CATCHING DISRUPTION: REGULATING CORPORATE VENTURE CAPITAL

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Sesame Street, Walgreens, 7-Eleven, General Motors, Campbell Soup—these are not the names of companies that come to mind when thinking about the startup world. Yet, each of these companies started its own corporate venture capital arm in the last eight years. Corporate venture capital ("CVC")—equity investments in external startups made by corporations or investment entities designated by corporations—no longer play a minor role in venture capital; they have become an influential force in the field. Business scholars have been at the forefront of studying this newly powerful phenomenon. Thus far, however, legal scholars have overlooked CVCs. Legal scholars—and many in the venture capital community—see only two players: traditional venture capital firms and entrepreneurs. The failure to appreciate the significance of CVCs as a third major player impoverishes theoretical and practical accounts of venture capital. This Article reframes the legal discussion of venture capital to incorporate key shifts wrought by CVCs in areas from corporate governance to risk allocation.

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INTRODUCTION

Household names like Sesame Street,[1] Walgreens,[2] 7-Eleven,[3] General Motors,[4] and Campbell Soup[5] have joined

[1] *See* Matthew Lynley, *Yep, Sesame Street Now has a Venture Fund*, TECHCRUNCH (Feb. 1, 2016), http://techcrunch.com/2016/02/01/yep-sesame-street-now-has-a-venture-fund/ [perma.cc/5NF7-6R4U].

[2] *See* discussion *infra* Section III.D and accompanying notes.

[3] 7-Eleven's corporate venture capital arm, 7-Ventures, began in 2010 and focuses on investments in the software industry. *See 7-Ventures*, PITCHBOOK, https://my.pitchbook.com/#page/profile_1884716116/ [perma.cc/HUW4-97NE].

[4] General Motors invests directly in startups as well as through its corporate venture capital arm, General Motors Ventures, which was formed in 2010. *See* discussion *infra* Section III.E and accompanying notes.

the ranks of high tech titans such as Google and Intel in the world of corporate venture capital ("CVC" or "corporate venture capital"). In contrast to venture capital ("VC" or "venture capital") firms which purely focus on financial returns, most corporations seek strategic benefits from their venture investments, in addition to financial returns."[6] Although CVC started in the 1960s and experienced four periods or "waves" of development, only in the past few years has it matured into a major force, finding a central place in the fast–evolving technology landscape that focuses on disruptive innovation.[7] CVC now permeates every stage of venture capital. In the race to remain innovative, larger corporations engage in CVC endeavors to associate with and profit from the next market disrupters.

CVCs are not mere analogs of traditional VC firms. As a result of their position within larger corporations, CVCs have different strategic goals and unparalleled financial and

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[5] Campbell Soup's newly-created venture arm (founded in 2016) is called Acre Venture Partners. *See* discussion *infra* Subsection III.C.3 and accompanying notes.

[6] *Equity*, EWING MARION KAUFFMAN FOUND., http://www.kauffman.org/microsites/state-of-the-field/topics/finance/equity [perma.cc/WVU6-BLW6]; *see also* VOLANS & GLOBAL CORP. VENTURING, INVESTING IN BREAKTHROUGH: CORPORATE VENTURE CAPITAL 9 (2014), http://www.breakthroughcapitalism.com/files/volans-investing-breakthrough-report.pdf [perma.cc/USP6-8NFT]. This differs from the goal of venture capital funds, which aim to get extremely high returns (i.e. homeruns) on investments made on behalf of limited partners who invest in venture capital funds. *See* BRAD FELD & JASON MENDELSON, VENTURE DEALS 115–28 (2d ed. 2013). "[CVC] is a subset of venture capital wherein corporations make systematic investments into startup companies, often by taking an equity stake in an innovative firm tangentially related to the company's own industry. They often also provide marketing expertise, management, strategic direction, and a line of credit." Jack Du, *The Rise of Corporate Venture Capital (TWTR, FB)*, INVESTOPEDIA, http://www.investopedia.com/articles/investing/082815/rise-corporate-venture-capital.asp [perma.cc/4C5A-Q7W2].

[7] Clayton Christensen coined the term "disruptive innovation." Joseph L. Bower & Clayton M. Christensen, *Disruptive Innovation: Catching the Wave*, HARV. BUS. REV., Jan. 1995, at 45. *See also infra* note 74 (for a full definition of disruptive innovation).

technical resources from which entrepreneurs can immensely benefit. These distinctions raise significant business and legal issues. Thus far, however, legal scholars have overlooked CVCs. This Article is the first to analyze how CVC has fundamentally altered legal considerations related to private ordering[8] in the venture capital world.[9]

CVC had a banner year in 2015,[10] accounting for twenty-five percent of later stage deals globally.[11] CVCs poured in roughly $7.7 billion in 930 venture rounds that equated to twenty-one percent of all deals and thirteen percent of all venture capital dollars.[12] The sectors benefitting the most from this influx of money were software companies,[13]

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8 Private ordering is defined as "where transactors are autonomous and employ extralegal mechanisms to enforce contracts . . . ." Barak D. Richman, *Firms, Courts, and Reputation Mechanisms: Towards a Positive Theory of Private Ordering*, 104 COLUM. L. REV. 2328, 2330 (2004).

9 See discussion *infra* Section II.D for a more robust definition of private ordering within the context of venture capitalism.

10 Press Release, Nat'l Venture Capital Ass'n, Corporate Venture Investment to Entrepreneurial Ecosystem Hits Fifteen Year High in 2015 (Jan. 19, 2016), http://nvca.org/pressreleases/corporate-venture-investment-to-entrepreneurial-ecosystem-hits-fifteen-year-high-in-2015/ [perma.cc/XJA6-LNJ6] [hereinafter NVCA, Corporate Venture Investment Hits Fifteen Year High].

11 Rachael King, *Corporate VC Investments Hold Steady amid Broader Downturn in Market*, WALL ST. J.: CIO J. (Jan. 22, 2016, 5:45 PM), http://blogs.wsj.com/cio/2016/01/22/corporate-vc-investments-hold-steady-amid-broader-downturn-in-market/ [perma.cc/B257-REA3].

12 *See* NAT'L VENTURE CAPITAL ASS'N, 2016 NATIONAL VENTURE CAPITAL ASSOCIATION YEARBOOK 94 (2016) [hereinafter 2016 NVCA YEARBOOK]. In light of the increasing number of corporations starting CVCs, the authors of the 2016 NVCA YEARBOOK note that corporate venture groups will continue to invest alongside venture capital funds. *See id.*; *see also* NVCA, Corporate Venture Investment Hits Fifteen Year High, *supra* note 10. In the fourth quarter of 2015 alone, investment from corporate venture capital amounted to "$1.2 billion in 199 deals, representing 10.3 percent of dollars invested and 21 percent of deals for the quarter." *Id.*

13 "As has been the trend with overall venture investing, software companies continue to receive the largest amount of corporate venture dollars, drawing $2.5 billion in 389 deals in 2015, representing 32.6

biotechnology companies,[14] and industrial/energy companies.[15]

CVCs have existed since the 1960s, but in a less influential, embryonic, form.[16] In their earlier stages of development, CVCs tended to invest only in the later stages of startups, and generally did not designate board members. Now the opposite is true: corporations increasingly make investments in the early stages of startups through their

percent of all corporate venture dollars deployed." NVCA, Corporate Venture Investment Hits Fifteen Year High, *supra* note 10.

14 In the biotechnology sector, CVCs deployed $1.2 billion in 133 deals, which amounted to 16.3 percent of all CVC dollars in 2015. *Id.* To highlight one example, with respect to cancer startups, "[e]xcept for a drop in funding in 2012 (consistent with overall funding trends to this sector that year), funding dollars from rounds involving corporate investors—including corporate parents and differentiated venture arms—increased nearly five-fold, from $259M in 2011 to $1.24B in 2015." *Corporate Deal Activity in Cancer Therapeutics Startups Nearly Doubles in 2015*, CB INSIGHTS (Mar. 25, 2016), https://www.cbinsights.com/research/corporate-investors-oncology-startups/ [perma.cc/SA4Z-H2BF].

15 In the industrial/energy sector, CVCs deployed $1.2 billion in forty-six deals which amounted to 16.1% of all CVC dollars and nearly forty percent of all venture investments in this sector in 2015. NVCA, Corporate Venture Investment Hits Fifteen Year High, *supra* note 10. "[C]orporate venture investment in industrial/energy companies continued to be over-weighted as compared to overall venture investment into the sector. In 2015, corporate venture groups accounted for nearly forty percent of all venture investment into industrial/energy companies." *Id.*

16 In 1968 to 1969, there were 150 CVC units but by 1973 only ten remained. There were similar downturns in the 1980s and 1999/2000. Josh Lerner, Professor, Harvard Bus. School, Discussion with Fan Munce at the SHIFT NYC Conference (Oct. 28, 2016), https://www.linkedin.com/pulse/corporates-shift-relations-vcs-james-mawson [perma.cc/6KBB-79ED]. Coupled with the rise of CVC is the fact that the VC industry has consolidated. "211 U.S. firms [did] at least five deals in a year . . . versus 1,000 or more in 2000. . . . 60% of [venture capital] money [is] now raised in funds being secured by the top 16 firms." Venky Ganesan, Chairman, NVCA, Remarks at the SHIFT NYC Conference (Oct. 28, 2016), https://www.linkedin.com/pulse/corporates-shift-relations-vcs-james-mawson [perma.cc/6KBB-79ED].

CVCs,[17] and CVCs frequently designate board members, heavily influencing all stages of startups receiving CVC.

CVCs are developing their own investment rhythm—one that differs significantly from that of VC funds. Additionally, CVCs are now investing in a broader spectrum of industries and the parent corporations of CVCs are reallocating funds from research and development ("R&D") to CVC activities. In fact, CVC augments and may eventually supplant R&D due to its increasing reach and influence. Corporate venture capital is now a mature economic force, and it is already changing things on the ground. Put simply, CVC is now a major player in the innovation ecosystem.

The legal implications of CVC with respect to private ordering have yet to be explored. In the past, legal scholarship has focused on the role of entrepreneurs and venture capital funds (and the limited partners who invest in them). With the swell of CVC activity, however, the dynamics of the private ordering system which undergirds the venture capital landscape has changed. While legal scholars have written extensively about venture capital, they have overlooked this shift.

This Article proceeds in four parts. Part I discusses the evolution of CVC. Part II briefly describes how private ordering works within the venture capital context when only startups and venture capital funds are involved. It then analyzes the growing role and importance of CVC and its impact on the implicit and explicit contracts made between the startup and venture capital fund. Part III critiques the legal issues raised by the increasing influence of CVC on venture capital using a few prominent public companies with CVC arms as examples. Part IV suggests possible solutions to the challenges raised by CVCs in private ordering in the venture capital context; specifically, the ramifications of CVC investments for early investors (i.e., venture capital funds),

[17] *See* CB INSIGHTS, THE 2016 GLOBAL CVC REPORT 13 (2017), https://www.cbinsights.com/research-corporate-venture-capital-report-2016 [hereinafter 2016 GLOBAL CVC REPORT] (registration required).

employees of the startups, and founders. This Article concludes with suggestions for future areas of study.

I. THE EVOLUTION OF CORPORATE VENTURE CAPITAL: THE FOUR WAVES

Corporate venture capital has matured and evolved over the course of a few decades. In its latest iteration, it has become a fixture in the VC landscape, and is now a major player in what historically has been a two-player private ordering world. To provide context, this Article briefly discusses the first three eras—called waves—of corporate venture capital. It then argues how the current wave, the fourth, marks the maturation of this new form of investment.

The evolution of corporate venture capital can be tied to four distinct time periods, or waves.[18] The first wave took place in the 1960s and was concentrated in the areas of technology and pharmaceuticals.[19] When the initial public

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18 There is no substantive or authoritative research about the origins of CVCs. It is difficult to pinpoint the number of CVCs in earlier waves. In the first wave, "[t]he prevailing spirit of American big business . . . favored large diversified corporations operating in many sectors." *The History of CVC: From Exxon and DuPont to Xerox and Microsoft, How Corporates Began Chasing 'The Future'*, CB INSIGHTS (Mar 7, 2017), https://www.cbinsights.com/research/report/corporate-venture-capital-history/ [perma.cc/PZ5X-EQ5E] [hereinafter *The History of CVC*].

19 VOLANS & GLOBAL CORP. VENTURING, *supra* note 6, at 20. The traditional venture capital model drove the success of the first CVC wave, and, "as corporations grew in size and scope in the 1960s, a need to diversify. They focused on internal ventures or external [startups]; the emergence of spin-out businesses benefiting from wider parent company support was yet to come. The activity was mainly in innovation-intensive industries such as technology and pharmaceuticals." *Id.* In the mid-1960s, corporations entered the venturing world with the goal of "generating above-average financial returns." Falk Bielesch et al., *Corporate Venture Capital: Avoid the Risk, Miss the Rewards*, BCG PERSPECTIVES (Oct. 31, 2012), https://www.bcgperspectives.com/content/articles/innovation_growth_mergers_acquisitions_corporate_venture_capital/ [perma.cc/4WVM-N85P]. "It was a period of rapid technological advancement, robust corporate profits, a soaring stock market, and widespread management faith in the strategic value of diversification." *Id.* U.S. corporations in the

offering ("IPO") market collapsed and the oil crisis emerged in the 1970s, the first wave ended.[20] The second wave occurred in the 1980s when venture capitalists re-emerged due to less stringent pension fund regulations and tax cuts.[21] Biotechnology and technology companies received the bulk of the investments in that time period until the market downturn in 1987.[22] The third wave took place during the dot-com boom in the late 1990s—CVC surged again due to the allure of riches in the Internet realm and rising stock markets.[23] In the early 2000s, however, the bubble burst, and CVC activity decreased substantially.[24] These dramatic

technology and pharmaceutical sectors invested in new ventures, but shut down their corporate venture capital arms when the initial public offering market collapsed in 1973. *Id.*

[20] Bielesch et al., *supra* note 19.

[21] Due to the loosening of pension fund regulations and tax cuts, venture capital funds re-emerged in the 1980s and CVCs followed suit, hoping to match the returns of traditional VC firms. *Id.* "CVC as a broad theme lay dormant until the early 1980s, when a new generation of independent venture capitalists emerged, their coffers bulging with cash from U.S. investors taking advantage of a cut in the capital gains tax and the relaxation of restrictions on pension fund investments." *Id.* As was the case in the 1970s, the technology and pharmaceutical industries were the most active CVC investors, but when the stock market crash of 1987 occurred, their interest faded and they "went into retreat." *Id.*

[22] VOLANS & GLOBAL CORP. VENTURING, *supra* note 6, at 21.

[23] "The third CVC wave boomed in investment levels around the time of the dotcom bubble, fueled by the seemingly limitless potential of the Internet and rising stock markets—and fell victim to the bubble's pop in the early 2000s." *Id.* It also marked the first time that European corporations and emerging markets engaged in venture investing. *Id.*

[24] *Id.* In the late 1990s, corporations invested heavily in startups until the economic downturn. From September 2000 to September 2001, investments in startups fell by eighty percent. Henry Chesbrough, *Making Sense of Corporate Venture Capital*, HARV. BUS. REV., Mar. 2002, at 90, 101, https://hbr.org/2002/03/making-sense-of-corporate-venture-capital [perma.cc/6HX8-LJJU]. "Quarterly corporate venture-capital investments in [startups] rose from $468 million at the end of 1998 to $6.2 billion at the beginning of 2000 and then tumbled to $848 million in the third quarter of 2001." *Id.* "The advent of the Internet in the mid-1990s heralded the beginning of the third CVC cycle. Amid a strong market for stocks, especially dot-com issues, and hungry for above-market returns,

shifts in CVC investments contribute to the low esteem with which many venture capital funds hold in-house corporate venture capital operations. Specifically, they view public companies that engage in CVC as having neither the fortitude nor nimbleness to manage the high-risk, quick moving environment of venture capital investing.[25] From a historical perspective, earlier cycles of CVC reflected the ups and downs of the broader economy.[26] As an example, the absence of clear objectives and strategic focus led to the failure of many CVCs in the third wave.[27]

Today, however, companies take proactive measures to address market trends by shifting their CVC investment priorities and partnering with ventures that can mitigate the risks experienced by the third wave CVCs.[28] As a result, the modern CVC: (1) responds quickly to market transformations; (2) gathers intelligence on competitive threats; (3) allows parent companies to more easily extricate themselves from investments that are not advancing their interests (as compared to the reluctance of companies to abandon a languishing R&D project); (4) has a greater impact since CVCs are co-investing with others; (5) manages portfolio companies that develop technologies requiring the use of the parent company's platform (as Apple did with the

corporations returned in force to the game, with more than 400 of them worldwide launching VC programs." Bielesch et al., *supra* note 19. European corporations and emerging markets "entered the market in force. CVC activity reached a high point in 2000, when corporate equity investments in new ventures soared to more than $4.5 billion, according to *GCV*." *Id.* With the dot-com bust in 2000 and the recession of 2001 and 2002, however, the third wave ended. *Id.* "In a newly risk-averse business environment and amid high uncertainty over new accounting and governance regulations, corporations wound down their VC operations." *Id.*

[25] "In their eyes, the wild swings are further evidence that big companies have neither the stomach nor the agility to manage investments in high-risk, fast-paced environments." Chesbrough, *supra* note 24, at 92.

[26] *See* VOLANS & GLOBAL CORP. VENTURING, *supra* note 6, at 21.

[27] *See The History of CVC*, *supra* note 18.

[28] *See id.*

iFund); and (6) allows the parent company to enjoy higher returns on investments.[29]

Since the financial crisis in 2008, the ranks of corporate venture capital have swelled dramatically.[30] "CVC is actually growing at a faster rate than venture capital investment in general."[31] More than 1200 corporations across the globe have CVC programs, of which over half were formed since 2010.[32] Between 2012 and 2016 the number of active CVCs "more than doubled."[33]

As of March 2017, there were approximately 200 CVCs active in every quarter.[34] In 2016, CVCs grew at a rate of twenty percent globally, with 107 new CVC funds making

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[29] Josh Lerner, *Corporate Venturing*, HARV. BUS. REV., Oct. 2013, at 86 [hereinafter *Corporate Venturing*].

