflict. In a notable 2013 decision of the Delaware Court of Chancery, *In re Trados*,[281] the court examined a venture-backed startup board's decision to enter into an M&A deal in which the proceeds went to a management incentive plan and the preferred shareholders, pursuant to liquidation preferences, with nothing left over for the common shareholders.[282] The startup was unprofitable, its cash balance had declined, and it faced dim prospects for growth after several years of operation.[283] The court ultimately found that the deal was fair to the common shareholders because the stock lacked economic value due to the company's limited prospects, but it sharply criticized the board, especially the conflicted VC directors, for initiating a sale process "to take advantage of their special contractual rights" and without consideration of the common shareholders.[284] The court's decision, and its language about "maximiz[ing] the value of the corporation for the benefit of its residual claimants," pushes startup boards in the direction of creating value for the common shareholders.[285] Scholars have offered a number of critiques and concerns, primarily stemming from the observation that common stock maximization may not be the same as enterprise value maximization.[286]

This Article's theory of startup failure illuminates why common stock value maximization may also be a difficult rule to navigate in practice, adding new weight to arguments pushing for doctrinal clarification. For example, common stock value can potentially be generated by pivoting or escalating the initial commitment at the expense of the preferred shareholders and creditors.[287] Often in this situation, the company would need to raise more capital to extend its runway. If the startup is in distress when this occurs, it can potentially raise capital through (1) an inside equity round (and then might

---

[279] Some Delaware courts have seemed to add to the traditional balance-sheet test that there is "no reasonable prospect that the business can be successfully continued." Prod. Res. Grp. v. NCT Grp., Inc., 863 A.2d 772, 782 (Del. Ch. 2004) (citation omitted); *see also* Teleglobe USA Inc. v. BCE, Inc., 392 B.R. 561, 599 (Bankr. D. Del. 2008) (relying on the same test in a discovery dispute related to bankruptcy proceedings).
[280] On the value of vesting decision-making fiat in the board of directors, see generally Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003) (describing the framework and advantages of director primacy).
[281] *In re* Trados S'holder Litig., 73 A.3d 17 (Del. Ch. 2013).
[282] *Id.* at 20.
[283] *Id.* at 23–25.
[284] *Id.* at 58, 64–66, 76–78.
[285] *Id.* at 41.
[286] For scholarly literature on *Trados*, see *supra* note 5.
[287] *See* Talley & Sanga, *supra* note 5, at 13 (explaining dynamics that make common shareholders favor exit too rarely).

face "pay-to-play" issues or other fiduciary conflicts);[288] (2) an outside equity round with unfavorable terms, such as high liquidation preferences (which might impinge on the previous preferred shareholder preferences and generate volatility for the common stock); or (3) venture debt (perhaps using the intellectual property as collateral). These scenarios all pose potential issues of their own and it may be difficult to incentivize individual founders and employees to stay through a pivot or a high-risk, last-ditch effort when their talent is not locked into the company.

Common stock value maximization therefore creates a difficult objective to navigate in this context, and in that sense "exits with honor" serve a similar function on the downside as IPOs can play on the upside—a way out of a complicated governance situation for a venture-backed startup.[289] For example, acqui-hires can lead to exit or shutdown of the company with at least a significant portion of the shareholders and stakeholders relatively happy, considering the circumstances. Acqui-hire transactions do not necessarily maximize the common stock value from the perspective of an option analysis, which assumes it is possible to continue the firm in the status quo.[290] These transactions can, however, protect the human capital and reputation of founders and employees, and provide a separate pool of consideration to motivate the team to stay together instead of individually defecting to new employment. And, so long as the team stays together as an asset, the preferred shareholders might recoup their original investment capital or a small portion, but in either event they get out of a company that is not going to be a home run anyway and save their time and attention for more promising ventures. This analysis reveals that additional doctrinal clarity for startup boards facing these decisions, particularly as to triggers for the onerous entire fairness standard of review, would be valuable for reducing transaction costs and the potential for litigation abuse or hold-up value.[291]

Another impactful area of potential reform could be state insolvency procedures. The use of ABC laws by venture-backed startups has received relatively little attention since the dot-com bust era, but continues to be a useful option for failed startups, particularly in states with favorable laws such as California.[292] States vary widely in their procedures,

---

[288] *See, e.g.*, R. Montgomery Donaldson, *Inside Funding Rounds in Venture-Backed Startups: The Perils of "Effective Control"*, 43 DEL. J. CORP. L. 419, 445–50 (2019) (discussing fiduciary issues that arise in inside funding rounds).

