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Good Corporate Governance Policies and Disclosure Mechanisms in Startup Companies

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Good Corporate Governance Policies and Disclosure Mechanisms in Startup Companies

Yahel Kaplan[1]

Abstract

In the past decades, particularly following the collapse of huge corporation such as WorldCom and Enron due to dubious or illegal financial management, countries began gradually increasing the oversight of publicly traded companies with few jurisdictions conjuring recommended corporate governance codes (RCGC) to ensure sufficient oversight, reduce manager's ability to loot their companies, and ensure that shareholders' and stakeholders' interests are monitored effectively by companies. While RCGC was intended namely for public company, several organizations called for the adoption of RCGC in startup companies. Startup companies suffer from various failures which the classic corporate laws are not equipped to address significant conflicts of interest throughout their financing process, interested parties' transactions, and rapid change in ownership and board composition. Among the proposed solutions for such failures, as regulated in recent years for public companies, is the implementation of such RCGC. This article presents the fundamental issues in startups which call for adoption of RCGC: the principal-agent problem, numerous conflicts of interest and misalignment of interest between the founders and the investors (and amongst the investors) regarding the company's management and future. This article reviews the possible application of RCGC doctrines to startups; with respect to empirical and economical researchers that examine the benefit of RCGC on the value of startups and reducing the cost of raising capital, and researches and position papers which call for the

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adoption of RCGC in startup companies. This article also analyzes the clashes between the startups need for flexibility with the benefits and importance of adoption of RCGC. Lastly, the article presents various RCGC models, which have not yet been introduces in academic papers, which can be adopted in startups, inter alia, increasing the number of outside directors (both as a casting vote in even of founders-investors dead-locks as well as an impartial mentor for the founders), adopting procedures for board meetings and increasing their frequency, and amending the controlling and management rights in the company as a factor of the expected return on investment.

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1. WHAT ARE CORPORATE GOVERNANCE PRINCIPLES AND WHY SHOULD THEY BE INTRODUCED IN PRIVATE COMPANIES

Corporate governance, in its purest form, is a set of principles and conditions aimed at ensuring the adequate and appropriate allocation of the risks and returns from company activities between its various stakeholders, including stockholders, managers, creditor, employees and recently, also the community.[2] Corporate governance principles are, inter alia, conditions and criteria for improving a board of directors'

[2] J. ROBERT BROWN JR. & LISA L. CASEY, CORPORATE GOVERNANCE: CASES AND MATERIALS 2 (2012).

composition and roles, transparency requirements to overcome information asymmetry between shareholders, and succession planning.[3]

Similarly, to the discussion in public companies, the design of corporate governance principles in private companies is intended to prevent the relapse of past occurrences of abuse of shareholders capital by unchecked management, as was the case in Enron and WorldCom and to create an effective communication chancel between shareholders and management.[4]

Following these premises, the OECD laid out a proposed structure of the fundamentals of "corporate governance [to] reassure shareholders and other stakeholders that their rights are protected and make it possible for corporations to decrease the cost of capital and to facilitate its access to the capital market."[5] However, and unlike in public companies, in private, non-listed companies, the absence of market for corporate control (by, for example, hostile take-overs), reduces the ability to control for underperforming management.[6]

The recent years have seen a shift of capital raising from the public to the private section. While concepts of corporate governance and good governance codes in public companies have been promulgated around the world for over three decades[7], the notion of good governance in non-listed companies have been getting traction in the recent year. In this respect, OECD dedicated a summit and a comprehensive analysis of the implementation of corporate governance codes to non-listed companies, in particular in markets with less developed equity market.[8]

Private companies, and particularly startups, have been financing their operations through a venture financing channel for the past several decades, which occurs under the assumption that venture capital should be raised from efficient capital market that price the risk accordingly.[9] However, unlike with public companies, which are subject to various regulatory corporate governance obligations, private companies

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3 *Id.* at 8-13.

4 OECD, G20/OECD PRINCIPLES OF CORPORATE GOVERNANCE (OECD Publishing, 2015), http://dx.doi.org/10.1787/9789264236882-en.

5 *See id.* at 10 (distinguishing that this structure is based on a soft power approach of "comply or explain" model, rather than a mandatory regulation).

6 *Id.* at 28.

7 *See* Collins G. Ntim, *Defining Corporate Governance: Shareholder Versus Stakeholder Models*, UNIVERSITY OF SOUTHAMPTON BUSINESS SCHOOL, UK, Jan. 4, 2018, at 1.

8 ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD), *Corporate Governance of Non-Listed Companies in Emerging Markets*, https://www.oecd.org/corporate/ca/corporategovernanceprinciples/37190767.pdf (last visited Apr. 10, 2021).

9 Ntim, *supra* note 7, at 5.

governance is subject to a loose (or even non-existent) oversight by regulators or the financial market. This is most amply reflected by the fact that startups governance is arguably not priced in the process of venture financing.[10]

Lastly, it should be noted that implementation of good corporate governance guidelines have been found to reduce the cost of capital in bond-companies[11] (however, additional research is required to determine if these results would bear similar effect on private companies and startups).