[30] *See* Kevin Dowd, *What's Happened with the 10B+ Mega-Funds of 2008?*, PITCHBOOK (Apr. 26, 2016), http://pitchbook.com/news/articles/whats-happened-with-the-10b-mega-funds-of-2008 [perma.cc/9WU8-VAG5] (citing the financial crisis of 2008 and how the $10B+ mega-funds fared eight years after the crisis); *The Investors Fueling the Mega-Round Phenomenon*, CB INSIGHTS (May 16, 2016), https://www.cbinsights.com/blog/hedge-mutual-funds-investing-big-deals-tech-startups/ [perma.cc/PGQ9-AGMD]. Global corporations spend more than $650 billion on research and development on an annual basis primarily on technological advancements. Igor Sill, *New Era for Corporate Venture Capital*, ENTREPRENEUR COUNTRY GLOB. (Sept. 14, 2015), http://www.entrepreneurcountryglobal.com/united-kingdom/ecosystem-economics/item/new-era-for-corporate-venture-capital/ [perma.cc/U8AH-6DLM]. *See infra* Part II (discussing current state of CVC).

[31] *The History of CVC*, *supra* note 18.

[32] Press Release, DLA Piper, Corporate Venture Capital Compensation Report Released to Support High Performance Teams and Innovation Programs (Jan. 27, 2016), https://www.dlapiper.com/en/us/news/2016/01/corporate-vc-compensation-report-released/ [perma.cc/E9TX-EAW7]. *But cf.* Du, *supra* note 6 (which states that between 2010–2014 over 475 new CVC funds started and over 1100 are currently operational). The number of venture capital funds has changed significantly over a period of 20 years. In 1995, there were 425 venture capital firms; in 2005 and 2015, there were 1009 and 798 such firms, respectively. 2016 NVCA YEARBOOK, *supra* note 12.

[33] 2016 GLOBAL CVC REPORT, *supra* note 17.

[34] *The History of CVC*, *supra* note 18.

their first investment.[35] "Companies are using CVC as a compelling way to drive outside-in innovation for access to new and disruptive technologies, the development of new business models and participation in emerging markets, all of which may provide meaningful contributions to corporate growth."[36] Some argue that the rise of both social media and the smartphone was the impetus for the resurgence of CVC.[37] Historically low interest rates, together with the fact that many corporations were also sitting on large piles of cash, contributed to an increase in CVC as well.[38] The ever-present fear of disruption also played a role in the rise of CVC. The former leader of Intel Capital Corporation ("Intel Capital"), Arvind Sodhani, said, "CEOs who are worried they're going to get disrupted want to have an outpost in Silicon Valley to discern where the disruption is coming from."[39] In stark contrast to the growth of CVC, "the VC industry has consolidated, with 211 U.S. firms doing at least five deals in a year versus 1,000 or more in 2000" and with "60% of money now raised in funds being secured by the top 16 [traditional venture capital] firms."[40]

Historically, money from CVC has been invested in later stage funding rounds.[41] Even in 2015, this continued to be the case, with $2.7 billion in corporate venture dollars allocated to later stage companies across 159 deals, representing nearly thirty-six percent of all such dollars.[42] A new trend has emerged, however, as CVCs have increased

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35 2016 GLOBAL CVC REPORT, *supra* note 17, at 8.

36 Press Release, DLA Piper, *supra* note 32.

37 *The History of CVC*, *supra* note 18.

38 *Id.*

39 Randall Smith, *General Mills and 7-Eleven Join the Venture Capital Crowd*, N.Y. TIMES (Apr. 19, 2016), https://www.nytimes.com/2016/04/19/business/dealbook/general-mills-and-7-elevenjoin-the-venture-capital-crowd.html/ [perma.cc/K8U3-6A76].

40 *See* Ganesan, *supra* note 16.

41 *See* NVCA, Corporate Venture Investment Hits Fifteen Year High, *supra* note 10.

42 *Id.*

their participation in early stage deals, deploying $2.4 billion in 442 deals in 2015.[43] Although there was a marked decline in venture capital investing in the fourth quarter of 2015, corporate venture capital activity held steady, ending at twenty-one percent of all deals for the year.[44] There were also a high number of initial investments—approximately eighty-five—made by newcomers to the corporate venture capital realm.[45] In the fourth quarter of 2015, CVCs invested more money in early stage startups than in late stage companies.[46] CVCs also invested in unicorns at a high rate.[47]

In 2016, CVC investors continued to pour money into the market by participating in twenty-one percent of all U.S. venture capital-backed financings.[48] The average deal size which included CVC participation was double that of deals that included only traditional venture capital firms.[49] Globally, Intel Capital and GV (formerly Google Ventures)

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43 *Id.* This represents thirty-one percent of corporate venture capital invested in 2015. *Id.* The increasing sophistication of corporate investors and the fact that "companies in industries that live or die by innovation, such as telecommunications and pharmaceutical, are increasingly eager to capture new ideas and thus are willing to shoulder the risk of investing in the dwindling number of [startups] in their sectors." Bielesch et al., *supra* note 19.

44 NVCA, Corporate Venture Investment Hits Fifteen Year High, *supra* note 10.

45 King, *supra* note 11.

46 *Id.* In the fourth quarter of 2015, corporate venture capitalists invested $650 million in ninety-eight early stage company deals, representing 55.7 percent of all dollars invested for the quarter. NVCA, Corporate Venture Investment Hits Fifteen Year High, *supra* note 10. Expansion stage companies received 23.4 percent of all dollars invested in that same quarter, deploying $273 million in fifty-six deals. *Id.*

47 *See* ANAND SANWAL, CB INSIGHTS LIVE: STARTUPS AND ACCELERATING CORPORATE INNOVATION (2015), slides 70–91, http://www.slideshare.net/NikunjSanghvi/cb-insights-live-startups-and-accelerating-corporate-innovation (last visited Mar. 28, 2018) (Sanwal is Chief Executive Officer and Co-Founder of CB Insights); *see also* 2016 NVCA YEARBOOK, *supra* note 12, at 26.

48 2016 GLOBAL CVC REPORT, *supra* note 17, at 8.

49 *Id.* at 36.

were the most active CVCs.[50] CVC deal activity in 2016 was similar to 2015.[51] Notably, CVC deal size from the first quarter of 2013 through the second quarter of 2016 was consistently larger than that of traditional venture capital firm deal sizes.[52] In the fourth quarter of 2016 alone, the average CVC deal size reached $28 million—twice as large as the average VC deal size, which stood at $14 million.[53] As a result, these large sums of money from CVCs sometimes contributed to skewed valuations for private companies.

In many ways, 2017 was similar to 2016. CVC investors participated in approximately the same number of U.S. venture capital-backed financings at 847 deals.[54] Intel Capital and GV were again the most active CVCs globally.[55] However, the average venture capital deals size increased slightly in 2017.[56] CVC deals were, on average, $5 billion larger than their traditional venture capital firm counterpart.[57]

CVCs deployed half of their corporate venture capital dollars to software companies ($1.2 billion) and nearly thirteen percent ($320 million) to biotechnology companies in 2017.[58] CVCs participated in twenty-five percent of all venture deals and nearly eighteen percent in the biotechnology company context.[59] Other notable highlights

[50] *Id.* at 21.

[51] *Id.* at 8.

[52] *Id.* at 36.

[53] *Id.*

[54] CB INSIGHTS, THE 2017 GLOBAL CVC REPORT 6 (2018), https://www.cbinsights.com/reports/CB-Insights_CVC-Report-2017.pdf [perma.cc/4YBD-KTK9] [hereinafter 2017 GLOBAL CVC REPORT].

[55] *Id.* at 16.

[56] *Id.* at 12.

[57] *Id.*

[58] Press Release, Nat'l Venture Capital Ass'n, Corporate Venture Engagement in Entrepreneurial Ecosystem Continues to Rise (Apr. 22, 2016), http://nvca.org/pressreleases/corporate-venture-engagement-entrepreneurial-ecosystem-continues-rise/ [perma.cc/G57D-RTQF] [hereinafter NVCA, Corporate Venture Engagement Rise].

[59] *Id.*

include CVCs' more active participation in the seed stage, and CVCs' continued focus on early stage companies.[60] CVCs also expanded to more industries, in many cases outside their core areas of expertise. As an example, the top corporate investors in e-commerce companies for the period of 2010 to August 29, 2016 were Intel Capital and GV, ranked at numbers one and two, respectively.[61] Note, however, that the parent companies of each of the aforementioned CVC arms have historically not focused on e-commerce.[62] Intel Capital and GV, along with Motorola Solutions Venture Capital and Qualcomm Ventures, comprised the top four in terms of investments in private in-store technology companies from the period of 2010 to August 4, 2016.[63] The parent companies of each of these CVCs are not focused on in-store technology the way one might imagine a retail company like Walmart (which is ranked 46th in terms of investments in this space) would be.[64]

Over a twenty-year period, investments by U.S.-based CVCs have increased seventeen-fold.[65] In 2009, CVCs invested nearly $1.4 billion in 411 deals or 12.9 percent of all venture capital deals;[66] 2010 was much of the same with CVCs investing $1.8 billion in 473 deals, comprising 12.8 percent of all venture capital deals.[67] In addition to an increase in dollars invested, since 2011 there has also been an uptick in the number of deals. CVCs invested almost $2.4

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[60] *Id.*

[61] *Big Box vs. Big Tech: Retailers Sit on Hands when It Comes to Startup Bets and M&A*, CB INSIGHTS (Sept. 14, 2016), https://www.cbinsights.com/blog/big-retail-vs-tech-future-commerce/ [perma.cc/5XRC-NJ3A].

[62] *Id.*

[63] *Id.*

[64] *Id.*

[65] In 1995, there was $433 million in CVC investments. By 2015, CVCs invested $7.76 billion in private companies. NAT'L VENTURE CAPITAL ASS'N, Q1 2016 CORPORATE VENTURE ACTIVITY (2016) (on file with author).

[66] *Id.*

[67] *Id.*

billion in 595 deals that equaled 14.6 percent of all venture capital financings.[68] The increase in the number of venture capital financings and percent of venture capital deals with CVC involvement continued. Other reports note that U.S.-based CVCs participated in 607 deals or 16.3 percent of all venture capital financings in 2013, 788 deals or 18.5 percent in 2014, 851 deals or 20 percent in 2015, 752 deals or 21 percent in 2016,[69] and 847 deals or about 20 percent in 2017.[70] The increase in deal activity and not just dollars invested shows greater involvement and suggests a new, emerging role of CVC in directing outcomes. Bobby Franklin, President and Chief Executive Officer of the National Venture Capital Association remarked on this shift in behavior: "[C]orporations are increasingly engaging in a more meaningful way with startup founders and the broader entrepreneurial ecosystem."[71] An increasing number of corporations choose to start CVCs, recognizing the importance of keeping up with the newest innovations. "The benefits of this deeper engagement accrue not only to the parent corporations but also the startups as they draw on the knowledge, expertise and networks of the parent corporations to scale and grow."[72]

Regarding CVC, corporations want the ability to enhance their R&D efforts in a nimbler way and perhaps have even better acquisition opportunities.[73] In short, they want to be part of the disruptive innovation that the media, companies, and Wall Street all laud.[74] In the past, "incumbency was the

68 *Id.*

69 2016 GLOBAL CVC REPORT, *supra* note 17, at 33.

70 *See* 2017 GLOBAL CVC REPORT, *supra* note 54, at 3, 9, 11.

71 NVCA, Corporate Venture Engagement Rise, *supra* note 58.

72 *Id.*

73 "For the corporations, the purpose of CVCs is to increase the flexibility and entrepreneurial spirit of otherwise large, bureaucratic, multi-billion dollar companies. CVCs essentially act as a supplement to internal research and development. In this way, investing in small companies serves as a gateway for possible acquisition." Du, *supra* note 6.

74 Clayton M. Christensen et al., *What Is Disruptive Innovation?*, HARV. BUS. REV., Dec. 2015, at 46, https://hbr.org/2015/12/what-is-

goal. . . . Now incumbency is seen as a burden. . . . Precisely the organizational capabilities that underlie success in the industry as currently understood blind the firm to threats from outside of the dominant conception."[75] One might argue that CVC is itself disruptive.[76] Additionally, public companies use CVC to look more closely at potential disruptors to their line of business. By identifying and holding equity in these startups, the public (parent) companies using CVC hope to prevent the failure of the

disruptive-innovation [perma.cc/7SUA-W4EJ] ("'Disruption' describes a process whereby a smaller company with fewer resources . . . successfully challenge[s] established incumbent businesses. Specifically, as incumbents focus on improving their products and services for their most demanding . . . customers, they exceed the needs of some segments and ignore the needs of others."). Smaller companies target overlooked segments typically at a lower price. *Id.* Incumbents don't respond vigorously since they are focused on customers that will give them greater profits. *Id.* "Entrants then move upmarket, delivering the performance that incumbents' mainstream customers require, while preserving the advantages that drove their early success. When mainstream customers start adopting the entrants' offerings in volume, disruption has occurred." *Id.* The authors also noted that disruptive innovations get started in low-end or new-market footholds. *Id.* at 47. In the case of the low-end market, disrupters are initially focused on giving low-end customers a product that is "good enough." *Id.* With respect to new-market footholds, disrupters figure out how to convert nonconsumers into consumers. *Id.* The authors contend that Uber is not a disrupter because it started off by establishing itself as a contender in the mainstream market and then appealed to overlooked markets. *Id.*

[75] Ronald J. Gilson et al., *Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration*, 109 COLUM. L. REV. 431, 442 (2009).

[76] "Our current belief is that companies should create a separate division that operates under the protection of senior leadership to explore and exploit a new disruptive model." Christensen et al., *supra* note 74. In other words, perhaps the fact that public companies want to figure out a better way of identifying future disrupters in their respective industries or the next big innovation through small bets, like Alphabet does with Other Bets (see discussion *infra* Subsection III.B regarding GV and other entities under the banner of Other Bets) shows how leaders in public companies explore and exploit new, disruptive models.

parent company in the future.[77] "The entire technology industry is easily disrupted, with small companies exploding onto the scene and overtaking giants every couple years."[78]

At first blush, it may appear that CVC is heading toward another boom-and-bust cycle. Yet some experts believe that CVC is not destined to repeat such a cycle.[79] In the past, CVCs tended to mirror the VC investment climate.[80] In this fourth wave of CVC, however, the numbers indicate that CVCs are developing their own investment rhythm independent of the venture capital funds.[81] No longer an experiment, CVCs have entered a more mature chapter and now have a global reach.[82] They are becoming more sophisticated and strategic as they expand to new industries, looking toward adjacent and downstream industries, and

77 Du, *supra* note 6.

78 *Id.*

79 Bielesch et al., *supra* note 19.

80 "In the past, corporate interest in creating venture funds tended to wax and wane in sync with the general VC climate. Waves of corporate venture activity—in the late 1960s, the mid-1980s, and the late 1990s—corresponded with booms in VC investments and venture-backed IPOs." *Corporate Venturing*, *supra* note 29, at 88.

81 "But now we're seeing a corporate-venturing surge even during lackluster days for traditional venture capital." *Id.* During the global financial crisis, CVC funds invested more than eleven percent of the venture capital dollars—this was reminiscent of the amount invested by CVC funds during the dot-com boom. *Id.* "This new activity may indicate that as research functions face severe pressure to rein in costs and produce results, companies are looking for alternative means to learn and innovate." *Id.*

82 *Corporate Venture Capital Abroad: These Are the Top CVCs in the UK, China, and India*, CB INSIGHTS (Mar. 30, 2016), https://www.cbinsights.com/blog/top-corporate-venture-firms-uk-china-india/ [perma.cc/K8ND-YZYL]. CVCs invest in private companies in countries such as China, the United Kingdom, and India. *Id.* For example, Qualcomm Ventures ranks in the top four for the three aforementioned markets, while Intel Capital is the top CVC investor in China and India. *Id.*

reallocating resources to corporate venture capital instead of R&D.[83]

II. THE EFFECT OF CORPORATE VENTURE CAPITAL ON PRIVATE ORDERING IN THE VENTURE CAPITAL CONTEXT

The addition of a new major player—CVC—has fundamentally changed the dynamics of private ordering in the venture capital realm. Specifically, today, there are three major players in venture capital: (1) the entrepreneurs who found the startups; (2) the venture capital funds (and the limited partners who fund them); and (3) CVC. CVC exerts its own, independent force on the innovation industry. Yet legal scholarship has ignored or downplayed CVC, focusing solely on the relationship between the first two players.[84] This Part adds CVC to the theoretical structure of venture capitalism and explains the broadening influence of CVC on private ordering.

As Professor Ronald Gilson asserts, "[a]ll financial contracts respond to three central problems: uncertainty, information asymmetry, and opportunism in the form of

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[83] "In many cases, they are looking past the boundaries of their own industries toward adjacent and downstream industries, and they are banding together with companies from other industries to fund promising new ideas." Bielesch et al., *supra* note 19.

[84] *See generally* PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE (2d ed. 2004); Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1069 (2003) [hereinafter Gilson, *Engineering a Venture Capital Market*] (noting that three central inputs are necessary for a venture capital market: capital, specialized intermediaries, and entrepreneurs). The intermediaries Gilson refers to are the venture capital funds through which institutional investors such as pension funds, banks, endowments, and foundations invest as passive limited partners. *See id.* at 1070; Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281 (2003).

agency costs."[85] In order to address these problems in the venture capital context, Professor Gilson identifies five organizational and contractual techniques: "staged financing, allocation of elements of control, form of compensation, the role of exit, and reliance on implicit contracts."[86] This Part shows how CVCs have developed their own versions of these foundational techniques, borrowing from traditional venture capital where helpful, but charting their own path in significant and influential ways.

A. The Entrepreneur

To fund an innovation, entrepreneurs need money—in many cases, a lot of it.[87] While entrepreneurs may be able to secure a bank loan or debt financing for their startup, because of their need for significant funds, lack of substantial tangible assets, uncertain prospects, and the expectation that the startup will not turn a profit for many years, venture capital is frequently the more viable option.[88] By engaging in a venture capital financing, the entrepreneurs are selling an ownership stake in the startup to venture capitalists. By doing so, the company and the entrepreneur receive the following three things: (1) an explicit contract for "capital plus nonfinancial contributions including information, monitoring, and enhanced credibility with third parties,"[89] (2) "an implicit incentive contract denominated in control,"[90] and (3) "the explicit contract between the venture capital fund and the portfolio company [that] ensures that important control rights that were

[85] Gilson, *Engineering a Venture Capital Market*, *supra* note 84, at 1076.