[289] *See* Pollman, *supra* note 1, at 215–16.

[290] *See, e.g.*, Adam M. Katz, Comment, *Address the Harm to Common Stockholders in* Trados *and* Nine Systems, 118 COLUM. L. REV. ONLINE 234, 247 (2018) (arguing that the "option value" of the common stock should be considered in situations like *Trados*).

[291] *See In re* Trados S'holder Litig., 73 A.3d 17, 44 (Del. Ch. 2013) (stating that entire fairness is "Delaware's most onerous standard" and requires that defendants establish "fair dealing *and* fair price") (internal quotation marks omitted); *see also* Cable, *supra* note 5, at 346–47 (noting that "in the ordinary case, boards are not faced with a choice between sale and pivot" but rather "between sale and dissolution," and so "[t]he next time the court re-visits the *Trados* fact pattern, it should articulate what fair process might mean in the ordinary case"); *id.* at 340 (noting that "the potential plaintiffs" are often the "'cats and dogs'—estranged founders and former employees holding small stakes"). Reinforcing the negotiability of fair-value protections could also be beneficial for navigating unavoidable trade sales more efficiently. *See* Nigro & Stahl, *supra* note 5, at 45–46.

[292] *See* Mann, *supra* note 81, at 1398. California courts have also given startup boards wide discretion under the business judgment rule to decide to take this path. *See, e.g.*, Berg & Berg Enters., LLC v. Boyle, 100 Cal. Rptr. 3d 880, 880–81 (Cal. Ct. App. 2009) (holding that creditor failed to plead a cognizable claim for breach of fiduciary duty against startup directors who decided to do an ABC instead of pursuing the creditor's bankruptcy plan to protect net operating losses through a Chapter 11 reorganization).

however, ranging from assignments under common law with little standardization to detailed state statutory provisions for ABCs with significant legal formalities.[293] In some states, such as New York, for example, the assignee must make multiple court filings, including a final report, which adds cost and delay.[294] Efforts at harmonizing the vastly divergent state approaches have not taken off thus far and have not focused on promoting efficiencies for venture-backed startups.[295]

As startup hubs mature in locations outside of California, other states where there is significant activity such as New York, Texas, and Florida could reexamine their ABC laws with startups in mind. Procedural protections for creditors, such as notice requirements, could be balanced with timely, low-cost processes that can take place outside of court.

Lessons from ABCs might also be valuable for bankruptcy procedures. One proposal from the dot-com bust era, for example, is to adjust Chapter 7 to allow the company to select a private trustee.[296] Companies would still be subjected to the oversight of a bankruptcy court, the publicness of a filing, and so on, but could use experts with experience in the type of assets commonly held by venture-backed startups. Selecting a private trustee does not address the reasons that the formal bankruptcy system is often not a good fit for startups, but could enhance value for those that chose a formal process. Given the evolving landscape of the venture capital ecosystem, this Article shows that such reform is more timely than ever before.[297]

Finally, beyond implications for corporate law, state insolvency, and bankruptcy is a heated debate about ratcheting up antitrust scrutiny of Big Tech acquisitions of startups. This Article highlights the importance of having relatively low-cost means for dealing with large amounts of startup failure, and thus raises a concern that has gotten little attention: broad-based responses that have the effect of banning or chilling large technology companies from making acquisitions might not only impact the flow of successful startup exits, but also failures. Although this does not appear to be the primary aim of the recent crop of legislative proposals, it could be a costly unintended consequence with wide-ranging social impact.