2. LESSONS FROM ENRON – WHAT HAPPENS WITHOUT GOOD CORPORATE GOVERNANCE PRINCIPALS

On December 2001 Enron, which was considered for many years as one of the most innovative companies in the U.S. with reported profits of $1 Billion[12] and among the largest corporations in the U.S., declared bankruptcy.[13] The events that led to Enron's collapse were considered by many as destructive corporate governance practices that causes a steep decline in the trust of investors in the capital markets. This set in a motion various corporate governance reforms including the Sarbanes-Oxley Act of 2002 ("SOX").[14]

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[10] The question of appropriate financing of corporate governance has been widely debated; Bebchuk et. al found in the early 2010's that while investors were (positively) surprised by introduction of corporate provisions until 2001, thereafter there was no indication that introducing such provisions had any bearing on the stock price (Bebchuk, L.A., Cohen, A. and Wang, C.C., 2013. Learning and the disappearing association between governance and returns. Journal of financial economics, 108(2). Moreover, Larcker and Tayan argued that the sheer number of variables on the stock price of public capital renders the mission to isolate the effect of corporate governance on the stock price impossible (Larcker, D.F. and Tayan, B., 2019. Loosey-Goosey Governance: Four Misunderstood Terms in Corporate Governance. Rock Center for Corporate Governance at Stanford University).

[11] Feifei Zhu, *Cost of Capital and Corporate Governance: International Evidence*, UNIVERSITY OF WISCONSIN, MILWAUKEE, August 2009, at 1, https://www.researchgate.net/profile/Feifei-Zhu-7/publication/228775167_Cost_of_Capital_and_Corporate_Governance_International_Evidence/links/58cc4ad4a6fdcc5cccb98bec/Cost-of-Capital-and-Corporate-Governance-International-Evidence.pdf.

[12] Peter Munzig, *Enron and the Cconomics of Corporate Governance*, DEP. OF ECONOMICS STANFORD UNIVERSITY, June 2003, at 3, 20, https://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.198.1043&rep=rep1&type=pdf.

[13] Stuart Gillan & John D. Martin, *Corporate Governance Post-Enron: Effective Reforms, or Closing the Stable Door?*, 13(5) JOURNAL OF CORPORATE FINANCE 929, 932 (Feb. 2007).

[14] *Id.* at 932.

The Use of "Special Purpose Entities" in Enron's Financial Statements

Enron implemented various questionable practices that created a smokescreen to the financial market. Amongst such practices was the use of off-balance "Special Purpose Entities" (SPE). While the U.S. accounting regulations at the time did not require companies to disclose or consolidate their SPEs in their financial statements, many scholars argue that companies could have, and arguably should have, provided indication of such, possibly by means of a detailed footnote or management discussion and analysis disclosure.[15] The reason that omission of SPEs disclosure is detrimental for investors is the fact that the use of SPEs does not affect the credit rating of the parent company, which creates an artificial increase in shareholders' value. Additionally, this practice limits the ability of shareholders and the financial market to conduct the level of monitoring that is customarily provided by public market institutions.[16]

It has been argued that Enron's Board failed to supervise, and possibly prevent, the managements prolific use of SMEs. This is, predominantly, due to the management's use of SMEs, in place of then-existing market-provided vehicles, which should have at least raised concerns, and at best, led to an overall restriction of such practices by the Board.[17]

Arguably, as a direct result of Enron's financial practice of insufficient disclosure of SPEs, a provision in SOX was introduced to require that all "material off-balance sheet transactions" will have to be disclosed on all of the company's annual and quarterly reports.[18]

Compensation

In 2000, Enron's CEO and Chairman, Kenneth Lay, received compensation of more than $140 million, most of which was reflected in the value of his exercised options.[19] It is imperative to note that this rate of compensation was more than ten times greater than that of an average CEO of a publicly traded company in that year.[20] On the one hand, many economists argue that stock option grants to the C-level employees and directors are beneficial in that it aligns the interests of shareholders and management. However, such option grant could incentivize management

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[15] Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, COLUMBIA LAW SCHOOL, March 2003, at 1, 7-8, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=391363.

[16] *Id.* at 8.

[17] *See id.* at 4.

[18] Munzig, *supra* note 12, at 48.

[19] *Id.* at 30.

[20] *Id.*

to manipulate financial statements by self-dealing. This may occur by managers taking larger risks in order to increase the stock price of the company and as a result increase the value of their options.[21] This concern was materialized when Enron's management used "highly structured and hedged partnerships."[22] The problem with this practice is that it unequally allocates the risk between the management and shareholders. The result of this would be that while the management is expected to benefit from the upside of the increased risk while any fallouts would mainly affect the shareholders.[23]

It has been argued by many that Enron's Board had failed to supervise the management compensation, chiefly by knowingly failing to monitor and prevent the excessive executive under the company's compensation plan [24] including the stock-based compensation structure.[25]

It should be, therefore, of little surprise that the SOX imposes significant limitation on board discretion when it comes to the "release of material information to the market."[26] Additionally, SOX created a mandatory corrective disclosure whenever the board is unable to sufficiently monitor a company's "corporate financ[ial] strategy".[27]

Financial Reporting Restatements

During mid-2001, Enron started conducting a series of earning restatement for the period spanning from 1997-2001, which led to a dramatic plummeting of investors' confidence and debt rating.[28] Soon thereafter, on December 2001, Enron filed for bankruptcy.[29] Some mechanisms placed to prevent recurrence of such were enshrined under SOX which compels the CEO and CFO to reimburse the company for any compensation that resulted in the company filing financial noncompliance restatement.[30]

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21 *Id.* at 31.
22 *Id.*
23 *See id.*
24 Dennis M. Ray, *Corporate Boards and Corporate Democracy*, 20 JOURNAL OF CORPORATE CITIZENSHIP 93, 95 (2005), http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.530.6809&rep=rep1&type=pdf.
25 Gordon, *supra* note 15, at 4.
26 *Id.*
27 *Id.* (arguing that such overwhelming elimination of the board's discretion could be counter-productive).
28 Munzing, *supra* note 12, at 20-21.
29 *Id.* at 21.
30 *Id.* at 48.