[86] *Id.* at 1078.

[87] *See* GOMPERS & LERNER, *supra* note 84, at 6.

[88] *Id.*

[89] Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 259 (1998).

[90] *Id.*

initially given to the fund . . . disappear on an initial public offering."[91] Put differently, the relationship between entrepreneurs and a venture capital fund is structured through management assistance (both financial and nonfinancial contributions), intensive monitoring and control, and a reputation market.[92]

B. The Venture Capital Fund

Venture capital funds raise capital from limited partners (i.e., passive investors) for their venture capital funds.[93] A standard limited partnership agreement between the two parties sets a maximum term for the partnership of seven to ten years; at the end of the term, the partnership is liquidated.[94] As part of the agreement, the limited partners do not have the right to approve the investment decisions made by the general partners, exemplifying the Berle-Means problem of the separation of ownership (which lies with the limited partner in this case) and control (which lies with the general partners who were not the providers of the bulk of

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91 *Id.* at 261 (these rights include guaranteed board seats and the ability to block certain business decisions). *See also* D. Gordon Smith, *Venture Capital Contracting in the Information Age*, 2 J. SMALL & EMERGING BUS. L. 133, 134–35 (1998) (identifying the problems of shirking, opportunism and incompetence that entrepreneurs face when trying to obtain value-added services from venture capitalists).

92 Black & Gilson, *supra* note 89, at 252–55.

93 Typically, the limited partners are public employee pension funds, endowments, philanthropic foundations, and insurance companies, to name a few. *Funding Innovation*, NAT'L VENTURE CAPITAL ASS'N, http://nvca.org/ecosystem/funding-innovation/ [perma.cc/8Z8U-TDDU]. Traditional venture capital is what most people think of when venture capital is discussed—they are standalone investment entities. "Venture capital is financing that investors provide to startup companies and small businesses that are believed to have long-term growth potential." For startups without access to capital markets, venture capital is an essential source of money. *See Venture Capital*, INVESTOPEDIA, http://www.investopedia.com/terms/v/venturecapital.asp [perma.cc/K6Z9-3KKF].

94 Black & Gilson, *supra* note 89, at 256.

the capital).[95] The general partner is typically structured as a company (what this Article refers to as a venture capital fund) owned by professional investors who decide which companies to invest in—typically at the early stages of the private company and focused on a particular sector—and play an active role, often times serving on the board.[96] Specifically, "[v]enture capital investors specialize in providing portfolio companies with a combination of financial capital, monitoring and advisory services, and reputational capital."[97] There is an implicit contract for these nonfinancial contributions by the venture capital funds.[98] Typically, the general partner of the fund puts in only one percent of the capital and the limited partners put in the other ninety-nine percent; however, it is the general partner who has complete control over the fund.[99] Since the general partner "expects to continue in the venture capital market by raising successive funds after the capital in a particular fund has been invested in portfolio companies . . . [it] provides a powerful performance incentive [for the general partner]."[100] The general partner is compensated annually with a small management fee, which is between two to 2.5 percent of the committed capital.[101] Assuming that its portfolio companies have done well, at the time that distributions are made to the limited partners the general partner is handsomely rewarded in the form of a carried interest.[102]

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[95] *See generally* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

[96] The venture capital investors (i.e., the investment professionals at the venture capital firm) and the limited partners will enter into a limited partnership agreement. *Funding Innovation*, *supra* note 93.

[97] Black & Gilson, *supra* note 89, at 245.

[98] Gilson, *Engineering a Venture Capital Market*, *supra* note 84, at 1073.

[99] *Id.* at 1071.

[100] *Id.* The general partner is already fundraising for its next fund during the middle of the ten-year term of a current fund. *Id.*

[101] *See* GOMPERS & LERNER, *supra* note 84, at 124.

[102] Carried interest is "a share of any profits that the general partners of private equity and hedge funds receive as compensation, regardless of

A venture capital fund's initial investment in a startup is not sufficient to fund the entire operations of the company for the duration of its existence until it is either acquired or goes public. Instead, the investment is staged.[103] The venture capital fund is expected to participate in subsequent rounds (assuming that the company is progressing in a manner that the venture capital fund agrees with); however, it is not contractually bound to do so.[104] Like the nonfinancial contributions, it is an implicit contract.[105] These staged capital infusions keep the company "on a 'tight leash' and [reduce] potential losses from bad decisions."[106]

The governance structure created by a venture capital fund's investment contrasts to the Berle-Means governance structure where investors have greater equity and far less control.[107] The venture capital investors have much greater control than equity.[108]

Noted legal scholars contend that "a well-developed stock market that permits venture capitalists to exit through an IPO is critical to the existence of a vibrant venture capital market."[109] Put differently, IPOs create an exit and reinvestment cycle for both the venture capitalists and the limited partners who provide capital for the funds of venture capital firms. Not only is the cash contribution recycled since

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whether or not they contributed any initial funds. This method of compensation seeks to motivate the general partner (fund manager) to work toward improving the fund's performance." *Carried Interest*, INVESTOPEDIA, http://www.investopedia.com/terms/c/carriedinterest.asp [perma.cc/4KLK-6XWL].

103 Gilson, *Engineering a Venture Capital Market*, *supra* note 84, at 1073.

104 *Id.*

105 *Id.*

106 GOMPERS & LERNER, *supra* note 84, at 171.

107 Gilson, *Engineering a Venture Capital Market*, *supra* note 84, at 1073.

108 *Id.* at 1073–74 (citing an example of the venture capital investors having a majority of the board seats despite not having a majority of the equity of the portfolio company).

109 Black & Gilson, *supra* note 89, at 245.

the limited partners may be repeat investors in other venture capital funds of the general partner, but the noncash contributions of the venture capital funds will also be recycled. The exit addresses three challenges between venture capitalists and the limited partners who invest in their funds because it allows the limited partners to: (1) evaluate the performance of the venture capital firms; (2) determine how much to allocate to venture capital relative to other investments; and (3) withdraw their funds from venture capital firms which are not successful.[110] The model proposed by Professors Black and Gilson "predicts that the [VC's] successful exits will take place disproportionately through IPO. If so, IPO exits will be more profitable than exits through sale of the portfolio company. . . ."[111]

Professor Gilson identified three basic characteristics of the venture capital market based on the organizational and contractual techniques that he discusses throughout his various articles on the subject: (1) "high power *incentives* . . . for investors, GPs, and entrepreneurs are coupled with very intense *monitoring*,"[112] (2) "the organizational and contractual structure reflects the use of both explicit and implicit contracts,"[113] and (3) the braiding of the venture capital fund limited partnership agreement and the portfolio company investment contract "facilitates the resolution of

110 *Id.* at 255. In a later article, Gilson and a coauthor note:

> A firm's decision to go (or remain) public . . . may increasingly be less a function of the need to raise risk capital or diversity risk, as in the traditional construct, and more a balance between the incremental costs of going public . . . and the incremental benefits of being a public company.

Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231, 258 (2008).

111 Black & Gilson, *supra* note 89, at 264.

112 Gilson, *Engineering a Venture Capital Market*, *supra* note 84, at 1078 (emphasis in original).

113 *Id.*

problems internal to each."[114] In other words, formal and informal contracts are governance mechanisms that work (or braid) together in response to the holdup problem.[115]

C. CVC

As discussed in Part I, the purpose of CVC, the levels and stage of investment from CVC, and the role of CVC in the startup ecosystem have metamorphized over the years.[116] Corporations have different rationales for forming CVC arms, including financial returns and gaining perspective on what could be the next market disrupter.[117] They are also motivated by the opportunity to "identify[] novel technologies to enhance revenue streams and amplify a corporation's competitive position [and] validation of new market segments, as well as [to] leverage[e] relationships between the corporate venture capital portfolio and corporate business units."[118] Engaging in CVC activities may give parent companies access to more disruptive R&D, give R&D more scale, and provide companies access to talent and

114 *Id. But cf.* Matthew Jennejohn, *The Private Order of Innovation Networks*, 68 STAN. L. REV. 281, 309–10 (2016) (arguing that "the ownership, prosecution, and protection of foreground [intellectual property] are key—if overlooked—topics in many of the agreements that form the basis of Gilson et al.'s braiding theory").

115 The holdup problem is defined through the lens of contract economics which "has focused on how uncertainty and measurement problems combine with opportunism and asset specificity to lead to holdup problems." Jennejohn, *supra* note 114, at 315.

116 *Benchmarking Corporate Venture Capital*, CB INSIGHTS, https://www.cbinsights.com/research-benchmarking-corporate-venture-capital [perma.cc/57ES-XTLR].

117 *See* MAHENDRA RAMSINGHANI, THE BUSINESS OF VENTURE CAPITAL 22 (2d ed. 2014) (opining that everyone is interested in the "newest new thing").

118 *Id.* at 22–23. Ramsinghani also notes that "[a]bout 60 percent of corporations invest in ventures funds as LPs, and 90 percent of CVCs invest directly in [startups]." *Id.* at 23.

markets to which they would not otherwise be exposed.[119] Traditional R&D within the parent company, in contrast, is increasingly seen as costly and ineffective.[120]

Professor Henry Chesbrough of Harvard Business School wrote the seminal piece on corporate venture capital in which he identified four different investment categories for corporate venture capital: (1) driving, (2) enabling, (3) emergent, and (4) passive.[121]

A driving investment is both strategic and tightly linked to the operations of the company that is investing.[122] Such an investment sustains the current strategy of the company, but does not address when a company is faced with disruptive strategies or new opportunities.[123] For example, Campbell Soup Company's corporate venture capital arm

[119] *Not the Same: Understanding Corporate Venture Capital Versus Institutional VCs*, CB INSIGHTS (Feb. 5, 2016), https://www.cbinsights.com/research/corporate-venture-capital-institutional-venture-capital/ [perma.cc/RM25-ZTQ5]. CVCs also look at what type of startup will benefit the corporation. As one CVC head noted, as a startup, "[y]ou must convey how you can benefit the organization, not how it can help you solve the challenges you're facing as a startup. This requires understanding the core business of the fund . . . as well as why pursuing a relationship would be mutually beneficial for both organizations." Ilya Pozin, *Three Things to Know About Corporate Venture Capital*, INC. (Jan. 3, 2014), http://www.inc.com/ilya-pozin/3-things-to-know-corporate-venture-capital.html [perma.cc/N7H8-QKGS].

[120] Josh Lerner, *How Corporate Venture Capital Helps Firms Explore New Territories*, HARV. BUS. REV. (Sept. 10, 2013), https://hbr.org/2013/09/how-corporate-venture-capital.html [https://perma.cc/6STQ-49ZC] [hereinafter *New Territories*]. "Corporate R&D too often focuses on refining technologies that are already in use . . . . For decades in the U.S., billions were spent on big science, and the commercial returns were disappointing . . . . R&D has a tendency to be slow, rigid, and expensive." *Id.*

[121] Chesbrough, *supra* note 24, at 95.

[122] *Id.*

[123] "The tight coupling of these investments with a company's current processes means that these investments will sustain the current strategy. They will be unlikely to help a corporation cope with disruptive strategies or to identify new opportunities when the company must . . . respond to . . . a change in the environment." *Id.* at 94.

could fit into this category because of its investments in startups that offer healthier food alternatives.[124]

An enabling investment is one which is not as tightly interwoven with the company's own operations, but the goal of the investment is primarily strategic.[125] This type of investment will encourage the development of the company's current ecosystem of suppliers, customers, and third-party developers which will in turn enhance the demand for the company's own products.[126] Intel Capital is cited as an example.[127]

The focus of emergent investments is not on enhancing strategy, but rather for the startup to be tightly linked to the company's operating capabilities.[128] This investment strategy can be helpful if the company's strategy or the business environment changes; it provides the company with strategic business options beyond any potential financial gains the investment may produce.[129] In other words, it means that the company is investing in a technology that it has no current intention to use in its own products, but that it was involved in developing and can incorporate into its business plans if circumstances change.[130] Alphabet is a good example: it invests in businesses outside its main products.

Lastly, a passive investment is neither connected to the corporation's strategy nor is it tightly linked to the corporation's operational capabilities.[131] Therefore, the

124 See discussion *infra* Section III.C and accompanying notes about Campbell Soup Company.

125 Chesbrough, *supra* note 24, at 95.

126 "A company can take advantage of this notion by using its [venture capital] investments to stimulate the development of the ecosystem in which it operates—that is, the suppliers, customers, and third-party developers that make goods and services that stimulate demand for the company's own offerings." *Id.*

127 *See id.*

128 *Id.* at 96.

129 *Id.*

130 *Id.* at 96–97.

131 *Id.* at 97–98.

company cannot advance its own business.[132] Chesbrough even characterizes passive investing as "arguably a misuse of shareholders' funds."[133] The other three investment types, in contrast, each cultivate the expansion of a company's current or future businesses.[134]

As Professor Chesbrough notes, however, a company's "resources and processes can become liabilities rather than capabilities, particularly when it faces new markets or disruptive technologies."[135] The investments "are made primarily to increase the sales and profits of the corporation's own businesses. A company making a strategic investment seeks to identify and exploit synergies between itself and a new venture."[136] If the objective is financial, the company's primary goal is a high rate of return.[137]

Unlike venture capital funds, the corporations engaged in CVC do not need to raise money from limited partners. In fact, they may have much more capital at their disposal than their venture capital fund counterparts. Sources of capital for CVC include the corporate level of the parent company, one of the parent company's business units, or external investment partners, such as a venture capital fund; the former is the most common.[138] In terms of the legal mechanics, CVCs are structured in a few different ways: (1) corporations join existing venture capital funds as limited

[132] "[T]he corporation lacks the means to actively advance its own business through these investments." *Id.* at 98.

[133] *Id.*

[134] *Id.* (including the "Paths to Growth" chart).

[135] *Id.* at 94.

[136] *Id.* at 92.

[137] "Here, a corporation seeks to do as well as or better than private VC investors, due to what it sees as its superior knowledge of markets and technologies, its strong balance sheet, and its ability to be a patient investor." *Id.* The company's brand may also attest to the startup's quality to other investors and potential customers. *Id.*

[138] IAN MACMILLAN ET AL., NAT'L INST. OF STANDARDS & TECH., NIST GCR 08-916, CORPORATE VENTURE CAPITAL (CVC): SEEKING INNOVATION AND STRATEGIC GROWTH (2008).

partners;[139] (2) current operating business units are tasked with venture capital investing;[140] (3) wholly-owned subsidiaries are organized for the exclusive purpose of CVC;[141] (4) dedicated funds are co-managed by a venture capital fund and the corporation;[142] and (5) evergreen or discretionary funds make investments opportunistically and capital is allocated when such opportunities arise.[143] CVC operations are structured in a variety of ways ranging from simple (resembling the general partner, limited partner structure of a venture capital fund) to complex.[144] "The simplest way to structure a [CVC] operation is for the corporation to invest as a [venture capitalist] directly from the corporate treasury, with employees managing the investment activities."[145] Due to financial issues (i.e., accounting, tax, and compensation) and internal corporate politics, however, corporations have had to implement creative structures or contractual arrangements.[146]

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[139] Gary Dushnitsky, *Corporate Venture Capital: Past Evidence and Future Directions*, *in* THE OXFORD HANDBOOK OF ENTREPRENEURSHIP 408 (Anuradha Basu et al. eds., 2008).

[140] *Id.*; *see* discussion *infra* Subsection III.C and accompanying notes (discussing General Mills' structure).

[141] Nokia Ventures is an example of this. Dushnitsky, *supra* note 139, at 408; *see* discussion *infra* Sections III.A and III.B and accompanying notes (discussing the structures of GV and Intel Capital).

[142] Sequoia Seed Capital, a joint venture between Sequoia Capital and Cisco Systems is an example of a dedicated fund. Dushnitsky, *supra* note 139, at 408.

[143] IAN MACMILLAN ET AL., *supra* note 138.

[144] Asher Bearman, *Corporate Venture Capital—An Introduction*, DLA PIPER: THE VENTURE ALLEY (Feb. 23, 2012), https://web.archive.org/web/20151019014806/http://www.theventurealley.com/corporate-venture-capital-an-introduction/.

[145] *Id.* This type of structure may be best suited for new players to CVC that are able to be the sole capital source for the venture capital investments. *Id.*

[146] *See id.*

D. The Effect of CVC on Private Ordering

Thus far, this Article has explained what private ordering historically looked like when the two main parties were the entrepreneurs and the venture capital fund, and has also provided background information on CVCs. Next, this Article turns to how the "new" player—CVC—has impacted private ordering in the venture capital financing context specifically regarding the five techniques that address the three major contractual problems. In short, staged financing, control, compensation, exit, and reliance on implicit contracts help with the problems of uncertainty, information asymmetry, and opportunism in the form of agency costs.

First, unlike the goals of a venture capital firm which are solely financial, the goals of a CVC are hybrid in nature—they are both financial and strategic.[147] Whether CVC investments skew more towards financial or strategic depends on which one of Chesbrough's four categories corporate venture capital falls in. In terms of private ordering, the two-pronged goals of a CVC may affect the staging aspect of a venture capital financing. Staging is intended to respond to the high degree of uncertainty that early stage companies face.[148] In effect, staging gives investors the option to cease providing funds if the entrepreneur fails to reach certain milestones.[149] By creating this performance incentive, it "aligns the interests of the venture capital fund and entrepreneur."[150] It also reduces agency costs because it shifts the decision to continue the

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147 VOLANS & GLOBAL CORP. VENTURING, *supra* note 6, at 9 (Strategy includes "[d]eveloping capabilities, access and . . . markets of the parent company, aligning with long-term strategy. Multiple CVC units may be created to focus on different aspects of the strategy—and they often adapt and evolve over time. A strategic CVC investment will identify and amplify synergies between itself and the venture.").

148 Gilson, *Engineering a Venture Capital Market*, *supra* note 84, at 1078.

149 *Id.* at 1079.