It is difficult to know the magnitude of the potential impacts of various legislative proposals on the greater startup and venture capital ecosystem, but it is conceivable that some could alter the dynamics for M&A deals and acqui-hires that are not producing returns for all equity holders.[298] For example, large technology companies might respond to the current regulatory environment by slowing down acquisitions and prioritizing ones

---

[293] GEOFFREY L. BERMAN, GENERAL ASSIGNMENTS FOR THE BENEFIT OF CREDITORS: THE ABCS OF ABCS (5th ed. 2021) (providing overview of state ABC procedures); Landon, *supra* note 252, at 1472–75 (examining widely varying state ABC procedures).

[294] Landon, *supra* note 252, at 1478.

[295] *See* Geoffrey L. Berman & Catherine E. Vance, *Model Statute for General Assignments for the Benefit of Creditors: The Genesis of Change*, 17 AM. BANKR. INST. L. REV. 33, 34–35 (2009) (arguing for adoption of a model statute to harmonize divergent state laws and discussing the proposed model statute's provisions, including court supervision and required consent to the assignment by a majority of the creditors).

[296] Mann, *supra* note 81, at 1442–43.

[297] Subchapter V of Chapter 11, which became effective in 2020, is another potentially fruitful area for study as coming years will reveal whether its streamlined process for qualifying small businesses is attractive to startups and how its qualification standards could be calibrated for greater use. *See supra* note 80.

[298] *See* Evans, *supra* note 21 (noting that out of the 616 acquisitions between 2010–2019 by Google, Apple, Facebook, Amazon and Microsoft, "the vast majority of [the target] companies were very small: 40% were bought for less than $10m and 80% for less than $50m, while 55% had less than ten staff and 90% had less than 50 staff").

of most strategic importance, while minimizing acqui-hires and small deals that do not pose the same competition concerns but might raise their total number of deals and attract attention. The existence of Big Tech as an exit path might also contribute to ex ante incentives for some entrepreneurs to found startups because they hope for a successful exit,[299] and expect that even if they do not have a big success, they might at least get a good job at a large technology company, and their reputation will not be harmed and might even be improved. Restricting the pathway for soft landings and recycling talent may therefore be counterproductive, as it could make entrepreneurship less attractive and venture capital investment less efficient without tackling the competition concerns at the heart of the current debate.

Of course, there is a counterargument—the problem of relying on Big Tech to acquire a bunch of startups or employees to continue the flow of innovative ventures stems, in the first place, from allowing companies to grow to such sizes that they have vast cash reserves and voracious appetites for hiring and expanding into new technologies and product lines. Some policymakers and observers might have little patience for concerns about the incentives of startups and venture capitalists as they have proven over time to be optimistic, adaptable, and resilient. Moreover, some would argue that Big Tech companies are not the only potential acquirers for startups and reform will bolster the vibrancy of competition, ultimately benefitting startups.

Taking account of these various concerns, this Article highlights the importance of a balanced approach that seeks not to chill acquisitions of failed startups that did not otherwise have other independent paths or acquisition opportunities. For example, when looking for indicia of potential antitrust harm,[300] this Article's analysis reveals that an initial distinction might be drawn between deals that occur as stock acquisitions or mergers (which might be acquisitions of viable competitors) and asset acquisitions and hiring of personnel (which are more likely to be failed startups that do not pose the same sorts of competitive concerns). Another inquiry might be into whether the startup exit produces return to the common shareholders or if it has taken more capital to develop than it receives upon exit.[301] Moderately successful "beach money" exits, in which founders and employees might get a payout that is relatively small compared to the potential value of the company if it had maintained an independent path, are more likely to raise concerns about anticompetitive effects,[302] but even then only a small number of those likely pose

[299] For an argument that a "change of policy" that would "unduly restrict large tech firms from undertaking acquisitions" may "hurt incentives for innovation in the economy by chilling business formation in start-ups," see Sokol, *supra* note 20, at 1357.