The Result of Insufficient Board Oversight

> The lack of Board independence gets to the core oversight function of a board of directors. It is imperative that a board be capable of looking objectively at the management and outside professional advisors of a firm, and Enron's Board was not capable in this respect. This layer of corporate governance, that is the board oversight function, should act as a final mechanism to protect investors when other governance institutions have broken down. It should serve to help avoid conflicts of interest, ensure auditing independence and accurate financial reporting, oversee compensation practices, as well as many other breakdowns that occurred within Enron. This last layer, however, failed to serve its purpose and was compromised largely because of the relationships between Enron, management, and the directors themselves.[31]

3. Corporate Governance Under Existing Legal Regime

a. *Disclosures*

Disclosure is, in essence, a mechanism by which companies share information on their financials, operations, and developments with their shareholders.[32] In particular, disclosure enables shareholders and board members to make informed decisions.[33] The catastrophes of recent history, such as Enron's Board flimsy monitoring, is a prime example for Board's informed consent. Enron's Board often failed to give enough consideration when approving costly or risky decisions and transactions, even with insufficient information or grasp of the types of transactions Enron was engaging in.[34] Moreover, Enron's Board's failure to monitor the company's financial disclosure limited the financial market's ability to analyze the company's financial performance and created an increased risk to existing and prospect investors.[35]

To date, periodic reports remain a critical source of information for shareholders of public companies, as varying regulation enable companies

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[31] *Id.* at 46.
[32] Brown & Casey, *supra* note 2, at 509.
[33] *Id.*
[34] *See* Munzing, *supra* note 12, at 6-7.
[35] Gordon, *supra* note 15, at 4.

to interact with the public market in less formal ways, commonly not subject to SEC regulation, and enables companies to engage in selective disclosure to specific shareholders or investors.[36]

For public companies, there are various regulatory disclosure obligations; for example, companies with more than 500 shareholders of record and assets in the access of $10M must file quarterly reports to their respective shareholders.[37] In private companies, however, the disclosure obligations are far scarcer, depending heavily on the type of exempted offering[38] and are otherwise namely contractual-dependent. Moreover, the only information available to the pubic are the Regulation D exempt offerings.[39] The most common contractual mechanism of disclosure for venture-backed companies is set forth in investor rights' agreements. The investor rights' agreement is a common venture capital investment agreement which sets forth, inter alia, the right of major investors to access certain information of private companies, and often also includes the right to appoint a board observer, and commonly requires provisions of quarterly and annual financial statements.[40] However, while this is a rather powerful contractual tool, it is namely reserved for major investors, and other stockholders have no access to such information and observance rights.[41]

As a result, "in the U.S., for example, only rarely will a private company voluntarily disclose any financial reports, regardless of firm size."[42] This is of particular importance as "some of the largest firms in the U.S. are private."[43] On the other hand, some calls have been made to regulate the disclosure obligations in private companies once they reach a certain market capitalization (namely, above $1 Billion in valuation).[44] The significance of this proposal is founded in the fact that unicorns share similar traits to those of public companies, both in size and effect on the economy and communities. For example, Uber, prior to its IPO earlier this

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36 Brown & Casey, *supra* note 2, at 549 ("Whenever an issuer, or any person acting on its behalf, discloses any material nonpublic information regarding that issuer or its securities to any person described in paragraph (b)(1) of this section, the issuer shall make public disclosure of that information as provided in § 243.101(e) . . . .").

37 *Id*.

38 Jennifer S. Fan, *Regulating Unicorns: Disclosure and the New Private Economy*, 57 B.C. L. REV. 583, 591 (2016) (noting that many venture financings rely on Regulation D "safe harbors" which indicate the type of disclosure required by the company to the investors).

39 *Id*. at 598.

40 *Id.* at 596-597.

41 *Id.*

42 Michael Minnis & Nemit Shroff, *Why Regulate Private Firm Disclosure and Auditing?*, 47(5) ACCOUNTING AND BUSINESS RESEARCH 473, 474 (2017).

43 *Id.*

44 Fan, *supra* note 38, at 609.

year, reportedly had tens of thousands drivers across the globe and grosses billions of dollars.[45] Therefore, in light of the recent trend toward favoring stakeholder approach of corporate purpose, a company with such a significant impact on the economy and communities, which operation often requires changes in infrastructure which cannot be accounted for sans data about the company and its operation, should be adequately monitored by the public and regulators. This is in line with the basis of the stakeholder approach, which stipulates that since local communities supply the companies with local infrastructure and employees, they require in return an improvement in their quality of life[46] (which can only be ensured and regulated with sufficient information and disclosures from the companies).