150 *Id.*

startup from the entrepreneur to the venture capital fund.[151] However, a CVC may not be incentivized solely by the goal of maximizing its financial return from the investment in the startup. As such, a CVC may decide to continue funding a startup even if a startup did not reach a particular milestone. Alternatively, a CVC may decide not to provide additional funding, even if the startup is making progress in the business, if the success of the startup is no longer aligned with the success of the CVC's parent. This may increase the agency costs since now there are multiple decision-makers instead of the venture capital fund and they are not all motivated to accomplish the same goals. Also, a CVC may still intend to continue to invest in a startup (even if a venture capital fund did not) because it may be interested in acquiring the company for strategic reasons or seeing how the startup develops technology in ways that they may not have anticipated. CVCs are not focused on maximizing financial returns on their investments like venture capital firms are which may frustrate the venture capital firm. The firm may disagree with the CVC, yet still be compelled to allocate its limited dollars in the venture capital fund to continue to maintain the fund's percentage ownership and therefore the control levers set forth in the venture capital financing documents. If the CVC was the lead investor in the deal, it may also decide to fund the bulk of the round (and therefore have the majority or two-thirds vote necessary to revise certain key parts of the Certificate of Incorporation, such as the antidilution and protective provisions).[152]

Recent studies show that CVCs have now expanded their investments to all stages of a startup (but still make the majority of their investments in the seed/early stage or the

151 *Id.* at 1080.

152 *See* Jennifer S. Fan, *Regulating Unicorns: Disclosure and the New Private Economy*, 57 B.C. L. REV. 583, 594–95 (2016). However, if the venture capital fund was the lead investor in a prior round of funding, its vote would be required to amend the Certificate of Incorporation and approve a new round of financing.

late stage).[153] If a CVC is the lead investor in the early stages of a startup or holds a sizeable percentage ownership in a particular financing round, the startup will typically need its vote for future funding decisions based upon the votes required under the amendment provisions in the Certificate of Incorporation. As a result, venture capital funds will need to navigate how syndicates are formed.

There is also the question of whether the CVC may be around long term to fund the various stages of financing (assuming that it would choose to fund at each stage). The life span of a venture capital fund is dictated by the terms of the limited partnership agreement it enters into and is typically between seven to ten years. The life span of a CVC, in contrast, may vary widely since it is typically not bound to a limited partnership agreement. Generally speaking, CVCs now have longer life spans than before, though typically not as long as a venture capital fund.[154] In the past, CVC programs lasted no longer than one to two years.[155] In the fourth wave, however, the majority of CVC programs have been active for four years or longer.[156] "The lengthening life

153 PITCHBOOK, 2Q 2017 PITCHBOOK-NVCA VENTURE MONITOR 14 (2017), http://files.pitchbook.com/pdf/2Q_2017_PitchBook_NVCA_Venture_Monitor.pdf [perma.cc/4GL8-23E8]; 2016 GLOBAL CVC REPORT, *supra* note 17.

154 There are two groups of CVCs—one with a long history of corporate venturing (technology, pharmaceutical, telecommunications, and media and publishing) called "CVC first movers" and the other, "CVC follower" group comprising of machinery, power and gas production, consumer, and construction. Bielesch et al., *supra* note 19.

155 *Corporate Venture Capital (CVC)*, EWING MARION KAUFFMAN FOUND., http://www.kauffman.org/microsites/state-of-the-field/topics/finance/equity/corporate-venture-capital [perma.cc/WL2Y-MFFK].

156 *Id. But cf.* Gary Dushnitsky, *Riding the Next Wave of Corporate Venture Capital*, 3 BUS. STRATEGY REV. 44, 44 (2011) (which states that the average lifespan for CVC in the past was 2.5 years and is now 3.8 years with more prominent CVCs now in their second decade of activity). Furthermore, forty percent of the approximately 350 corporate investors in the 2000–2009 timeframe were in operation for four or more years, which was almost double the longevity of CVCs in previous wave. *Id.* Another source reports that CVCs have an average age of five years and 120 last

spans of CVC units may be the most compelling evidence that venture investing is finding a permanent place in the corporate-development arsenal and has become a must-have innovation tool in many industries."[157] The increasing duration of CVCs indicates the level of commitment of corporations to CVCs and shows how commonplace such investing is becoming.[158] However, it is unclear how long more recent corporate investors will remain committed to their CVC programs, and is one aspect to keep in mind in the context of staged financings.

Second, Professor Gilson observes that venture capital funds typically have more control than equity.[159] This control is established through the five major documents of a venture capital financing: the Certificate of Incorporation, the Stock Purchase Agreement, the Investors' Rights Agreement, the Right of First Refusal and Co-Sale Agreement, and the Voting Agreement. The control levers set forth in the documents address the uncertainty and information asymmetry of funding early stage companies by incentivizing the venture capital fund to closely monitor the startup's

ten years or more—this is longer than the tenure of many chief executive officers. *If You Can't Beat Them, Buy Them*, ECONOMIST (Nov. 22, 2014), http://www.economist.com/news/finance-and-economics/21633883-fear-being-displaced-startups-turning-firms-venture-capitalists-if [perma.cc/DRT6-LZYM].

[157] "Average lifetimes of corporate venture units are increasing across the board, in industries with a long history of venture activity as well as industries that are relative newcomers to the game." Bielesch et al., *supra* note 19. Since 2002, the life span of CVC units in the pharmaceutical industry has increased by fifty percent and, in the case of CVCs in technology, from 2002 to 2012, it has increased to almost six years. *Id.* Newcomers to the CVC world also have longer life spans. *Id.* As an example, CVCs in the consumer industry had a lifespan of 10.5 years in 2012 compared to 3.3 years in 2002. *Id.*

[158] "No longer an exotic sideline indulged in by a handful of well-heeled giants in clearly circumscribed industries, it is . . . well on its way to becoming a mainstream innovation and corporate-development activity, alongside R&D, M&A, and joint venturing." *Id.*

[159] Gilson, *Engineering a Venture Capital Market*, *supra* note 84, at 1081–82.

progress during each period of the staged financing.[160] However, the role of CVCs in monitoring activities of a startup is unclear. As an example, venture capital funds typically do not invest in competing companies in their specialized area of investment—a venture capital fund would not invest in two artificial intelligence companies working to solve the exact same problem. In contrast, CVCs may be investing in companies that directly compete with each other or that have a direct correlation to the work of the parent company of the CVC. Furthermore, CVCs are increasingly taking board seats. This may impact the levers of control currently put in place by the venture capital financing documents and also lead to conflicts of interest.

Third, the compensation structure of both the entrepreneur and the investors investing on behalf of the venture capital fund, "creates extremely high-powered performance incentives that serve to align the incentives of the portfolio company management and the venture capital fund."[161] The entrepreneurs, who are typically the founders and play a management role in the company, receive relatively low salaries, but have significant stock ownership which has the potential to increase substantially in value if the company has a successful exit.[162] However, under the terms of a Restricted Stock Purchase Agreement, the stock vests over time to incentivize the founder to stay during the formative years of the company.[163]

In the case of the venture capital fund, under the terms of the limited partnership agreement between the venture capital fund and limited partners, "[b]y investing through a financial intermediary, [limited partners] secure the benefit of the [general partner's] skill and experience, which help to

160 *Id.*

161 *Id.* at 1083.

162 *Id.*

163 While a founder may be able to negotiate some amount of vesting upfront for time put into the company, the vesting schedule needs to be reasonable from the perspective of investors to incentivize the founder to stay with the company for a longer period of time. *See* Fan, *supra* note 152.

reduce the level of uncertainty and information asymmetry that must be addressed in the contract governing a portfolio company's investment."[164] This benefit comes at a steep cost—general partners wield the utmost discretion to use their skills and experience to make investments on the investors' behalf.[165] The compensation structure addresses agency costs by paying carried interest to the general partners.[166]

CVCs, unlike venture capital funds, may not receive carried interest or fixed fees. Therefore, the incentives between the venture capital fund and entrepreneur on the one hand, and the CVC on the other hand, may be misaligned. Some corporations may structure their CVC funds as independent or semi-independent funds to ensure that corporations can recruit and retain talent to manage their respective CVC investments by offering compensation that's competitive with venture capital funds, including carried interest.[167] While there is growing evidence that CVCs are heading in this direction, compensation for CVCs is still a work-in-progress.[168] If CVCs have compensation structures similar to venture capital funds, it is easier to retain the employees who are investing in portfolio companies. If the personal compensation of each of the major players is tied to the success of the startup, there will be an alignment of interests of all parties involved.[169]

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164 Gilson, *Engineering a Venture Capital Market*, *supra* note 84, at 1088.

165 *Id.*

166 *Id.* at 1088–89. Carried interest is typically 20% of the of the venture capital fund's profits. There is also a yearly fixed fee of 2% to 2.5%. *See id.* at 1090.

167 *Id.*

168 *See* Dana Olsen, *These 5 Charts Illustrate Current CVC Compensation Trends*, PITCHBOOK (Apr. 5, 2017), https://pitchbook.com/news/articles/these-5-charts-illustrate-current-cvc-compensation-trends [perma.cc/8V75-58LT].

169 That being said, the "intensity of the performance incentives created by the compensation structure gives rise to a corresponding incentive for the venture capital to monitor the portfolio company's

In order to ensure that funds are deployed effectively, corporate venture capitalists cannot "become entangled in the agendas of various corporate stakeholders or demotivated by inadequate or poorly designed financial incentives. That's why it's important that venture funds' goals be aligned with corporate objectives, approvals for funding be streamlined, and compensation levels match those offered by independent venture groups."[170] One study showed that there was a direct correlation between the performance of CVCs and payment structure—if the investment professionals employed by CVCs had similar performance pay to venture capital funds then their performance was better.[171]

Fourth, while venture capital funds are highly motivated to exit and strive to provide significant returns to their limited partners, CVCs do not operate within the same time limitations nor are they necessarily motivated by financial concerns. In fact, taking CVC money may have the unintended effect of allowing private companies to stay private longer because CVCs are not pushed to exit by limited partners like venture capital and private equity funds are.[172] The dramatic increase in corporate venture capital activity contributed to mind-boggling valuations of private companies. When corporate venture capital was deployed in later stage financings (at a rate of nearly thirty-

performance. This monitoring, together with the signaling properties of the entrepreneur's willingness to accept such powerful incentives, also serves to reduce information asymmetries." Gilson, *Engineering a Venture Capital Market*, *supra* note 84, at 1084.

170 *New Territories*, *supra* note 120.

171 *See* Gary Dushnitsky & Zur Shapira, *Entrepreneurial Finance Meets Organizational Reality: Comparing Investment Practices and Performance of Corporate and Independent Venture Capitalists*, 31 STRATEGIC MGMT. J. 990 (2010).

172 *See* COMM. ON CAPITAL MARKETS REGULATION, U.S. PUBLIC EQUITY MARKETS ARE STAGNATING (2017), http://www.capmktsreg.org/wp-content/uploads/2017/06/US-Public-Equity-Markets-are-Stagnating.pdf [perma.cc/4BKB-DCFG].

six percent)[173] with "tourist" investors, such as hedge funds and mutual funds, joining the venture capital financing bandwagon, company valuations spun out of control.[174] This, in turn, created the explosion of the unicorn phenomenon.[175] Now, private companies with arguably more weight and influence than some public companies choose to stay private longer.[176] There is a dearth of public company offerings and many companies are unwilling to contemplate a possible down round[177] because they view it as a failure.[178] Acquisitions are also not likely options for highly valued private companies since few companies can afford them.

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173 *See* NVCA, Corporate Venture Engagement Rise, *supra* note 58.

174 *See Unusual Suspects: Hedge Funds, Mutual Funds, and Banks Put the Brakes on Tech Startup Deals*, CB INSIGHTS (Mar. 15, 2016), https://www.cbinsights.com/blog/tech-crossover-investors-slowdown/ [perma.cc/R56Z-YLEC] (noting the effect of crossover or tourist investors, such as hedge funds and mutual funds during the unicorn boom: in 2015 alone, crossover investors invested more than $40 billion in almost 800 deals related to private technology companies).

175 *See* Fan, *supra* note 152 (discussing how the outsized effect of unicorns on the marketplace necessitates changes in the current disclosure regime under federal securities laws); Brad Feld, *Current Startup Market Emotional Biases*, FELD THOUGHTS (Apr. 21, 2016), http://www.feld.com/archives/2016/04/current-startup-market-emotional-biases.html [perma.cc/HDW5-ES22] (reflecting on Bill Gurley's post and discussing emotional biases which prevent the unicorns from taking part in down rounds; Feld urges looking to long-term value rather than paper value); *see also* Fred Wilson, *Don't Kick the Can Down the Road*, AVC (Apr. 21, 2016), http://avc.com/2016/04/dont-kick-the-can-down-the-road/ [perma.cc/2ZHG-JYJP] (calling for hard decisions to be made now rather than later regarding unicorns and other startups). For the definition of a down round, see *infra* note 177.

176 *See* Fan, *supra* note 152, at 637.

177 "A down round occurs in private financing when investors purchase stock or convertible bonds from a company at a lower valuation than the preceding round." *Down Round*, INVESTOPEDIA, http://www.investopedia.com/terms/d/downround.asp [perma.cc/ 5M6A-E6C6].

178 *See* Bill Gurley, *On the Road to Recap: Why the Unicorn Financing Market Just Became Dangerous . . . for All Involved*, ABOVE THE CROWD (Apr. 21, 2016), http://abovethecrowd.com/2016/04/21/on-the-road-to-recap/ [perma.cc/GP5Y-BDCW].

Investors in unicorns then turn to the secondary markets for liquidity; rank and file employees (unlike investors) may not be able to sell their shares on the secondary markets as they may be contractually bound from doing so.[179]

In the first quarter of 2016, there were no IPOs of venture capital-backed technology companies;[180] the technology IPO market at that time was reminiscent of the numbers during the Great Recession.[181] Although IPO activity was up in the second quarter of 2016 with sixteen IPOs (with eight VC-backed technology companies in this group), the first half of 2016 still lagged significantly behind the first half of 2015 with a forty-one percent drop.[182] Twilio, a communications application startup, completed the largest IPO of the

179 Unicorns do this all under the cloak of secrecy since very little disclosure is required of them. *See* Fan, *supra* note 152 (discussing the adverse consequences of the lack of disclosure required of unicorns).

180 William D. Cohan, *Good Luck Getting Out!*, FORTUNE (Feb. 1, 2016), http://fortune.com/silicon-valley-tech-ipo-market/ [perma.cc/DH2H-PYVQ] (discussing problems with the current way initial public offerings are conducted). There were, on average, thirty-six VC-backed IPOs per year from 2012–2014; that number decreased to twenty-three in 2015 with only seven IPOs occurring in the latter half of the year. *Id.* Also, the profitability of technology companies has plummeted—in 2015, the median EBITDA (earnings before interest, tax, depreciation and amortization) for tech companies was –$9 million. *Id.*

181 *See* Alison Griswold, *The Market for Tech IPOs Hasn't Been This Awful Since the Great Recession*, QUARTZ (Apr. 1, 2016), http://qz.com/652261/the-market-for-tech-ipos-hasnt-been-this-awful-since-the-great-recession/ [perma.cc/YW6H-FH76]; Rolfe Winkler, *For Silicon Valley, the Hangover Begins*, WALL ST. J. (Feb. 19, 2016, 8:12 PM), http://www.wsj.com/articles/for-silicon-valley-the-hangover-begins-1455930769 [perma.cc/KMT4-VSM4] (discussing how once-high-flying startups are now retrenching); Kevin Dowd, *Lackluster Opening for SecureWorks in First U.S. Tech IPO of 2016*, PITCHBOOK (Apr. 25, 2016), http://pitchbook.com/news/articles/lackluster-opening-for-secureworks-in-first-us-tech-ipo-of-2016 [perma.cc/CMY7-ASK9] (discussing how SecureWorks's lackluster opening may dissuade other tech companies from going public).

182 CB INSIGHTS, THE H1 2016 GLOBAL TECH EXITS REPORT 5 (2016).

quarter.[183] By the end of 2016, a total of forty-one venture-backed companies had gone public.[184] Things started to look up in 2017 with fifty-eight venture-backed companies going public, but the expected increase in IPOs after a promising beginning fizzled.[185]

On the merger and acquisition front, in the first three quarters of 2016, "[d]eal flow . . . slowed considerably" and there were fewer quality companies.[186] "There have been an average of [three] $1 [billion plus] exits in tech over the last six quarters. At this rate, it would take . . . [a] two-term presidency, plus another five years, for all the . . . tech unicorns to exit."[187]

However, if a startup is backed by a CVC, there may be positive outcomes regarding the following: (1) decisionmaking process of the startup to go public; (2) type of backing it receives during the IPO process; and (3) performance of the stock after going public. One study noted that when startups receive money from corporations they "are more likely to list their shares than are those championed by conventional venture groups."[188] In another study, researchers found that startups with money from corporations are more likely to attract the attention of

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[183] Twilio raised $150 million on the first day of its IPO. Corrie Driebusch, *Twilio Raises More than Expected in IPO*, WALL ST. J. (June 22, 2016, 7:31 PM), http://www.wsj.com/articles/twilio-ipo-tests-markets-appetite-for-tech-companies-1466606076 [perma.cc/45ER-D22R].

[184] NAT'L VENTURE CAPITAL ASS'N & PITCHBOOK, 4Q 2017 VENTURE MONITOR 3 (2017), https://files.pitchbook.com/website/files/pdf/4Q_2017_PitchBook_NVCA_Venture_Monitor.pdf [perma.cc/5DNY-PLQS].

[185] *Id.*

[186] PITCHBOOK, M&A REPORT 3Q 2016 (2016), https://pitchbook.com/news/reports/3q-2016-ma-report [perma.cc/EG3Q-FX63] (noting that the deals that do go through command "outsized multiples").

[187] E-mail Newsletter from Marcelo Ballve, Research Director, CB Insights, to CB Insights subscribers (Sept. 23, 2016, 4:18 PM) (on file with author).