[300] *See, e.g.*, A. Douglas Melamed, *Mergers Involving Nascent Competition* 5 (Stanford L. & Econ. Olin Working Paper No. 566, Jan. 17, 2022), https://ssrn.com/abstract=4009229 [perma.cc/DF6R-2PU3] (noting that "[t]he expected value of merger enforcement cannot be measured or even approximated with precision, especially in the case of mergers involving nascent competition," so "[t]he objective, therefore, is to develop suitable proxies that will help identify those mergers that are most likely to have a negative expected impact on competition and economic welfare compared to the but-for-world without the merger").

[301] These criteria could be considered in tandem with other proposals. *See, e.g.*, Bryan & Hovenkamp, *supra* note 4, at 352–54 (suggesting as relevant factors the market power of the acquirer, the commercial significance of the startup technology or transaction value, and any pattern of acquisitions by a dominant firm).

[302] *See* Matthew Wansley, *Beach Money Exits*, 45 J. CORP. L. 151, 156, 200–02 (2019) (discussing startup acquisitions to buy off competition and observing that "[s]tartups only pose a threat to the market dominance of tech giants if they do not succumb to beach money exits" which provide "moderate upside").

an unusual risk for competition.[303] The challenge is thus to more finely tune regulatory policy to distinguish these various exits as they have different motivations and impacts. Ultimately, more finely tuned antitrust enforcement of acquisitions of nascent competitors may help sustain and fuel the rise of a greater number and diversity of potential acquirers for the next generation of startups that will continue the cycle of successes and failures.[304]

CONCLUSION

Startups play an increasingly pivotal role in the U.S. economy, and successful exits attract significant scholarly examination and regulatory focus. The vast majority of startups, however, fail to reach an exit with a return for all equity holders, and scant attention has been paid to understanding how law and culture facilitate dealing with these ventures.

Scholars have long theorized bankruptcy as a system and recognized its importance in providing an institutional framework for entrepreneurship. For reasons explored in this Article, bankruptcy is often a poor fit for the distinctive features of venture-backed startups, but an array of alternative paths for dealing with failed startups has developed and plays a critical role in sustaining the startup and venture capital ecosystem. In particular, soft-landing acquisitions, acqui-hires, and assignments for the benefit of creditors mitigate the potential stigma of failure and allow entrepreneurs, investors, employees, and creditors to "fail with honor" and redeploy their talent and capital into other ventures. Recent developments in venture capital and the regulatory environment may strain these existing practices and underscore the value of exploring a range of possible doctrinal and regulatory responses to reduce the costs of failure. Although success is naturally the aim for startups and the venture capital industry that funds them, improving the pathway to failure is inextricably linked to this goal.

---

[303] *See* Melamed, *supra* note 300, at 20 (arguing that "[o]nly a small portion of mergers affecting nascent competition – those that pose an unusual risk to competition – should be prohibited"); Axel Gautier & Joe Lamesch, *Mergers in the Digital Economy* 1 (CESifo Working Paper No. 80506 Jan. 13, 2020), https://ssrn.com/abstract=3529012 [perma.cc/TJ37-S525] (studying the acquisitions of Google, Amazon, Facebook, Apple, and Microsoft from 2015–2017 and finding that "just a single [deal]" out of 175 in the sample "could potentially be qualified as" a "killer acquisition[,]" the assets and capabilities acquired are typically integrated into the acquirer's ecosystem, and acquisitions act as a substitute for in-house R&D).

[304] *See* Hemphill & Wu, *supra* note 4, at 1893 ("[A]llowing anticompetitive deals reduces the set of future acquirers.").

Electronic Access to the Working Paper Series

The full set of ECGI working papers can be accessed through the Institute's Web-site (https://ecgi.global/content/working-papers) or SSRN:

Finance Paper Series	http://www.ssrn.com/link/ECGI-Fin.html
Law Paper Series	http://www.ssrn.com/link/ECGI-Law.html