(1) Benefit of disclosure regime

Behavior Correction

Disclosure serves as an effective corporate governance mechanism as it creates an incentive for improved governance in order to avoid disgraceful disclosure by being required to correct matters subject to disclosure.[47]

The mandatory disclosure regime is particularly important for several additional reasons:

- Misalignment of interest – misalignment of interest between management and shareholders have been found to generate ineffective financial and growth results for startups, both with respect to growth as well as returns for stockholders[48], whereas the misalignment might be eliminated by gapping the information asymmetry through mandatory disclosure.
- Non-diversifiable Investment – an effective governance system (inter alia, through mechanism of disclosure) have been found to increase shareholders likelihood to invest even though they might face a reduced ability to diversify their investment or increase their likelihood to invest in poor-performing companies.[49]

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[45] *Id*. at 599-600.
[46] Ntim, *supra* note 7, at 9.
[47] Brown & Casey, *supra* note 2, at 509.
[48] Michael Klausner & Stephen Venuto, *Liquidation Rights and Incentive Misalignment in Start-up Financing*, 98 CORNELL L. REV. 1399, 1399 (2013).
[49] Allen Ferrell, *The Case for Mandatory Disclosure in Securities Regulation Around the World*, 2 BROOK. J. CORP. FIN. & COM. L. 81, 107 (2007). It should also be noted that diversification is a crucial instrument for an investor which is often associated with an increased cost of capital. Angela Gore, *Does Mandatory Disclosure Reduce the Cost of Capital? Evidence from Bonds*, LUNDQUIST COLLEGE OF BUSINESS, UNIVERSITY OF OREGON

- Reduction in transaction costs – Many economists found that a regime of mandatory disclosures of information by companies not only reduces the company's costs of operations but also facilitates the company's access to credit[50], lowering the cost of credit[51] and increase its liquidity.[52]
- Reduction in race-to-capital competition – As indicated by the Chairman of the Securities and Exchange Commission, Jay Clayton: "Increased disclosure and other burdens may render alternatives for raising capital, such as the private markets, increasingly attractive."[53] Therefore, among the benefits of disclosure in small companies is the reduction in competition with large public companies over capital;[54] the new access of small private companies to credit rating, which internalizes company's information, acts as an intermediary of information sharing and increases the attractiveness of investing in the small company. This adds an additional layer of incentive to private companies to disclose information, as credit rating agencies tend to increase the credit rating of companies with organized disclosure mechanism.[55] Moreover, disclosure of startups' financial status and operation can be a positive indicator of its growth potential and governance stability, which would "radiate" to potential investors of its transparency and thus reduce the risk (and cost) of venture financing (by reducing the required due diligence and implementation of safeguards).[56]
- Disclosure credibility – one of the suggestions made in connection with the creation of a mandatory disclosure regime is to require disclosure to an impartial third party. That is since a disclosure to a third party, rather to an investor, increases the credibility of the disclosure and would potentially reduce transaction costs.[57]Also, especially for micro-companies wishing to opt in to such

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1, 5 (July 2012). This further supports the significance of disclosure regime even compared to an investor's right to demand a higher return.

50 Benito Arruñada, *Mandatory Accounting Disclosure by Small Private Companies*, 32 EUR. J. LAW ECON. 377, 379 (2010).

51 *Id.* at 380.

52 Gore, *supra* note 49 at 1.

53 Macfarland, Matt, SEC chairman: Disclosure requirements encourage companies to stay private, The SNL Insurance Daily; Charlottesville (July 13, 2017).

54 Arruñada, *supra* note 50, at 398.

55 *Id.* at 401.

56 Zhu, *supra* note 11 at 2–3. On the other hand, startups should be cautious on disclosure since it could be viewed as desperate to receive influx of cash which would increase the cost of capital.

57 Arruñada, *supra* note 50, at 389.

> mandatory-disclosure regime, an external mandatory rule can save them a cost in terms of evaluating the value of disclosure in an optional-disclosure regime. This is since while "individuals may be perfectly rational in evaluating costs and benefits but may be pressured by maladapted social norms to behave in accordance with the norm. This may happen, for instance, if the norm imposes additional costs (e.g., a reputational loss) on those who do not comply with it."[58]

While mandatory disclosure does not necessarily benefit small companies as it does to public ones, there is a requirement, though less comprehensive, of information disclosure by small private companies in connection with investments.[59]

(2) Objection to disclosure regime

Irrespective of the benefits mentioned above, the main discouraging factor is the costs associated with disclosure, particularly for small companies; for example, some disclosures could relate to the company's tax position which could require retaining expensive advisors. Additionally, small companies are often incapable of correctly estimating the costs and benefits of disclosure, particularly in companies with separation of ownership and control.[60] Moreover, private and public companies alike may suffer several harms that disincentivize disclosure, amongst them, competitive disadvantage and loss of personal privacy.[61] This concern is substantiated by several researchers that have found that many businesses in "Europe routinely download the financial reports of their competitors, suppliers, and customers".[62]

In this respect, a more comprehensive disclosure regime or an expansion of statutory disclosure exemptions may limit the costs associated with disclosure since all non-disclosing companies would be required to find an alternative means to provide information to investors

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[58] *Id.* at 404.

[59] *Id.* at 396.

[60] *Id.* at 404.