[188] *If You Can't Beat Them, Buy Them*, *supra* note 156. In addition, "[a] bank in Silicon Valley estimated . . . that corporate [venture capital] yields three times the number of patents per dollar invested than in-house R&D." *Id.*

investment banks, equity analysts, and institutional investors when they go public when compared to those backed by venture capital funds.[189] The researchers further showed that in the first three years as public companies, those that were backed by corporate venture capital funds did better, on average, on stock price performance than such venture capital funds.[190]

Fifth, although not required by the venture capital financing documents, the venture capital fund "is expected to make important noncash contributions to the portfolio company."[191] It helps a startup recruit the management team, intensively monitors the performance of the startup, and uses its reputation capital to give credibility to the startup with respect to potential customers, suppliers, and employees.[192] CVCs, on the other hand, offer other non-financial contributions, including access to the resources and opportunities afforded to parent companies of CVCs, possible collaboration with market development and sales, access to follow-on funding, and the infrastructure of the corporate parent.[193] In particular, Dave McClure, who was previously at 500 Startups, stated that the "primary advantage that corporate VC has over traditional VC is customers and distribution."[194] However, the problem is that those who run venture capital funds remain leery of CVCs.

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189 *See generally* Thomas J. Chemmanur et al., *Corporate Venture Capital, Value Creation, and Innovation*, 27 REV. FIN. STUD. 2434 (2014).

190 *See id.*

191 Gilson, *Engineering a Venture Capital Market*, *supra* note 84, at 1072.

192 *Id.*

193 Robert C. White, Jr., *Corporate Venture Capital Investments—Good for Startups?*, SEC. EDGE (Feb. 2, 2016), http://www.thesecuritiesedge.com/2016/02/corporate-venture-capital-investments-good-for-startups/ [perma.cc/UBZ4-DX76].

194 *Startups Are the New Corporate R&D*, CB INSIGHTS (Jan. 13, 2017), https://www.cbinsights.com/blog/corporate-vc-startup-innovation/ [perma.cc/M7M3-J7YS].

With notable exceptions, such as Intel Capital[195] and GV,[196] leaders of venture capital funds generally do not hold corporate venture capitalists in high esteem, derisively characterizing them as "innovation theater"[197] or "dumb money"[198] because they view CVCs as adding little value and not being as valuation-sensitive. In fact, some venture capitalists argue that CVC investments can be harmful to startups.[199] When Alphabet (formerly Google) initially considered forming a corporate venture capital arm, it was not well received.[200] Union Square Ventures' Fred Wilson

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195 *See* INTEL CAPITAL, http://www.intelcapital.com/ [perma.cc/UJC8-NH66].

196 When Google first contemplated a corporate venture capital arm, noted venture capitalist Fred Wilson, a partner at Union Square Ventures, one of the most prominent venture capital firms, said:

> We like working with corporate investors in the right situations and we'd certainly love to work with Google considering all that they bring to the table. But I do think that venture investing is not the best use of a corporation's capital and that it is inevitable that it will produce sub-par returns at best and significant losses at worst. And as a Google shareholder, I'd prefer to see them do something else with all that money they are making.

Fred Wilson, *Corporate Venture Capital*, AVC (July 31, 2008), http://avc.com/2008/07/corporate-ventu/ [perma.cc/22YB-6JAB]. Mr. Wilson also states that corporate venture capital can't keep the talent that it needs; a successful investment is just a one-time gain for the parent company; and there is a misalignment of the motives of the corporate venture capital arm on the one hand and the founders, management, and financial investors on the other. *See id.*

197 *CB Insights Presents: Corporate Innovation Theater in 8 Acts*, CB INSIGHTS (Dec. 16, 2015), https://www.cbinsights.com/blog/corporate-innovation-theatre/ [perma.cc/Q33N-LDAH].

198 Mark Lennon, *Corporate Venture Investors Starting to Look a Lot More Like Private VCs*, TECHCRUNCH (Nov. 5, 2013), http://techcrunch.com/2013/11/05/corporate-venture-investors-starting-to-look-a-lot-more-like-private-vcs/ [perma.cc/WE5V-7HJ4].

199 *See* discussion *supra* note 196.

200 "'There were some in the venture world who weren't particularly welcoming to Bill [Maris, head of what was then called Google Ventures,] or Google Ventures,' recalls John Doerr, a legendary partner at Kleiner

said as recently as 2016 that when startups take money from corporations they are "doing business with the devil" and that "[c]orporate investing is dumb."[201] Mr. Wilson opined, "These type of investments and relationships have almost universally 'sucked' for our portfolio companies. The corporate strategic investor's objectives are generally at odds with the objectives of the entrepreneur, the company, and the financial investors. I strongly advise against entering into these kinds of relationships."[202] He is not alone in his unfavorable sentiment about CVC. Keith Rabois, a partner at Khosla Ventures, intimated that GV's ability to lead rounds in high profile companies was easier because financial returns did not concern GV.[203] He said, it was "much easier to lead rounds if you don't care about earning a return."[204] Bill Gurley, a general partner at another VC firm, Benchmark Capital, observed, "There is an inherent paradox to the notion of corporate venture . . . ."[205] As a result, some

Perkins Caufield & Byers, one of the most important first-generation California [traditional venture capital] firms." Katrina Brooker, *Google Ventures and the Search for Immortality*, BLOOMBERG: MKTS. (Mar. 8, 2015, 9:01 PM), http://www.bloomberg.com/news/articles/2015-03-09/google-ventures-bill-maris-investing-in-idea-of-living-to-500/ [perma.cc/W9WG-PWV2].

201 *The History of CVC*, *supra* note 18. In 2013, Fred Wilson said that he would "never ever ever ever do" a deal with corporate venture capitalists. *The Rise of Corporations in Tech Venture Capital Investment—Are Tech VCs Going to Have to Play Nice with Corporate Investors?*, CB INSIGHTS (Sept. 23, 2013), https://www.cbinsights.com/blog/tech-corporate-venture-capital-balance-sheet/ [perma.cc/F2JS-85X5].

202 Fred Wilson, *On Corporate VCs*, AVC (June 20, 2013), http://avc.com/2013/06/on-corporate-vcs/ [perma.cc/BC7A-3FEP].

203 *See* Keith Rabois (@Rabois), TWITTER (Sept. 22, 2013, 2:40 PM), https://twitter.com/rabois/status/381895737505624064/ [perma.cc/VU7G-43RC].

204 *Id.*

205 Brooker, *supra* note 200. "The conflict is, do the fund's loyalties lie with the startup or with the parent? Just about every independent venture capitalist in tech has stories of being burned by corporate funds." *Id.* The corporation either uses its CVC investment to gather intelligence and competes with the startup or no longer has an interest and decides not to fund the startup. *Id.*

CVCs, particularly those with no reputation in venture investing or who are not as well-established, may find it difficult to syndicate (e.g., put together groups of investors), which is critical to most venture capital investing.

The implicit contract between general partners and their portfolio companies is that when the startup transfers discretion to the general partners, the general partners are then policed by a reputation market. In other words, since general partners are repeat players in the venture capital industry, there is an understanding between them and their portfolio companies that they will act appropriately and conform to shared expectations based on previous deals in the venture capital arena.[206] Given that many of the CVCs are new players in venture capital financings, they do not have much in the way of reputation capital. Therefore, it is up to the venture capital funds or entrepreneurs to obtain information about the CVC since they cannot rely on reputation capital.

There are three components that are necessary for a reputation market to operate. First, the party whose discretion will be policed by the market must anticipate repeated future transactions. Second, participants must have shared expectations of what constitutes appropriate behavior by the party to whom discretion has been transferred. Finally, those who will deal with the advantaged party in the future must be able to observe whether that party's behavior in past dealings conforms to shared expectations.[207]

However, as Part III shows, information is limited in all these areas for CVCs. As a result, there is a question of how startups obtain the potential information that they need about a CVC arm since many of them do not have the same reputational aspects that venture capital funds do.

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[206] *See* Gilson, *Engineering a Venture Capital Market*, *supra* note 84, at 1086.

[207] *Id.*

III. CHALLENGES OF CVC IN PRIVATE ORDERING

In Part II, this Article discussed how private ordering addresses the three major problems of financial contacts: uncertainty, information asymmetry, and opportunism in the form of agency costs. Specifically, it discussed how CVC impacts five techniques—staged financing, control, compensation, exit, and reliance on implicit contracts (i.e., the role of the reputation market)—which have historically worked well in the venture capital fund and entrepreneur context. Using five case studies, this Part examines the challenges facing CVCs with respect to private ordering in the VC context, highlighting both the promise and perils of CVC.

A. GV Case Study

GV is one of the most prolific CVCs—in the seed stage alone, it is the fourth most active seed investor in all of venture capital.[208] GV has a formidable array of resources to entice startups to work with it, including that any startup it invests in can have access to anyone at Google.[209] It also has a design team that has been likened to a SWAT team for startups that can troubleshoot any problem a startup may have.[210] GV's diverse investments are illustrated by its recent exits.[211] Under Chesbrough's framework, GV would be engaging in emergent investments. The startups it invests in are outside its core business (Google) and instead suggest

[208] Since 2010, GV has invested in 135 seed-stage deals making it the fourth most active seed investor among all venture capital investors. *The 5 Most Active Seed Investors*, PITCHBOOK (May 2, 2016), http://pitchbook.com/newsletter/the-5-most-active-seed-investors/ [perma.cc/U73P-MX3E].

[209] *See* Brooker, *supra* note 200.

[210] *Id.*

[211] *Google Strategy Teardown: Betting the Future on AI, Cloud Services, and (Tamed) Moonshots*, CB INSIGHTS (Oct. 20, 2016), https://www.cbinsights.com/research/report/google-strategy-teardown/#gv/ [perma.cc/E3S3-HLMP].

future directions in which the company is heading.[212] Alphabet Inc., a Delaware corporation ("Alphabet"), is the public holding company of Google.[213] Alphabet's Form 10-K for the fiscal year ended December 31, 2016 states, "Google is not a conventional company. We do not intend to become one . . . . [We] make smaller bets in areas that might seem very speculative or even strange when compared to our current businesses."[214] These bets that they refer to are reported as "Other Bets" and include GV, along with a few other businesses that are not part of Google's core business; these various operating segments are characterized as not individually material.[215] Other Bets is mentioned forty-two times in the Form 10-K, primarily in the financial section.[216] Other Bets revenue is listed as $327 million in 2014, $445 million in 2015, and $809 million in 2016.[217] It had operating losses of $1.893 billion in 2014, $3.456 billion in 2015, and $3.578 billion in 2016.[218]

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212 Alphabet Inc., Annual Report (Form 10-K), at 3 (Feb. 2, 2017), https://www.sec.gov/Archives/edgar/data/1652044/000165204417000008/goog10-kq42016.htm [perma.cc/N8EX-8JNU] [hereinafter Alphabet Form 10-K].

213 According to the company's Form 10-K,

> Alphabet is a collection of businesses—the largest of which, of course, is Google. It also includes businesses that are generally pretty far afield of our main Internet products such as Access, Calico, CapitalG, GV, Nest, Verily, Waymo, and X. We report all non-Google businesses collectively as Other Bets. Our Alphabet structure is about helping each of our businesses prosper through strong leaders and independence.

Id.

214 *Id.*

215 *See id.*

216 A search for "Other Bets" in the Form 10-K yielded thirty-five hits.

217 Alphabet Form 10-K, *supra* note 212, at 24. "Revenues from the Other Bets are derived primarily through the sales of internet and TV services through Google Fiber, sales of Nest products and services, and licensing and R&D services through Verily." *Id.* at 23.

218 *Id.* at 80.

More specifically, in the risk factors section of its Form 10-K for the fiscal year ended December 31, 2016. Alphabet notes, "[m]aintaining and enhancing the brands of both Google and Other Bets increases our ability to enter new categories and launch new and innovative products that better serve the needs of our users."[219] This statement indicates the potential influence that GV's investment in a particular startup could have for the long-term goals of Alphabet.[220] There was no specific information about GV in Alphabet's Form 10-K for the fiscal year ended December 31, 2016. However, there were references to "Non-Marketable Investments," which undoubtedly included GV-related investments.[221]

As of June 2017, GV had $2.4 billion in assets under management of which $167.56 million was "dry powder."[222] In addition, it had a total of 570 investments and 141 exits, and fifty-one professionals working for GV.[223] According to a PitchBook report, GV's investment preferences are as follows: (1) its preferred investment amount is between $0.25 million to $50 million; (2) it prefers a minority stake; (3) it prefers to originate a deal; (4) it will lead a deal; and (5) it

[219] *Id.* at 13.

[220] GV is mentioned in Alphabet's filings with the SEC, but it differs from most other in-house CVC funds. "The firm makes its investments independent of its parent's corporate strategy. It can back any company it wants, whether or not it fits with Google's plans. The fund also can sell its stakes to whomever it wants, including Google competitors. Facebook and Yahoo have bought startups funded by [GV]." Brooker, *supra* note 200.

[221] The line item "Purchases of non-marketable investments" in the Notes to the Consolidated Financial Statements is of particular interest because it indicates the amount of money spent on equity investments and debt securities. Alphabet Form 10-K, *supra* note 212, at 46.

[222] *See GV*, PITCHBOOK, https://my.pitchbook.com/#page/profile_178611086 [hereinafter *GV PitchBook Report*]. Dry powder is defined as "a slang term referring to marketable securities that are highly liquid and considered cash-like." *Dry Powder*, INVESTOPEDIA, http://www.investopedia.com/terms/d/drypowder.asp [perma.cc/U637-NBWB].

[223] *See GV PitchBook Report*, *supra* note 222.

will syndicate.[224] This information, however, was not available in any SEC filing, but through PitchBook, a comprehensive database that provides information and analytics about investments.[225] This database is a resource that is only available through a paid subscription and is not available to (or affordable for) everyone. Although not required by law to report such information for the benefit of startups, more transparency helps startups that GV invests in or is considering investing in to have a better understanding of how they fit into GV's long-term strategy.

In May 2017, GV invested in a number of startups. The investments included $15 million in the Series B round of FullStory, a software company; $50 million in the Series B round of Magenta Therapeutics, a biotechnology company and drug developer; and $10 million in the Series A round of Abundant Robotics, an apple-picking robot manufacturer.[226]

Like venture capital funds, GV engages in staged financing and has disproportionate control compared to its equity in any given portfolio company.[227] It is unclear whether its compensation structure mimics venture capital funds.[228] GV is not motivated to exit as venture capital funds are since it does not have limited partners that it needs to provide substantial returns for. That being said, however, it

224 *See id.*

225 *See generally* PITCHBOOK, https://pitchbook.com/ [perma.cc/8S6K-AMYC]. The report generated by PitchBook's platform also contains information on the parent and sister companies of GV, all investments, exits and co-investors, stated investment preferences, service providers, and related news. *See GV PitchBook Report*, *supra* note 222.

226 *GV PitchBook Report*, *supra* note 222. Alphabet may consider incorporating this more specific information into its periodic reports in tabular format as it gives more context to the information it currently provides on its CVC investments.

227 *See generally Google Strategy Teardown*, *supra* note 211.

228 There has been cursory mention of "competitive compensation," and "carried interest" but not much in the way of details. *See* Dan Primack, *Bill Maris Steps Down as CEO of Google Ventures*, FORTUNE (Aug. 10, 2016), http://fortune.com/2016/08/10/bill-maris-google-ventures/ [perma.cc/DS8R-9Z2X].

has among the highest number of exits among CVCs.[229] Although initially looked upon with disdain by venture capital funds, GV is now highly regarded and reputable in the eyes of the venture capital community.[230] Since it is a repeat player in the venture capital arena that venture capital funds want to syndicate with,[231] there is an implicit contract that GV will act how the traditional venture capital firms have become accustomed to it acting. Also, GV provides nonfinancial help by providing access to its infrastructure and talent as noted in the initial description of it above.[232]

Although GV acts more like a venture capital fund and has established a reputation in venture capital given its longevity, it diverges from a venture capital fund in the control category of private ordering. As a general matter, CVCs need to tread carefully when determining the appropriate number of boards that they can serve on and what type of decisions they may need to recuse themselves from. This can help address concerns that governance procedures are being ignored in the startup context. In the 2009 survey "A Seat at the Table Study" conducted by the National Venture Capital Association and venture capital research firm Dow Jones VentureSource, the two organizations reported that venture capitalists serve on an average of 4.4 boards (compared to 4 in 2006), but venture capitalists believe that 4.6 board seats for early-stage companies and 5.4 for later-stage companies is ideal; chief executive officers, in contrast, believe that the ideal number

229 *Analyzing the Top Corporate VCs by Exits—and How Early They Got In*, CB INSIGHTS (Aug. 27, 2015), https://www.cbinsights.com/research/top-corporate-venture-firms-exits/ [perma.cc/YSK3-FEDM].

230 *Compare* Richard Waters, *Bumbpy Ride for Google Ventures*, FIN. TIMES (Dec. 6, 2015), https://www.ft.com/content/de210fe6-9c3b-11e5-b45d-4812f209f861 *with* Michael Rapoport, *What's Behind $3 Billion of Alphabet's Earnings Gains*, WALL ST. J. (April 24, 2018 1:11 PM), https://blogs.wsj.com/moneybeat/2018/04/24/whats-behind-3-billion-of-alphabets-earnings-gain/.

231 *See Google Strategy Teardown*, *supra* note 211.

232 *Id.*

of board seats for VCs is 3.8 seats for early-stage companies and 4.2 for later-stage companies.[233] GV typically gets a seat on the board as an investor in a private company. Out of the "Top 25 Board Seats" in a PitchBook report on GV, only three were board observers; the remaining twenty-two were voting board seats.[234] One of the general partners of GV, Andrew Wheeler, is on seven of the "Top 25 Board Seats" representing GV's interests;[235] Mr. Wheeler serves on the boards of thirteen companies in the aggregate.[236] In light of the increasing complexity of private companies (e.g., Uber and other unicorns) and startups staying private longer, the question is whether service on such a high number of boards remains manageable. Former SEC Chair Mary Jo White observed, "As the latest batch of [startups] mature, generate revenue, achieve significant valuations, but stay private, it is important to assess whether they are likewise maturing their governance structures and internal control environments to match their size and market impact."[237] She suggested that startups should look at expanding board seats to include those who have had experience with large

[233] Scott Austin, *New Study Peers into Venture-Backed Company Boardroom*, WALL ST. J.: VENTURE CAPITAL DISPATCH (Nov. 10, 2009, 7:58 AM), http://blogs.wsj.com/venturecapital/2009/11/10/new-study-peers-into-venture-backed-company-boardroom/ [perma.cc/L88X-JE79].

[234] *See GV PitchBook Report*, *supra* note 222.

[235] *See id.* Note that the report only covers the top twenty-five board seats—he could be on more since GV has 501 total investments. Richard Miner, another General Partner of GV, sits on four of the top twenty-five boards and Krishna Yeshwant, yet another General Partner of GV, sits on two. *See id.*

[236] *See Andrew Wheeler*, PITCHBOOK, https://my-pitchbook-com/#page/profile_793205757.

[237] Mary Jo White, Chair, Sec. Exch. Comm'n, Keynote Address at the SEC-Rock Center on Corporate Governance Silicon Valley Initiative (Mar. 31, 2016), https://www.sec.gov/news/speech/chair-white-silicon-valley-initiative-3-31-16.html/ [perma.cc/X7XG-D6UP] (discussing private companies—with particular references to unicorns—and the role of SEC rules and regulatory actions to foster innovation while protecting investors).

companies and public companies.[238] In this manner, having board members designated by CVCs may be helpful since they provide a public company perspective that board members representing a venture capital fund typically cannot. Additionally, she stressed the importance of having board members with the appropriate regulatory and financial expertise, including those with relevant industry expertise to ensure differing viewpoints and the ability to spot critical issues.[239]

Part of what private ordering strives to do is prevent opportunistic behavior by either the entrepreneur or venture capital fund through the five techniques discussed earlier. There may be more of a danger of opportunistic behavior and potential conflicts of interest for CVCs, however, since they do not have the same motivations as venture capital funds. For example, Alphabet has developed autonomous driving vehicles and has invested heavily (through GV) in competitors in the space, such as Uber.[240] Interestingly, David Krane, the managing partner and CEO of GV, sat on Uber's board.[241] Although Mr. Krane has very close ties to Alphabet—he was one of Google's first 100 employees and has been involved with a number of Google's $1 billion plus exits—he remained a member of the Uber board until recently.[242] The conflicts have only intensified in recent

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[238] *See id.*

[239] *See id.*

[240] *See* E-mail Newsletter from Kerry Wu, Auto Tech Industry Analyst, CB Insights, to Auto Tech Insights by CB Insights subscribers (Sept. 1, 2016, 8:33 PM) (on file with author); Mikey Tom, *Alphabet, Uber Set to Go Head-to-Head*, PITCHBOOK (Aug. 30, 2016), http://pitchbook.com/news/articles/alphabet-and-uber-set-to-go-head-to-head/ [perma.cc/U78J-7P2J]; Mark Bergen, *Google Ventures' New Chief, David Krane, Is the Überconnector*, RECODE (Aug. 12, 2016, 2:10 PM), http://www.recode.net/2016/8/12/12445218/google-ventures-david-krane-connector [perma.cc/E349-4S89]; *Uber Technologies*, PITCHBOOK, https://my.pitchbook.com/#page/profile_1141265663 [hereinafter *Uber PitchBook Report*].

[241] *See Uber PitchBook Report*, *supra* note 240.

[242] *See* Bergen, *supra* note 240.

months. Waymo, which recently spun-out from Alphabet, filed a lawsuit against one of GV's portfolio companies, Uber, alleging theft of trade secrets and intellectual property and patent infringement of Waymo's LiDAR technology by Otto, which was acquired by Uber on August 18, 2016.[243]

B. Intel Capital Case Study

Intel Capital, a Delaware corporation and wholly-owned subsidiary of Intel Corporation ("Intel"),[244] is one of the most prolific investors in the corporate venture capital world. Under Chesbrough's framework, Intel Capital is making enabling investments. It invests in startups that will expand the ecosystem of companies that use Intel's products. Despite that fact, Intel's Form 10-K for the fiscal year ended December 31, 2016 does not mention Intel Capital at all[245] and there is an oblique reference to investments in the risk factors section.[246] Since it began in 1991, "Intel Capital has

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243 Romain Dillet, *Uber Acquires Otto to Lead Uber's Self-Driving Car Effort*, TECHCRUNCH (Aug. 18, 2016), https://techcrunch.com/2016/08/18/uber-acquires-otto-to-lead-ubers-self-driving-car-effort-report-says/ [perma.cc/QQ68-YTZG]; Daisuke Wakabayshi, *Uber and Waymo Settle Trade Secret Suit Over Driverless Cars*, N.Y. Times (Feb. 9, 2018), https://www.nytimes.com/2018/02/09/technology/uber-waymo-lawsuit-driverless.html. "LiDAR" stands for "light detection and ranging." *What is LIDAR?*, NAT'L OCEANIC AND ATMOSPHERIC ADMIN., http://oceanservice.noaa.gov/facts/lidar.html/ [perma.cc/9WRF-6AZ8]. LiDAR has risen to the forefront as a piece of technology to further the development of self-driving cars.

244 Intel Corp., Annual Report (Form 10-K), Ex. 21.1 (Feb. 17, 2017), https://www.sec.gov/Archives/edgar/data/50863/000005086317000012/ex21112312016q4.html/ [perma.cc/3SXV-BTQZ].

245 Intel Corp., Annual Report (Form 10-K) (Feb. 17, 2017), https://www.sec.gov/Archives/edgar/data/50863/000005086317000012/a10kdocument12312016q4.html/ [perma.cc/9MNM-APU9] [hereinafter Intel Corp. Form 10-K].

246 In the "Risk Factors" section under the subheading, "We are subject to risks associated with transactions[,]" Intel states:

> We invest in companies around the world that we believe will further our strategic objectives, stimulate growth in the digital economy, create new business opportunities for

invested about $12.2 billion in 1,500 companies" in fifty-seven countries across a range of sectors including security, wearable technology and digital media, according to the company's website.[247] It is also the leading investor (among institutional venture capital investors and CVCs) in certain areas, such as the cybersecurity space.[248] In addition, Intel has invested heavily in the drone space and is the top CVC investor in the robotics realm.[249] Intel's R&D as a percentage of net revenue was 21.4 percent, equating to $12.740 billion.[250] It is unclear whether Intel Capital is included in the R&D number.

Intel Capital has been at the forefront of venture capital investments in newer areas, such as the Internet of Things ("IoT"); it has invested in seventeen IoT deals since 2010.[251]

> Intel, and generate financial returns. Our investments take different forms, including acquisition of companies to further advance our strategic objectives . . . .

Id. at 21.

247 *Our Advantage*, INTEL CAPITAL, http://www.intelcapital.com/advantage/index.html [perma.cc/ZVB5-HHDC].

248 *The Most Active Cybersecurity VC Investors and Their Investments in One Infographic*, CB INSIGHTS (Aug. 3, 2016), https://www.cbinsights.com/blog/cybersecurity-most-active-investor-infographic/ [perma.cc/T8YM-4CKA].

249 *See* E-mail Newsletter from Anand Sanwal, CEO & Co-Founder, CB Insights, to CB Insights subscribers (Oct. 6, 2016, 4:05 PM) (on file with author).

250 Intel Corp. Form 10-K, *supra* note 245, at 27.

251 Internet of Things refers to the "concept of . . . connecting any device with an on and off switch to the Internet (and/or to each other)." Jacob Morgan, *A Simple Explanation of "The Internet of Things"*, FORBES: LEADERSHIP (May 13, 2014, 12:05 AM), http://www.forbes.com/sites/jacobmorgan/2014/05/13/simple-explanation-internet-things-that-anyone-can-understand/ [https://web.archive.org/web/20180203124208/https://www.forbes.com/sites/jacobmorgan/2014/05/13/simple-explanation-internet-things-that-anyone-can-understand/]. Since 2010, 844 investors have participated in at least one IoT deal; $1.22 billion was invested in 199 deals. Adley Bowen, *A Pile of Dead Unicorns Is Not Around the Corner*, PITCHBOOK (May 9, 2016), http://pitchbook.com/news/articles/a-pile-of-dead-unicorns-is-not-around-the-corner [perma.cc/NH8U-4YF5]. Two other CVCs were in the top five

It has been quite active in the drone space as well.[252] Intel's corporate venture capital investments are noted in five sections in its Form 10-K: Risk Factors; Management's Discussion and Analysis of Financial Conditions and Results of Operations; Quantitative and Qualitative Disclosures About Market Risk; Consolidated Statements of Cash Flows; and Notes to Consolidated Financial Statements. However, the Form 10-K does not tie those investments explicitly to Intel Capital.[253] It states in part, "We regularly invest in non-marketable equity instruments of private companies, which range from early-stage companies that are often still defining their strategic direction to more mature companies with established revenue streams and business models."[254] Intel reported that the carrying value of its non-marketable equity investment portfolio amounted to $4.4 billion as of December 31, 2016[255] and specified that such investments were "classified within other long-term assets . . . ."[256] A number of items fall under long-term assets and only after reviewing the Form 10-K several times, did the author discover that the information about CVC investments was

for IoT investments: Cisco Investments was tied with Kleiner Perkins Caufield & Byers for second place and Qualcomm Ventures was tied for fifth place with Kima Ventures. *See id.*

[252] Intel Capital, Airware's Commercial Drone Fund (a venture arm for Airware, a drone startup), and GV were tied for second most active CVCs. *See Qualcomm, Intel, and Google Ventures Among the Top Corporates Betting on Drones*, CB INSIGHTS (May 10, 2016), https://www.cbinsights.com/blog/drone-startups-corporate-investment/ [perma.cc/RT34-DE7F]. Qualcomm Ventures was also noted as another corporate venture arm increasingly active in the drone space; it was ranked the top CVC in this space. *See id.* In 2012, only one CVC participated in a drone-related startup; by 2015 the number of deals had dramatically increased. *See id.* Most of the more recent deals were focused on seed or Series A stages (partially because there were no later stage deals since it is a relatively new area of investment). *See id.*

[253] Intel Corp. Form 10-K, *supra* note 245.

[254] *Id.* at 60.

[255] This number excludes equity derivatives. *Id.*

[256] *Id.*

buried in the section addressing equity method investments.[257]

Although Intel provided some information about its investments in private companies, it was somewhat opaque and obscure. As was the case with GV, the most pertinent information came from a non-publicly available source, PitchBook. According to PitchBook, Intel Capital has $1.30 billion in assets under management, a total of 1610 investments, and 705 exits.[258] There are seventy-nine professionals who work at Intel Capital, and a management team that oversees it.[259] In any given month, Intel Capital may have a number of investments at different stages of the portfolio companies. For example, in May 2017, Intel Capital invested almost $84 million in three different ventures, including $65.32 million in the later stage Series B round of Peloton Technology, an automated vehicle technology company specializing in freight transportation.[260]

Despite the fact that Intel Capital has been doing CVC investments longer than most corporations, it does not always subscribe to the private ordering framework. For example, it may not stage its financings which may impact the portfolio's company's particular expectations as well as the venture capital funds that may be investing alongside Intel Capital. Intel Capital may decide to fund the company in one big round like they did in the case of Cloudera, a

[257] The equity method "is an accounting technique used by firms to assess the profits earned by their investments in other companies." *Equity Method*, INVESTOPEDIA, http://www.investopedia.com/terms/e/equitymethod.asp/ [perma.cc/JQP4-UJ6M]. It is commonly used "when one company has significant influence over another. When a company holds approximately twenty to twenty-five percent or more of another company's stock, it is considered to have significant control, which signifies the power one company can exert over another company. This power includes representation on the board of directors." *Id.*

[258] *Intel Capital*, PITCHBOOK, https://my-pitchbook-com/#page/profile_402709779 (last visited April 25, 2018) [hereinafter *Intel Capital PitchBook Report*].

[259] *See id.*

[260] *See id.*

software company, which went public in 2017.[261] This, in turn, skews the valuation of the company. Cloudera ultimately ended up going public at a valuation below the valuation at which Intel Capital invested.[262] It is also unclear how intensively Intel Capital monitors its portfolio companies or provides its marketing and infrastructure might to them. Since Intel Capital falls under Chesbrough's enabling investments category, its main motivation is to build up its ecosystem of potential customers, not to necessarily help the company with an exit.[263] Therefore, like with most CVCs, the lack of impetus to exit in some ways misaligns their goals with the venture capital funds and entrepreneurs. With respect to the compensation question, there are no publicly available sources that detail how Intel Capital compensates those who invest on their behalf. However, given that Intel Capital is a wholly-owned subsidiary, those that make the investment decisions most likely receive carried interest.[264] Lastly, like GV, Intel

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[261] Katie Roof, *Cloudera Posts Long-Awaited IPO Filing*, TECHCRUNCH (Mar. 31, 2017), https://techcrunch.com/2017/03/31/cloudera-posts-long-awaited-ipo-filing/ [perma.cc/47A3-V83M].

[262] Cloudera had a valuation of $4.1 billion after its Series F round in 2014, but was valued at about $1.9 billion at IPO. *Id.*; Cromwell Schubarth, *Cloudera Raises $225M in IPO that Tops Target but Slashes Valuation,* SILICON VALLEY BUS. J. (Apr. 28, 2017, 6:20 AM), http://www.bizjournals.com/sanjose/news/2017/04/27/cloudera-raises-225m-in-ipo-that-tops-targets-but.html/ [perma.cc/4XRG-8RSD].

[263] *See* discussion *supra* Section II.C and accompanying notes describing Chesbrough's framework.

[264] See discussion *supra* Section II.C and accompanying notes detailing the different rationales for structuring a CVC in a particular manner. In a study done in 2013, the discrepancy between CVCs and venture capital firms was stark. "[In 2013], [c]orporate venturing unit leaders on average earn[ed] $304,250 a year, with a further $164,865 as cash bonus. A similar 2012 survey by bank JPMorgan and J Thelander Consulting found the top-ranking financial venture capitalist (VC) at a firm managing less than $1bn earned $541,329 on average in the 2011-12 period with a bonus of $868,092." James Mawson, *Spotlight on Compensation*, GLOBAL CORP. VENTURING (Sept. 9, 2013),

Capital has good standing in the reputation market because venture capital funds believe they are dealing with a known quantity given the involvement of Intel Capital in a high number of deals over a few decades' time.

C. Acre Venture Partners Case Study

The food industry is undergoing tremendous change right now—some even say a revolution.[265] Every year, an increasing number of new products proliferate in the marketplace.[266] The dollar amount that corporate venture capital invested in the consumer packaged goods ("CPG") space increased by a multiple of eight from 2011 to 2015 and well-known corporate players play a significant role.[267] More

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http://www.globalcorporateventuring.com/article.php/6966/spotlight-on-compensation/ [perma.cc/AS2V-ZWTJ].

[265] "'The food industry is in a time of revolution,' said Campbell Soup President and CEO Denise Morrison." Brian Sozzi, *Amid Food Revolution, Campbell Starts $125 Million Venture Fund*, THESTREET (Feb. 17, 2016, 1:08 PM), http://www.thestreet.com/story/13461909/1/amid-food-revolution-campbell-soup-starts-125-million-venture-fund.html/ [perma.cc/Y2P2-A6KL]. "Referring to the packaged-food industry as being in the middle of a 'period of revolutionary change,' Chief Executive Officer Denise Morrison . . . cited major cultural changes, changes in the size of American households, and a growing movement toward simpler foods and organics." Brian Sozzi, *Campbell's Soup CEO: "I Have Never Seen Industry Conditions Like Today,"* THESTREET (July 22, 2015, 7:36 PM), http://www.thestreet.com/story/13227872/1/campbells-soup-ceo-i-have-never-seen-industry-conditions-like-today.html/ [perma.cc/XQ2H-PZZ7].

[266] *See* CB INSIGHTS WEBINAR: THE CHANGING LANDSCAPE OF CONSUMER PACKAGED GOODS: WHAT'S CHANGING TODAY, WHO'S DOING IT, AND WHAT THE FUTURE HOLDS slide 40 (2016), http://www.slideshare.net/CBInsights/the-changing-landscape-of-consumer-packaged-goods/ [perma.cc/VN3M-YPXV] [hereinafter CB INSIGHTS WEBINAR] (graph showing increase in new food and non-food products in the consumer packaged goods space).

[267] *Big CPG Corporates: Where They're Investing in Food, Personal Care, Tech, and More*, CB INSIGHTS (Apr. 25, 2016), https://www.cbinsights.com/blog/consumer-packaged-goods-startup-bets/ [perma.cc/L7RY-GWVQ] (mentioning Coca-Cola Company, Unilever, General Mills, and Anheuser-Busch as active investors in and acquirers of private companies with a quarter of the investments in private companies

than $6 billion in funding has been invested in 400 food startups since 2010.[268] Unsurprisingly, the top acquirers of these startups are large corporations.[269]

To cite one example of this change, this Article will discuss how Campbell Soup Company, a New Jersey corporation ("Campbell Soup"), became involved in corporate venture capital. In an attempt to innovate in the ever-competitive CPG space, Campbell Soup launched fourteen new products (both beverages and dressings) under its Bolthouse Farms brand in the spring of 2015, and also announced plans to expand its 1915 organic fresh pressed juice brand.[270] In August 2015, Campbell Soup launched three new organic, non-genetically modified chicken noodle varieties aimed at kids.[271] Despite these efforts to make themselves relevant, Campbell Soup decided that it needed to innovate in a different way.

In February 2016, Campbell Soup announced the formation of Acre Venture Partners, a Delaware limited partnership ("Acre Venture Partners"), intending to make venture capital investments in innovative new companies in food and food-related industries. Campbell Finance 2 Corp., an indirect wholly-owned subsidiary of Campbell, is the sole

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by these players to seed, angel, or Series A rounds and sixty mergers and acquisition transactions from 2011 to 2015).

268 Annie Gasparro, *Campbell Invests $125 Million in Project to Fund Food Startups*, WALL ST. J. (Feb. 17, 2016, 9:09 PM), http://www.wsj.com/articles/campbell-invests-125-million-in-project-to-fund-food-startups-1455750400/ [perma.cc/9U3Z-TQNC].