[61] *Id.*

[62] Dee Gill, *Should private companies be required to report their financials?*, CHICAGO BOOTH REVIEW (June 22, 2017), https://review.chicagobooth.edu/accounting/2017/article/should-private-companies-be-required-report-their-financials. In this regard, it should be indicated that in a review conducted by the Wall Street Journal, many noted to refrain from divulging financial information to prevents it "from falling into rival hands" which enables companies "freedom to invest for the long term". *See* Rolfe Winkler, *Startup Employees Invoke Obscure Law to Open Up Books*, THE WALL STREET JOURNAL (May 24, 2016), https://www.wsj.com/articles/startup-employees-invoke-obscure-law-to-open-up-books-1464082202.

(and thus disincentivized from operating outside the disclosure regime).[63] In addition to direct costs, several researchers indicated the existence of indirect costs, such as the cost of monitoring, compiling, and disseminating the financial information.[64] The information intermediaries (such as the credit rating agencies) tend to be relevant with respect to small companies, since some provide incomplete data to the intermediary and other completely fail to cooperate, resulting in incomplete data of the intermediary.[65] Small companies often face significant competition (which is more detrimental to their survival than to listed and established firms). Therefore, since disclosure exposes small companies to other companies exploiting their data, such companies might be disincentivized to disclose.[66] However, several researchers found that in some cases the benefits from the ability to learn about the financial information of competitors outweighs the risk of disclosing the company's own information.[67]

Disclosure decision by company managers can be one that would not maximize the value of the firm for shareholders, which may occur due to misalignment of management and ownership.[68] However, commonly small firms have little separation of ownership and management since the managers area usually also the shareholders.

b. Board of Directors

(1) Structure

The current version of the Delaware General Corporation Code contains virtually no qualification prerequisites for board members, and thus, unless such prerequisites are enshrined in a company's charter, none shall apply.[69] This approach has been widely criticized, inter alias, by Ralph Nadar who contended that board members are often unaware of management illicit behavior, such as discrimination, workplace hazard, and the likes.[70]

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63 Arruñada, *supra* note 50, at 382.
64 Gore, *supra* note 49, at 3.
65 Arruñada, *supra* note 50, at 404.
66 *Id.*; Gore, *supra* note 49, at 5–6.
67 *See* Gill, *supra* note 62.
68 Arruñada, *supra* note 50, at 29.
69 ZABIHOLLAH REZAEE, CORPORATE GOVERNANCE POST-SARBANES-OXLEY, REGULATIONS, REQUIREMENTS, AND INTEGRATED PROCESSES 217–218 (2007).
70 See RALPH NADER, MARK GREEN, AND JOEL SELIGMAN, TAMING THE GIANT CORPORATION 17–32 (1977) (citing which calls to question, for example, the requirement for appointment of independent directors.).

The importance of a strong monitoring board is essential, and particularly important in public companies in light of the Enron scandal. There, the board's monitoring failure was an indication of a disconnect between the board and the company's strategy and each director's fiduciary duties and responsibility to shareholders.[71]

In private companies, the composition of the board of directors of a startup changes rapidly during the nascent stages of the company, when the board is commonly comprised of the company's founders.[72] However, following the a financing round in the startup, member(s) of the investor(s) often receive a place in the board, as the investor's director contributes commercial and market experience, while the founders' position shift to ongoing management.[73]

It has been widely established that there is a commonplace disparity in of interest and mindset between the founder-manager, investors, and external board members. This is, in part, due to the fact management directors, particularly in private companies (and even more so in startups), are not compensated for their position in the board, unlike investor-directors and external directors which often receive compensation in a form of stock options, commonly ranging between 0.5%-1% of the company's outstanding shares.[74] Moreover, the founder-manager director show to have more psychological attachment and passion to the company[75], and investor-director are more focused on growth and have fiduciary duty to their own investors to advance successful exit strategies[76], while public company directors focus on long-term strategic planning and monitoring.[77] Therefore, private company board is much more prone to conflicts of interest and goal determination than in public companies.[78]

(2) Role and purpose in corporate governance.

The role of the board of directors in private companies vary rapidly between managerial approaches and scholars. At its core, the board of

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71 Brown and Casey, *supra* note 2, at 96.

72 JONAS GABRIELSSON, HANDBOOK OF RESEARCH ON CORPORATE GOVERNANCE AND ENTREPRENEURSHIP 113 (2017).

73 *Id.*

74 Suren Dutia, *Primer for Building an Effective Board for Growing Startup Companies*, 1, 7 (2014), https://www.kauffman.org/wp-content/uploads/2019/12/primer_for_building_an_effective_board.pdf.

75 Gabrielsson, *supra* note 72, at 114.

76 Renée B. Adams, Benjamin E. Hermalin, and Michael S. Weisbach, THE ROLE OF BOARDS OF DIRECTORS IN CORPORATE GOVERNANCE: A CONCEPTUAL FRAMEWORK AND SURVEY 29–30 (2009).

77 Brown & Casey, *supra* note 2, at 96.

78 Gabrielsson, *supra* note 72, at 114.

directors is responsible for laying a framework of corporate objectives, reviewing the management's workplan, hiring, firing, and compensation of senior management and interaction with shareholders.[79] Moreover, the board of directors is the ultimate supervisory body of the company and the ultimate responsibility for good corporate governance of the company.[80]

Per the Delaware General Corporation Law "the business and affairs of every corporation organized under this chapter shall be managed by or under the direction of the board of directors, except as otherwise be provided in this chapter or in its certification of incorporation".[81] The significance of this provisions is based on the fact that it is optional and can be excused if explicitly prescribed in a company's charter. Thus, as Professor Stephan Bainbridge stipulates, the provision would easily be applied close corporations[82], as is the case of startup companies.