269 CB INSIGHTS WEBINAR, *supra* note 266, at slide 19. Note that innovation in the CPG space does not come from R&D; compared to advertising costs, R&D is a small expenditure. *Id.* at slide 28. Interestingly, CPG corporates (not necessarily CVCs) increasingly invested in CPG startups in 2014, 2015 and Q1 '16 once non-CPG corporates such as GV and Comcast Ventures did so. *CPG Is Still Hot: 100+ Deals in Q1'16, Corporates Participate More*, CB INSIGHTS (May 15, 2016), https://www.cbinsights.com/reasearch/cpg-startup-financing-q1-2016/ [https://perma.cc/S5QY-7C7G].

270 Sozzi, *Amid Food Revolution*, *supra* note 265.

271 Sozzi, *Campbell's Soup CEO*, *supra* note 265.

limited partner of Acre Venture Partners.[272] Under Chesbrough's framework, Campbell Soup makes driving investments meaning that its investments in CPG startups are tightly linked to its strategic and operational goals.

Acre Ventures GP, manages Acre Venture Partners, which is independent of Campbell Soup.[273] Jeff Dunn, president of the company's Campbell Fresh division, is the Campbell Soup representative on the investment committee of Acre.[274] Campbell Soup agreed to make a $125 million capital commitment to Acre Venture Partners.[275]

Acre Venture Partners has made multiple recent investments. As an example, it invested $40 million in the later stage Series C round of Farmer's Business Network, an analytic and data management company for farms. It also invested $20 million in the early stage round of Evolve BioSystems, a provider of microbiome-based products.[276]

By creating a corporate venture capital arm, Campbell Soup is positioning itself to be a part of the food revolution for healthier foods. General Mills, Inc., a Delaware corporation[277] and a competitor of Campbell Soup, had started developing newer products through one of its business units, 301 Inc., to address consumers' desire for healthy foods. Ultimately, however, 301 Inc. shifted its focus

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272 Sozzi, *Amid Food Revolution*, *supra* note 265.

273 *Id.*

274 *Id.*

275 *Id. See also* Campbell Soup Company, Quarterly Report (Form 10-Q) (June 7, 2016), at 20, https://www.sec.gov/Archives/edgar/data/16732/000001673216000124/cpb-512016x10q.htm [perma.cc/UU3N-NTZ5] (noting that through May 1, 2016, Campbell Soup funded $26 million of the $125 million capital commitment and that the company has no further financial obligations to Acre Venture Partners except for the remaining $99 million).

276 *See Acre Venture Partners*, PITCHBOOK, https://my.pitchbook.com/#page/profile_1981226419 (on file with author).

277 *See generally* General Mills, Annual Report (Form 10-K) (July 6, 2015), http://www.sec.gov/Archives/edgar/data/40704/000119312515245476/d947722d10k.htm [perma.cc/7Q2P-EX2Y] (highlighting material information regarding General Mills).

away from internal R&D to investments in regional startups.[278] Kellogg Company also recently launched a "food tech-focused venture fund" called Eighteen94 Capital.[279]

Notably, despite the fact that Campbell Soup, Kellogg, and General Mills all largely focus on making investments in traditional food startups, each differed in the manner in which they set up their corporate venture capital arms. In October 2016, Campbell Soup became the sole investor in Habit, a nutrition-focused startup that tailors personal nutrition recommendations based on a person's body biology.[280] This new investment deviates from how Campbell

[278] In July 2015, General Mills implemented a new strategy for one of its business units, 301 Inc. *See* John Kell, *General Mills Is Starting a VC for Food Startups*, FORTUNE (Oct. 22, 2015, 8:34 AM), http://fortune.com/2015/10/22/general-mills-vc-small-food [perma.cc/4KLM-67KZ]. 301 Inc. had existed for three years and was originally intended to develop small, disruptive brands internally—now, the plan is for 301 Inc. to invest in small regional startups that seek capital to grow. *See id.* John Haugen, vice president and general manager of 301 Inc. stated, "We have found that more and more innovation was coming from small companies . . . . There were ways for us to partner and provide growth capital." *Id.* (internal quotations omitted). There are three factors that will be considered by 301 Inc. when it considers whether to invest in a startup: (1) gives General Mills an opportunity to compete in new categories; (2) allows certain deals to be structured in a way that would allow General Mills to acquire the startup in the future; and (3) meets certain financial metrics and goals. *See id.* (author noted that being an early investor and nurturing the brand of a startup is much cheaper than having to pay hefty price tags on acquisitions such as General Mills' acquisition of the natural food company, Annie's, for $820 million in 2014).

[279] E-mail Newsletter from Marcelo Ballve, Research Director, CB Insights, to CB Insights subscribers (June 24, 2016, 11:26 AM) (on file with author).

[280] John Kell, *Campbell Soup Invests in Nutrition Tech Startup*, FORTUNE (Oct. 26, 2016, 2:23 PM), http://fortune.com/2016/10/26/campbell-soup-invests-habit/ [perma.cc/4B8P-MKZ3]. Habit "uses data from an at-home test kit to make personalized food recommendations tailored to an individual's unique DNA." *Id.* Denise Morrison, Campbell CEO and President, said, "Campbell's investment is part of our broader efforts to define the future of food, which requires fresh thinking, new models of innovation, smart external development, and venture investing to create an ecosystem of innovative partners." *Id.*

Soup's competitors are investing. In addition, Campbell Soup invested right off of its balance sheet rather than through its CVC arm.[281] This indicates a shift away from a driving investment model to one that may be more appropriately characterized as emergent. Put differently, Campbell Soup is trying to predict where future trends may be headed so that it can position itself to pivot accordingly.

The structure of Campbell's corporate venture capital arm is distinctly different than the other CVCs mentioned so far. First, although Acre Venture Partners is funded by Campbell Soup, a general partner outside of the parent company, Acre Ventures GP, manages the fund.[282] Second, the sole limited partner of Acre Venture Partners is a wholly-owned subsidiary of Campbell Soup.[283] The structure suggests that Campbell Soup[284] may want to operate in stealth mode as it makes investments in private companies—at least until it strategically makes sense for the parent company to do otherwise. Note 15 to the Consolidated Financial Statements in Campbell Soup's Form 10-K for the year ended July 31, 2016 provides details on its $125 million capital commitment to Acre. It states that Campbell Soup's "share of earnings (loss) is calculated according to the terms of the partnership agreement. Acre is a [variable interest entity]."[285] Campbell Soup characterizes the third-party ownership as a noncontrolling interest.[286] As is the case with the previous examples, the parent company reports very

[281] In doing CVC research, it was never made clear why certain companies invested off their balance sheets versus a stand-alone corporate venture capital arm.

[282] Campbell Soup Co., Annual Report (Form 10-K) (Sept. 20, 2016), at 62, https://www.sec.gov/Archives/edgar/data/16732/000001673216000146/cpb-7312016x10xk.htm [perma.cc/C8KD-B4C2] [hereinafter Campbell Soup Co. Form 10-K].

[283] *Id.*

[284] As of February 16, 2018, Campbell Soup Company had a market cap of $13.879 billion. *Campbell Soup Company (CPB)*, YAHOO! FINANCE, http://finance.yahoo.com/q?s=CPB [perma.cc/8RYZ-HDW7].

[285] *See* Campbell Soup Co. Form 10-K, *supra* note 282, at 62.

[286] *See id.*

basic information about its corporate venture capital investment activity. The only way one may glean that information is to read information from non-publicly available sources or information on media websites.

Based on the limited information available about Acre Venture Partners in both the media and public filings, as well as its relative newness, this particular CVC illustrates how the lack of public knowledge about it may stymie its efforts to be part of the venture capital landscape. It has no reputation market other than one based on its parent company, Campbell Soup Company, and there is not enough information for either an entrepreneur or venture capital fund to determine whether it will stage its investments. One can surmise, however, that unless Campbell Soup puts more money into Acre Venture Partners or makes bigger bets on the startups it does invest in, it will be relegated to a minor role. Therefore, its impact on private ordering may be minimal.

D. Well Ventures Case Study

Well Ventures, a Delaware LLC ("Well Ventures"), is a subsidiary of Walgreens Boots Alliance, Inc. ("Walgreens"),[287] "a global pharmacy-led health and wellbeing enterprise."[288] Well Ventures either has board or

[287] Walgreens Boots Alliance, Annual Report (Form 10-K), Ex.-21 (Oct. 20, 2016), https://www.sec.gov/Archives/edgar/data/1618921/000114036116083198/ex21.htm [perma.cc/57PQ-THCN] [hereinafter Walgreens Form 10-K].

[288] *Id.* at 59. There are three different segments of its operations: Retail Pharmacy USA, Retail Pharmacy International and Pharmaceutical Wholesale. See *id.* at Section 19, Segment Reporting, for additional discussion. By way of background, "[o]n December 31, 2014, Walgreens Boots Alliance became the successor of Walgreen Co. ('Walgreens') pursuant to a merger designed to effect a reorganization of Walgreens into a holding company structure (the 'Reorganization')." *Id.* at 54. As a result, "Walgreens became a wholly-owned subsidiary of Walgreens Boots Alliance, a newly-formed Delaware corporation, and each issued and outstanding share of Walgreens common stock, par value $0.078125,

observer seats in its portfolio companies and typically invests up to $5 million in such companies.[289] Under Chesbrough's framework, Walgreens engages in driving investments because its investments are tightly linked to its operations and strategies. It prefers to exit within four to eight years.[290] While there are vague references to strategic investments, Well Ventures[291] is not mentioned in Walgreen's Form 10-K or Form 10-Q.[292] Instead, the only potential reference to Well Ventures is that Walgreens invests in businesses that are complementary to its own businesses or that can further its growth strategies.[293] The Form 10-K then states that these

converted on a one-to-one basis into Walgreens Boots Alliance common stock, par value $0.01." *Id.*

[289] *Company Overview of Well Ventures*, BLOOMBERG, http://www.bloomberg.com/research/stocks/private/snapshot.asp?privcapId=266098258 [perma.cc/2FPX-GYMB].

[290] *See id.*

[291] Founded in 2009, Well Ventures is described as "the venture and growth capital investment arm of Walgreen Co." with a focus on being "the preeminent strategic investor and partner for companies with disruptive technologies, products, and services that align with Walgreens' mission to 'help people get, stay, and live well.'" Walgreens: Well Ventures, https://web.archive.org/web/20151025144221/http://www.walgreens.com/topic/well-ventures/well-ventures-info.jsp (archived Oct. 25, 2015) (emphasis omitted).

[292] *See generally* Walgreens Boots Alliance, Inc., Quarterly Report (Form 10-Q) (Apr. 5, 2017), https://www.sec.gov/Archives/edgar/data/1618921/000161892117000026/wba-2017228x10q.htm/ [perma.cc/A3WR-47BG]; Walgreens Form 10-K, *supra* note 288.

[293] The full text of the relevant section reads:

> Our growth strategy is partially dependent upon acquisitions, joint ventures and other strategic investments, some of which may not prove to be successful.
>
> We have grown, in part, through acquisitions in recent years and expect to continue to acquire or invest in businesses that build on or are deemed complementary to our existing businesses or further our growth strategies. . . Acquisitions, joint ventures and strategic investments involve numerous other risks, including potential exposure to unknown liabilities, as well as undetected internal control, regulatory or other issues, or additional costs not

strategic investments involve risk and may materially adversely affect Walgreens business operations, financial condition or results of operations.[294]

As is the case with the other public companies discussed, Walgreens has a significant market cap—$75.801 billion.[295] Well Ventures has not publicly disclosed the funds allocated to it by Walgreens.[296] In addition, one cannot merely look at the dollar amount to determine what type of influence or impact the CVC is having on the parent company as a whole. Well Ventures differs from GV and Acre Venture Partners in that it is a subsidiary of Walgreens (like Intel Capital). The venture capital portfolio of Well Ventures has over a dozen companies across its focus areas; however, for "strategic reasons," Well Ventures does not publicize all of them.[297] If a

> anticipated at the time the transaction was completed. No assurance can be given that our acquisitions, joint ventures and other strategic investments will be successful and will not materially adversely affect our business operations, financial condition or results of operations.

Walgreens Form 10-K, *supra* note 287, at 10 (emphasis omitted).

294 *See id.*

295 *Walgreens Boots Alliance, Inc.*, YAHOO! FINANCE (Jan. 30, 2017), http://finance.yahoo.com/q?s=WBA [perma.cc/FUD2-2MUC].

296 Despite thorough research into the amount allocated to Well Ventures, the author was unable to locate this information.

297 *See Company Overview of Well Ventures*, BLOOMBERG, https://www.bloomberg.com/research/stocks/private/snapshot.asp?privcapId=266098258 [perma.cc/TYB7-CZB5]. Bloomberg lists the types of startups Well Ventures has invested in. It also notes Well Ventures' typical investment and exit strategy. The web page does not, however, list the amount of Well Ventures' investment. "[Well Ventures'] portfolio companies include such ventures as the creator of a consumer sleep apnea device, and a solar energy company that specializes in the energy needs of multi-site retailers." Jeremy Quittner, *What's Really Driving the Boom in Corporate VC Firms*, INC.COM (Aug. 8th, 2014), http://www.inc.com/jeremy-quittner/corporate-venture-capital-drives-innovation-for-big-companies.html [perma.cc/4RUV-CSQH]. Well Ventures can be the lead for a financing or part of a syndicate; they prefer co-investing with institutional investors that they collaborate with. *Evaluation Criteria*, WALGREENS: WELL VENTURES, https://web.archive.org/web/20151026172717/http://www.walgreens.com/to

deal is admittedly strategic to (presumably) the parent company, then it logically follows that the investments Well Ventures makes could potentially play a critical role for Walgreens and are therefore material. In Walgreens' Form 10-K for the fiscal year ended August 31, 2016, there is a reference to equity investments in other companies in its "Risk Factors" section. "From time to time, we make debt or equity investments in other companies that we may not control or over which we may not have sole control."[298] It also acknowledges the risks of operating in businesses that differ from their primary lines of business or which operate in different geographic markets.[299] Furthermore, Walgreens states that it relies on the internal controls and financial reporting controls of these companies in which, they have non-controlling interests and that such entities "failure to maintain effectiveness or comply with applicable standards may materially and adversely affect [them]."[300]

Like Acre Venture Partners, Well Ventures is a relative newcomer to venture capital financings. From a private ordering perspective, it appears that its stated exit goals are somewhat in the timeframe of a venture capital fund since it intends to exit within four to eight years (in contrast to seven to ten for the venture capital fund). From a compensation perspective, those that invest on behalf of Well Ventures may receive carried interest since that is typically why CVCs are structured as wholly-owned subsidiaries.[301] This type of compensation would also align the incentives between Well Ventures and the venture capital fund. Since it takes both board observer and board seats, Well Ventures' impact on its portfolio companies will differ in terms of impact. A seat on

pic/well-ventures/evaluation-criteria.jsp [perma.cc/6YXL-849P] (archived Oct. 26, 2015). For each portfolio company, Well Ventures requests board observer seats. *Id.*

298 Walgreens Form 10-K, *supra* note 287, at 15.

299 *Id.*

300 *Id.*

301 *See* discussion *supra* Section II.C and accompanying notes (specifying the rationale behind the different legal structures of CVCs).

the board gives Well Ventures a vote in the portfolio company whereas being a board observer only gives it access to certain financial information which is based on the terms of the Investors' Rights Agreement. Through a designated board member, Well Ventures would have a greater impact on the control aspect of private ordering. It would be more involved in monitoring the company, and, perhaps, it would provide nonfinancial assistance to help the company to move forward—whether in the form of marketing or offering expertise in a particular area that is beneficial to the portfolio company.

E. General Motors Ventures Case Study

The year 2015 was a record year for financing deals for automotive-related startups.[302] Funding increased by 154 percent and deals saw a jump of fifty-eight percent.[303] In 2016, funding to the sector continued unabated and saw another increase. The amount of investments into private companies in the auto tech space in 2016 totaled $1.102

[302] *Big Auto's Startup Bets: Where They're Investing Across AI, Mapping, Automation, and Materials*, CB INSIGHTS (May 11, 2016), https://www.cbinsights.com/blog/auto-corporates-investing-startups/ [perma.cc/2YEA-ZQXU]. Major automakers are playing defense as startups encroach on their territory. *See* E-mail Newsletter from Kerry Wu, Auto Tech Industry Analyst, CB Insights, to Auto Tech Insights by CB Insights subscribers (July 14, 2016, 7:29 PM) (on file with author). Companies are fighting back by actively investing in autotech startups through CVCs or the parent companies themselves to the tune of $450 million as of June 2016. *See id.* A record-breaking year in investments is a strong possibility if the current pace of investment continues.

[303] *Foot on the Gas: 2015 Sets Record for Deals in Auto Tech*, CB INSIGHTS (Apr. 1, 2016), https://www.cbinsights.com/blog/auto-tech-startups-funding-2015/ [perma.cc/9NG4-47XA]. Autotech startups were on a record-breaking pace for funding. For the first half of 2016, $450 million was invested in this area. Recently, one of General Motors' rivals, Ford, invested $6.6 million in a startup. Gina Hall, *Autotech Startups Set a Record Pace for Funding in 2016*, SILICON VALLEY BUS. J.: TECHFLASH (July 18, 2016, 12:01 PM), http://www.bizjournals.com/sanjose/blog/techflash/2016/07/autotech-startups-set-a-record-pace-for-funding.html [perma.cc/CLY7-MPUE].

billion.[304] By May 2017, investments surpassed that amount, with forty-nine deals equaling $1.307 billion.[305]

In order to secure their own futures while simultaneously addressing challenges such as the rise of electric vehicles and driverless cars, major auto manufacturers have become active investors in venture capital deals.[306] General Motors Company, a Delaware corporation ("General Motors"),[307] like much of the auto industry, is in a transformative time. It is moving from manufacturing and selling cars to the business of mobility.[308]

In 2010, General Motors established a Delaware subsidiary, General Motors Ventures LLC ("GM Ventures")[309] for the purpose of pursuing venture capital investments in the automotive cleantech, infotainment, advanced materials, and other automotive-related technologies.[310] As of June 2017, GM Ventures had made thirty-two investments and used almost ninety percent of its

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304 CB INSIGHTS, THE STATE OF AUTO TECH 10 (2017), https://www.cbinsights.com/reports/CB-Insights_Auto-Tech-Trends-2017.pdf [perma.cc/XY5R-RQVG].

305 *Id.*

306 *See Foot on the Gas*, *supra* note 303.