For example, one method for eliminating the majority tyranny is to require that major decision in the company will require the approval of all shareholders (or the majority of each type of shares, if the company issued preferred stock, or several series thereof), in order to prevent controlling shareholders that commonly also control the board to take value-extraction resolution against the interest of the minority shareholders.[83]

Brown and Casey argue that the board of directors is responsible for management of the business and affairs of the corporation as well as to delegate managerial duties to person on which the board is tasked with monitoring.[84] Adams et. al, however, take a more "advisory" view of the board's role, according to which the board is to "serve as a source of advi[s]e and counsel, serve as some sort of discipline".[85] Another criticism is that the board is often "captured by the top management".[86] This approach does not come without opposition; Adams et. al, referring to

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79 John D. Sullivan, Andrew Wilson, and Anna Nadgrodkiewicz, *The Role of Corporate Governance in Fighting Corruption*, at 11 https://www2.deloitte.com/content/dam/Deloitte/ru/Documents/finance/role_corporate_governance_sullivan_eng.pdf.

80 Rezaee, *supra* note 69, at 87.

81 Del. Code Ann., Tit. 8, § 141(a).

82 Stephen Bainbridge, *DGCL Section 141(a) versus Precommitment Strategies*, (Dec. 30, 2005) https://www.professorbainbridge.com/professorbainbridgecom/2005/12/dgcl-section-141a-versus-precommitment-strategies.html.

83 However, there's a caveat to this approach in a form of transaction proposed by a controlling shareholding which conditions its approval of the transaction upon the approval of the majority of the minority shareholders. *See* Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. Pa. L. Rev.785,785 (2003).

84 Brown & Casey, *supra* note 2.

85 Adams, *supra* note 76, at 64.

86 Brown & Casey, *supra* note 2, at 96.

Lorsch's review of board effectiveness, argue that board is too passive to be provide discipline to the management.[87]

Moreover, even accepting the premise that contemporary board is able to and expected to oversee and discipline the management, the board is unlikely to be preempt managerial wrongs, particularly absent information from outside auditors.[88] This is, in part, since board is rarely involved in the daily operational aspect of company management.[89]

(3) Minutes

The board of directors is the collegial organ of the company which decisions are commonly made by a majority vote.[90] The board meetings themselves raise several good governance questions; for example, the prior notice of board meetings, sans explicit prescription in the company's charter, can be made as late as two days prior notice, and there is no statutory obligation that such notices specify the purpose of the meeting.[91] However, good corporate governance would require for directors to be able to make an "informed decision;" further, a longer prior notice and a specification of the meetings purpose (including the relevant documentation) are advised.[92] One "best practice" recommendation was to deliver, prior to each meeting, the appropriate agenda which shall include the information and materials that will be delivered to directors and the matters that will be addressed and acted upon during the meeting.[93]

(4) Committees

While private companies are not legally required to form committees, it has become a common practice for private companies, particularly those who issue bonds, to establish various committees to which the board delegate certain tasks.[94] Audit committee is among the most ubiquitous and important committees in private companies; It is in charge of independent review of the financial records of the company, engagement with the auditor

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87 *See* Adams, *supra* note 76, at 64 (referencing Jay Lorsch, *Pawns or Potentates: The Reality of America's Corporate Boards*, Harv. Bus. School Press (1989)).

88 *Id.* at 65.

89 Brown & Casey, *supra* note 2, at 96.

90 STEPHEN M. BAINBRIDGE, CORPORATE LAW AND ECONOMICS 213 (Foundation Press 2d. ed 2002).

91 *Id.* at 215.

92 *Id.* (" . . . although directors are free to contest.").

93 Stuart Gelfond, Robert Schwenkel & Hayley Cohen, *Private Company Boards*, 20 THE J. OF PRIVATE EQUITY SUMMER 2017 3 (2017).

94 Bainbridge *supra* note 90, at 215.

In addition, the existence of an audit committee has an additional significant in private companies since they are often less sophisticated than public companies, have less organizational structure and understanding of financials, and therefore an independent committee of experts can be a significant contribution to the monitoring of the company's internal controls and prevention of illicit actions by the management.[95]

In this regard, it is pertinent to reference the provisions of SOX that were enshrined as a result of Enron's audit committee's and outside auditor's conflicts of interests. SOX dictates that audit committees must be composed of entirely independent directors and prohibits outside auditors from concurrently consulting a company it audits.[96]

c. Who Should Direct Company Corporate Governance – Shareholder Primacy Vs. Board Primacy Vs. Management Primacy?

For many years, the leading approach of company purpose was the *shareholder primacy*, pursuant to which company must operate, was to "primarily advance the interest of its owners".[97] The basis of this notion relies on the fact that the providers of capital delegated their daily management of the company to the management and the board which in return must act as the shareholders fiduciaries.[98]

The shareholding model also enables a mechanism for overcoming the agency problem it is associated with; Cadbury found that this model support the adoption of a voluntary corporate governance code of ethics and conduct, which lays out accountability and transparency principles, intended to regulate management activity.[99] This methodology manifest the crux of my argument in this paper – that adoption of good corporate governance principles, coupled with board supervision, are best to overcome the misalignment of interest in startup companies between shareholders, directors and managers-founders.[100]

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95 *Id.* at 215.

96 *Id.* at 48-49.

97 Ntim, *supra* note 7, at 3.

98 Bainbridge *supra* note 90, at 48-49.

99 Ntim *supra* note 7, at 5 (referencing Cadbury, C., *Report of the Committee on the Financial Aspects of Corporate Governance* ICAEW (1992) https://www.icaew.com/technical/corporate-governance/codes-and-reports/cadbury-report).

100 *Id.* (noting that that imposition of obligations by the government or other supervisory authorities would be counterproductive under an assumption of efficient factor markets as well as the fact that it would limit the bargaining power of the actors in the investment process).

The notion of the shareholder primacy also derives the purpose and role of the board of directors; Until recently, the pervasive view was that the primary goal of the board of directors management of the company was to achieve long-term shareholder value.[101] However, this approach might soon find itself outdated following the Business Roundtable's announcement that it views the purpose of companies in a broader view as to promote "an economy that serves all Americans"[102] and thus reflects a shift towards a stakeholder primacy, rather than maximize shareholder profits.

Moreover, last year Senator Elizabeth Warren introduced the Accountable Capitalism bill[103] which shifts the fundamental notion of "shareholder primacy" to "stakeholder primacy" by requiring that 40% of directors in companies, grossing above $1 billion annually, be selected by employees.[104]

The stakeholder model, in essence, is a notion that a company is not just a for-business entity but rather a "social-entity" which has both accountability and responsibility towards various stakeholders, such as employees, the government and local community, to name a few.[105]

In this respect, it was argued that a governance structure of a firm is considered as 'narrow' if it is focused is on development of mechanisms aimed at maximizing shareholders value instead of promoting the interests of other existing and potential stakeholders of the company.[106]

This distinction is significant since it would affect the identity of the appropriate organ to promote adequate corporate governance in the company. In this respect, I will reiterate that while startups' management is often lacking comprehensive market viewpoint and focused narrowly on the company and its success, the board of directors often includes representatives of venture capital funds[107], many of which are industry experts, which can more effectively promote governance devices which

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101 *See* Ntim *supra* note 7, at 7 (emphasizing that it is no longer sufficient for board's to merely oversee the financial results but rather take a more active role in the development of ethical culture of the company).

102 *Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans'*, BUS ROUNDTABLE (Aug. 19, 2019), https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans.

103 S. 3348, 115th Cong. (2017).

104 Martin Lipton, *Corporate Governance; Stakeholder Primacy; Federal Incorporation*, HARV. LAW (Aug. 17, 2018), https://corpgov.law.harvard.edu/2018/08/17/corporate-governance-stakeholder-primacy-federal-incorporation/.

105 Ntim, *supra* note 7, at 2.

106 *Id.*

107 Fan, *supra* note 38, at 590.

would also take into consideration cross-market entities, such as the community, suppliers, and creditors.[108]

Moreover, the board's good business judgment obligation is a precursor of its obligation to promote corporate social responsibility.[109] This stance is a gapping bridge between the stakeholder primary approach and the board primary approach. The latter, in a nutshell, is a view per which shareholders ought to endow the board with sufficient power to manage the company effectively, foregoing short-term value and decision-making.[110] The general underpinning of such 'board primacy', while still lacking structural consensus, is that the board should be granted with higher level of independence than the under the current 'shareholder primacy' regime.[111] It is important to note, however, that the fundamental application of the "board primacy" approach is for public companies, in which shareholders involvement in company's decision-making would be less efficient, as they are lacking the requisite knowledge and understanding of the firm to make an efficient determination vis-à-vis the directors which are involved in the core operation of the company.[112]

4. POSSIBLE CORPORATE GOVERNANCE SOLUTIONS TO MARKET FAILURES

Board independence

Following the previous arguments supporting the increase of director independence to better monitor and manage the company's growth and shareholders future returns, many scholars found that there's a direct negative correlation between the success of the CEO and independence of the board, meaning, the more successful the CEO the less independent the board will be (since the monitoring will seem less optimal as the CEO is doing a good job).[113] This is, to some extent, a legal (market) failure, since as a matter of law a conflict between the board and the management should

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[108] In this respect, White indicated that in light of the board of directors' power to cast company determinations through its board resolutions, as well as its composition, it should be the organ accountable for balancing the various stakeholders in the Company. Allen L. White, *The Stakeholder Fiduciary: CSR, Governance and the Future of Boards*, BUS. FOR SOC. RESP. (Apr. 2006), https://www.bsr.org/reports/BSR_AW_Corporate-Boards.pdf.

[109] *Id.* at 4.

[110] Grant Hayden & Matthew T. Bodie, *Shareholder Democracy and The Curious Turn Toward Board Primacy*, 51 WM. & MARY L. REV. 2071, 2071 (2010).

[111] *Id.* at 2088-89.

[112] *Id.* at 2089.

[113] Adams, *supra* note 76, at 66.

results in board prevailing, what doesn't commonly occurs in practice.[114] However, this approach could be counterproductive, particularly in the sphere of startups; reason being, as was found by Adams et. al, that an increase in director independence leads to better CEO efficiency, shorter CEO tenure and higher overall CEO compensation.[115] Therefore, since many startup directors are either representative of investors, possessing substantial market and management knowledge, and are also functioning as mentors to the founder-managers (and founder-CEO), they should be granted with greater independence to prevent inexperienced founder-managers from either looting the shareholders or making ill-advised decisions.[116]

In this respect, it should be noted there are other factors that affect the board's independence. One method of ensuring director's vigilance is the risk of replacement, a seemingly plausible assumption would be increased supervision which will result is higher company performance. However, since there is an underlying assumption that the board is at any given time "optimally independent", the risk of replacement is reduced (as change in board composition would result, in theory, in reduction in optimal supervision).[117]

While board independence in public companies is necessary (as to ensure the management acts in the best interest of the public shareholders), in private companies there's a benefit in the opposite, where directors have majority shareholders (whom are commonly also the management), as otherwise they are viewed as ineffective[118] mainly since in private companies, more often than in public ones, directors operate as mentors to the management, providing commercial knowledge to the management.[119]

Additionally, board independence is particularly salient in viewing past failures of board supervision of company's management, as was the case with the Enron's board. In that instance, the Board failed to prevent conflicts of interest with various of Enron's partnerships and failed to exert sufficient oversight of such relationships.[120]

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114 Brown & Casey, *supra* note 2, at 97.

115 Adams, *supra* note 76*,* at 70.

116 BRAD FELD & MAHENDRA RAMSINGHANI, STARTUP BOARDS: GETTING THE MOST OUT OF YOUR BOARD OF DIRECTORS, (John Wiley & Sons eds., 2013).

117 *Id.*

118 DOUG RAYMOND, INDEPENDENCE AND THE PRIVATE COMPANY BOARD: ADOPTING SARBANES-LIKE RULES ON DIRECTOR INDEPENDENCE WOULD IMPAIR THE SMOOTH FUNCTIONING OF THE BUSINESS, Dir. & Boards (2005).

119 Gabrielsson, *supra* note 72, at 113.

120 Munzing, *supra* note 12, at 6-7. Munzig further argues that these failures resulted from insufficient communication and direction by the board of the government, whereas, as argued throughout this paper, board "mentoring" of the management results in preferable financial and operational results.

b. Introduction of independent director

Independent directors are generally viewed as director who have no ongoing (or prior) relationship with the corporation other than as a director.[121] The importance of the appointment of independent directors is exemplified in several spheres: the first, Delaware court tend to condition the application of the "Business Judgment Rule" test in controversial transaction only when the board action has been taken by an independent director.[122] Moreover, as the appointment of independent directors became a manifestation of good corporate governance[123], neglecting to act accordingly to can cause market distrust. In this respect, Broughman analyzed the benefit of introduction of independent director in startup companies.[124] In startups, independent directors currently fill several duties, inter alia, breaking deadlocks in the board and impartial oversight on the management for the common stockholders (since other boards are usually representing the founder-managers or the investors).[125] An additional benefit of including an independent director(s), which are often industry experts, would be their function as an "adjudicator" between the interests of the various organs of the company in major company events.[126]This might be particularly salient in such events where serious "hold-outs" and "value extraction" can occur from either minority or majority stockholders.

5. CONCLUSIONS

In this paper, I have analyzed the current corporate governance regime that applies to private companies, with particular attention to the particular characteristics of startups, vis-à-vis the growing research on the effect of good governance in public companies for the past decades.

It has been found that implementation of good/recommended governance in startups reduces investor's risk and subsequently reduces

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[121] Brown & Casey, *supra* note 2, at 108 (citing Jeffrey N. Gordon, *The Rise of Independent Directors in the United State, 1950-2005: Of Shareholder Value and Stock Market Prices,* 59 STAN. L. REV. 1465, 1968-83 (2007)); *see generally* Jeffrey N. Gordon, *The Rise of Independent Directors in the United State, 1950-2005: Of Shareholder Value and Stock Market Prices,* 59 STAN. L. REV. 1465, 1468-83 (2007).

[122] Brown & Casey*, supra* note 2 at 106.

[123] *Id.* (Explaining that Jeffery Gordon indicated that following the Enron financial fiasco, federal legislation requires public companies to have audit committees comprised of only independent directors).

[124] Brian J. Broughman, *The Role of Independent Directors in Startup Firms,* 3 UTAH L. REV. 461, 461 (2010).

[125] *Id.* at 462.

[126] *Id.* at 465.

transaction costs, improves corporate management (though still unsure if affects company share price) and reduces the misalignment of interest between the various corporate organs (founders-managers, directors, and shareholders).

I have indicated several good-governance approaches that have been found by various legal scholars and economists alike to be successful in implementation in private companies, inter alia, introduction of independent director, creation of audit committee, elaborated board materials and longer notice period, alongside some more groundbreaking suggestions such as a mandatory disclosure regime, that can affect the inherent risk and uncertainty associated with startup venture financing.

While startups require flexibility in operation in order to successfully implement their disruptive technology, as I have indicated in this paper, the implementation of the aforementioned good governance methodologies (preferably under a soft power "comply or explain" method, as was used by the OECD private company guidelines) could have positive effects both on their management, financing ability and future growth.