307 General Motors Co., Annual Report (Form 10-K), Ex. 21 (Feb. 7, 2017), https://www.sec.gov/Archives/edgar/data/1467858/000146785817000028/ex-21x12312016.htm [perma.cc/HC6H-FKX3].

308 Erin Griffith, *Driven in the Valley: The Startup Founders Fueling GM's Future*, FORTUNE (Sept. 22, 2016, 6:30 AM), http://fortune.com/cruise-automation-general-motors-driverless-cars/ [perma.cc/BAN8-QHP6]. Startups don't "adapt well to the politics of slow-moving, risk-averse corporations. Once their life's work begins to feel like a job, a switch goes off in their brains. Some leave to start their next company. Others 'vest in peace.' Whatever innovative thing they built gets lost inside a giant corporate overlord." *Id.*

309 General Motors Co., Annual Report (Form 10-K), Ex. 21 (Feb. 7, 2017), https://www.sec.gov/Archives/edgar/data/1467858/000146785817000028/ex-21x12312016.htm [perma.cc/HC6H-FKX3].

310 *See About Us*, GM VENTURES L.L.C., http://www.gmventures.com/about/index.jsp [perma.cc/2XKY-Y6LS].

$200 million fund.[311] Under Chesbrough's framework, General Motors' investments would be characterized as both enabling and emergent investments. In other words, General Motors is strategically investing and innovating in areas that it anticipates will affect the future direction of the automotive industry. General Motors and its corporate venture capital arm, GM Ventures, have been the most active of the automotive manufacturers in making investments.[312] Their investments range from early stage to late stage, and the fund has eight professionals.[313] General Motors, like Campbell Soup, also makes investments directly.[314] In January 2016, it served as the sole investor in a $500 million Series F financing for Lyft.[315] In describing its venture capital investments, General Motors has a line item for private equity and debt investments[316] in its Form 10-K for the year ended December 31, 2016, which notes $546 million in this category, compared to $529 million for the year before—an increase of almost $20 million.[317] It is

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311 There was $14.90 million in dry powder as of June 10, 2017. *General Motors Ventures*, PITCHBOOK, https://my-pitchbook-com/#page/profile_1820009183 [perma.cc/4YEZ-NBY4] [hereinafter *General Motors PitchBook Report*].

312 *Big Auto's Startup Bets*, *supra* note 302.

313 *See id. But cf. About Us,* GM VENTURES L.L.C., http://www.gmventures.com/about/index.jsp [perma.cc/4YEZ-NBY4] (listing only five investment professionals).

314 *See* General Motors Company, Quarterly Report (Form 10-Q) (Apr. 21, 2016), at 19, 21, 32, 33, http://www.sec.gov/Archives/edgar/data/1467858/000146785816000317/gm2016q1.htm [perma.cc/WTR2-7MSL] (noting General Motor's $500 million investment in Lyft).

315 *General Motors PitchBook Report*, *supra* note 311.

316 "Private equity and debt investments consist of investments in private equity and debt funds. These investments provide exposure to and benefit from long-term equity investments in private companies, including leveraged buy-outs, venture capital and distressed debt strategies." General Motors Co., Annual Report (Form 10-K) (Feb. 2, 2017), https://www.sec.gov/Archives/edgar/data/1467858/000146785817000028/gm201610k.htm [perma.cc/KH3S-4PJ4] [hereinafter General Motors Form 10-K].

317 *See id.*

difficult to ascertain whether GM Ventures is included as part of that number since there are no specific references to it. In the "Notes to Consolidated Financial Statements" of the Form 10-K, there is also a brief reference to venture capital: "Private equity and debt investments primarily consist of investments in private equity and debt funds. These investments provide exposure to and benefit from long-term equity investments in private companies, including leveraged buy-outs, venture capital and distressed debt strategies."[318] References to GM Ventures or venture capital do not appear anywhere in the 2016 annual or quarterly reports of General Motors. No references are made to General Motors' venture capital activities in its proxy statement either.[319] As was the case with Campbell Soup and Walgreens, information about General Motors' CVC activity is available in the media and paid resources. However, in the SEC filings of General Motors itself, very little is reported. General Motors differs from the other examples in that it makes CVC investments through both the parent company and GM Ventures.

This Part discussed CVCs from five different industries at various stages of development in order to assess how CVC impacts private ordering in venture capital financings. From this discussion, three main themes emerged. First, the investment rhythm of CVCs did not always align with venture capital funds because it was not motivated by limited partners or exits. This affects both the staged financing and exit components of private ordering. Second, there are potentially more conflicts of interests with CVCs than venture capital funds because CVCs may invest in the same space that their parent companies are in. As a result, the implicit contracts of private ordering may be in jeopardy. Lastly, the limited information available about CVCs and the fact that many of them are newcomers may make them

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[318] *Id.* at 72.

[319] *See* General Motors Co., Definitive Proxy Statement (Sched. 14A) (Apr. 22, 2016), http://www.sec.gov/Archives/edgar/data/1467858/000130817916000367/lgm2016_def14a.htm [perma.cc/ A6DM-47VY].

difficult to assess from a reputation market standpoint of private ordering. This reputation market would be difficult to ascertain from both the perspective of the venture capital fund which may consider syndicating with them and the entrepreneur who wants to raise money from them.

IV. SOLUTIONS TO CVC CHALLENGES TO PRIVATE ORDERING

The advent of CVC has complicated the VC landscape. Because CVCs are not motivated purely by financial gain as traditional VC firms are, and many may be new to the startup scene, there will inevitably be growing pains. The private ordering structure that has worked well for so long within a two-player system now needs to adapt to accommodate CVC, which is now an influential third player in the venture capital landscape.

Part IV addresses the challenges that CVCs pose in private ordering and proposes possible solutions. One challenge is that CVCs, particularly ones who are new to VC investing and have not worked with entrepreneurs or early stage companies, may adversely impact staged financings and the ability of the portfolio company to go public or be acquired. Structuring CVCs in a way that encourages them to take a closer look at financial considerations is one way to tackle this issue. A second challenge is conflicts of interest. This Article recommends increased vigilance and a best practices framework. Finally, a third challenge is that CVCs typically do not have the reputation capital that traditional venture capital firms do. To address this issue, the parent companies of CVCs can voluntarily disclose more information about their CVC activities in their public company filings to earn a reputation for being more transparent. By offering transparency where none is required, the parent companies of CVCs can begin to build trust.

A. Investment Rhythm and Lack of Exits

Although staged financings are still the norm, CVCs—especially those that are less well-established—tend to invest in either the earlier or later stages of the company. CVCs may also come into the deal at unexpected points, like Intel Capital did with Cloudera, and drive up the valuation of a company.[320] In the case of Cloudera, when the company went public, it was worth less than it was in its Series F financing.[321] Furthermore, because of their deep pockets, CVCs may invest more money than expected, which leads to the problem of private companies staying private longer.[322]

As this Article points out in various Parts, there is a growing interest in the innovation that occurs outside of large corporations. There is a limited amount of R&D that corporations can do in-house and even when R&D is done internally, it may languish because of internal politics. Corporations use their CVC arms to create a pipeline of potential new acquisition targets or to understand the new direction of cutting-edge technologies. Therefore, in order to be accepted as a serious player in the venture capital ecosystem, new CVCs cannot dabble in investing, but need to stage their financings to mirror that of successful venture capital funds.

Additionally, economic realities may push CVCs to act in a way that follows private ordering principles. Therefore, although the investments by venture capital funds and CVCs are now skewed toward early or later stage startups, it is still staged in that the company raises money, and the interests of the venture capital fund and CVCs align around

[320] See discussion *supra* Section III.B and accompanying notes for more information about Intel Capital.

[321] See text *supra* Section III.B about Intel Capital's investment in Cloudera and the startup's subsequent IPO.

[322] "[T]he median time to exit for venture-backed companies is now 8.2 years for an IPO and five years for acquisitions, the highest level in a decade." Newsletter from Erin Griffith, Senior Writer, Fortune, to Fortune: Term Sheet subscribers (May 24, 2017, 6:57 AM) (on file with author).

the timing of the investment over time. If the entrepreneur is unable to raise money in the middle stage of the startup's life cycle, the money to run it may run out, and there will be a consolidation of the startups that succeed and the ones that fail—that is simply the nature of this business. Therefore, from a practical perspective, instead of being preoccupied about the unevenness of staged financings, the concerns of portfolio companies will shift to whether to accept the terms of a down round or the ability to get funding not only from a CVC but anyone at all. To cite one example, if unicorns fail to go public or they get too big to acquire, they will need to succeed as a private company or go out of business. Even the most highly valued unicorn, Uber,[323] has faced problems. It generated severe backlash following its recent litigation with Waymo,[324] its Greyball program,[325] and allegations of sexual harassment.[326]

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[323] *The Unicorn List: Current Private Companies Valued at $1B and Above*, CB INSIGHTS (updated daily), https://www.cbinsights.com/research-unicorn-companies [perma.cc/AK4M-ZUZZ].

[324] Complaint, Waymo, LLC v. Uber Technologies Inc., et al., No. 3:17-cv-00939, 2017 WL 726994 (N.D. Cal. Feb. 23, 2017).

[325] Greyball is an initiative that "uses data collected from the Uber app and other techniques to identify and circumvent officials who were trying to clamp down on the ride-hailing service." Mike Isaac, *How Uber Deceives the Authorities Worldwide*, N.Y. TIMES (Mar. 3, 2017), https://www.nytimes.com/2017/03/03/technology/uber-greyball-program-evade-authorities.html.

[326] Biz Carson, *An Ex-Uber Employee Claims He Was Fired for Reporting Sexual Harassment*, BUS. INSIDER: TECH. INSIDER (May 18, 2017, 9:00 AM), http://www.businessinsider.com/ex-uber-employee-claims-fired-reporting-sexual-harassment-2017-5 [perma.cc/83W6-Y5MJ]; Yuki Noguchi, *Uber Fires 20 Employees After Sexual Harassment Claim Investigation*, NPR (June 6, 2017, 6:57 PM), http://www.npr.org/sections/thetwo-way/2017/06/06/531806891/uber-fires-20-employees-after-sexual-harassment-claim-investigation [perma.cc/XG4C-LB6V]; Craig Timberg & Brian Fung, *Uber CEO Travis Kalanick Takes Leave amid Sweeping Changes at the Company*, WASH. POST (June 13, 2017), https://www.washingtonpost.com/news/the-switch/wp/2017/06/13/eric-holder-report-on-harassment-at-uber-calls-for-new-corporate-culture/ [perma.cc/TXD2-DWDD]; ERIC HOLDER & TAMMY ALBARRÁN, RECOMMENDATIONS FOR UBER (2017),

Experts also agree that the lack of IPOs and acquisitions is harmful to the economy.[327] CVCs can address this issue by having frank discussions with their venture capital fund counterparts to determine if going public or getting acquired is in the best interest of the various constituencies in the venture capital deal: the entrepreneur, the venture capital firm, and the CVC. Granted, CVCs are not focused on exits because they do not have the pressures of limited partners who expect a hefty return on their investment through the investment decisions made by the general partner. However, this Article suggests—and evidence has shown—that CVCs can be convinced to allow portfolio companies to go public if the IPO is a lucrative one (or at least has the promise of being one, as in the case of Snap).[328] The pent-up demand for IPOs can be used to stimulate exits as well. In order to increase the number of exits, CVCs should also have similar compensation structures to venture capital funds so that the general partners will benefit from an exit in the form of carried interest. Currently, there are many different legal structures for CVCs. The most prominent is the single LP-owned fund. In reality, ninety-nine percent of the company is owned by the LP (the parent corporation of the CVC) and the

https://assets.documentcloud.org/documents/3863808/Read-Holder-report-recommendations-for-Uber.pdf [perma.cc/JVS7-MGX9].

327 *See* COMM. ON CAPITAL MARKETS REGULATION, *supra* note 172.

328 The Snap IPO was initially hailed as a success; it "closed its first day of trading up 44 percent from its initial offering price of $17." Edmund Lee, *Snap's IPO Was a Success. Now It Has to Prove It's Not Twitter*, RECODE (Mar. 2, 2017, 4:43 PM), https://www.recode.net/2017/3/2/14795366/snaps-ipo-was-a-success [perma.cc/XG8H-XYV5]. Shortly after, Snap announced a $2.2 billion lost in its first quarter, causing the value of its shares to drop and potentially sending a warning signal to other unicorns looking to go public. *See* Katie Benner, *Snap's $2.2 Billion Loss Caps Bumpy First Months as a Public Company*, N.Y. TIMES (May 10, 2017), https://www.nytimes.com/2017/05/10/technology/snap-earnings.html [perma.cc/7QA9-EME6]; Katie Benner, *In Snap Inc.'s Tumble, Start-Ups See a Warning from Wall Street*, N.Y. TIMES (May 11, 2017), https://www.nytimes.com/2017/05/11/technology/snap-public-company-start-ups.html [perma.cc/7C2A-8NBF].

remaining one percent is owned by the general partners. However, the fund is commonly referred to as a wholly-owned subsidiary. This legal structure is typical of how venture capital funds are run. In other words, encouraging carried interest for general partners in CVCs will incentivize CVCs to take their portfolio companies public and look at merger and acquisition opportunities. This structure also has the added benefit of the CVC being able to reinvest any monies earned into other CVC arms of the parent company so that like the venture capital funds, there is a cyclical rhythm to how the money is deployed.

B. Board Matters

This Article has suggested following a staged financing model to mimic venture capital funds (albeit in a slightly skewed form where money is clustered in the early or later stages of a startup) and considering exit strategies more seriously. Now, this Article turns to the control element of private ordering. Under private ordering, there are certain control mechanisms at work to combat issues of uncertainty and information asymmetry. This Article argues for more vigilance regarding the board observer and board seat arrangements in startups with respect to the control that CVCs might exert over it through their board designee. It also sets forth a best practices framework. The suggested best practices for the boards of startups were made to address potential conflicts of interest for board members designated by CVCs and the need for appropriate financial and industry expertise given the increasing complexities of startups, which are starting to look more like public companies that are operating in the private sphere. As discussed in Part II above, with private companies staying private longer, in part as a result of increased CVC investments, getting the correct board mix is more critical than ever to help ensure that the internal controls and governance keep pace with the growth of the private company.

1. Board Observer

Board observers differ from board members in three fundamental ways: (1) there are no board voting rights as an observer, (2) observers can be excluded during certain discussions, and (3) information rights are contractual. Put simply, the rights of an observer are limited by the investors' rights agreement[329] and observers do not have fiduciary duties like board members do.[330] The CVC arm is required to have a certain threshold level of shares for the particular series of stock it invested in to maintain its observer rights.[331] An observer designated by the CVC will receive notices, minutes, consents, and other materials that are provided to the portfolio company's directors.[332] From a contractual standpoint, the board observer designated by the CVC may, but typically does not, agree to act as a board member would (essentially agreeing to be bound to the same fiduciary duties as board members), and the portfolio company maintains the right to decide whether to exclude such board observer from certain meetings for reasons related to attorney-client privilege, disclosure of trade secrets, or conflict of interest.[333] Additionally, the portfolio

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329 *See* NAT'L VENTURE CAPITAL ASS'N, MODEL LEGAL DOCUMENTS, INVESTOR RIGHTS AGREEMENT 22–23, http://nvca.org/resources/model-legal-documents/ (last visited Apr. 17, 2018).

330 Sometimes companies choose to include such provisions in a management rights letter signed between the company and the particular investor receiving such rights. *See id.* at 23 n.35. A company may also request that board observers execute confidentiality agreements since they are not subject to the same fiduciary duties as directors. *See id.*

331 *See id.* at 22.

332 *See id.*

333 The relevant language in the investors' rights agreement states:

> [S]uch representative shall agree to hold in confidence and trust and to act in a fiduciary manner with respect to all information so provided; and provided further, that the Company reserves the right to withhold any information and to exclude such representative from any meeting or portion thereof if access to such information or attendance at such meeting could adversely affect the attorney-client

company could choose to exclude the board observer designated by the CVC if the CVC's parent is a competitor of the portfolio company.[334]

From a best practices standpoint, it would behoove the CVC to designate a board observer from a corporate venture capital arm that is a subsidiary instead of a corporate venture unit that is part of the parent company. Regardless of whether a board observer is designated by the CVC that is a subsidiary of the parent company or a corporate unit of the parent company, CVCs should implement appropriate internal confidentiality procedures for such board observers to prevent them from disregarding contractual confidential provisions with portfolio companies and sharing such confidential information broadly within the parent company. CVCs should also disclose any potential conflicts early to ensure that proper board procedure can be followed—i.e., CVC-designated board observers leave the board discussion for a certain portion of the meeting—to prevent any hint of impropriety.

Although CVCs have designated more board observers in the past, the current trend is for many of them to designate board members.[335] Ultimately, however, the role such individuals play—whether as a board observer or board member—depends on the philosophy of the CVC arm of the public company and the amount of money it invests in the startup. To cite some examples, when American Express

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> privilege between the Company and its counsel or result in disclosure of trade secrets or a conflict of interest, or if such Investor or its representative is a competitor of the Company.

Id. at 22–23.

334 *See id.*

335 The top ten CVCs—the top ten being denoted by a CB Insights article—often take an active board position in the private companies they invest in (versus a more passive board position, such as "board observer"). For example, Intel Capital has sixty-four board member seats out of 154 total current board positions. *Intel Capital PitchBook Report*, *supra* note 258. GV has seventy-five board member seats out of eighty-two current board positions. *GV PitchBook Report*, *supra* note 222.

Ventures participates on a board, it typically designates a board observer.[336] Intel Capital, in contrast, is much more likely to designate a board member.[337]

2. Board Member

Board members designated by CVCs are bound to certain fiduciary duties by statute.[338] These include the duty of loyalty[339] and the duty of care.[340] There are also other

[336] *See American Express Ventures*, PITCHBOOK, https://my-pitchbook-com/#page/profile_567803052.

[337] Under the section titled "Top 25 Board Seats" in the PitchBook report, Intel Capital had board observer status in only seven of the twenty-five seats; the other eighteen were all board memberships. *See Intel Capital PitchBook Report*, *supra* note 258.

[338] Specifically, this refers to the statutory law of the state of incorporation of the company that the CVCs are investing in. For example, if the company is incorporated in Delaware, board powers are codified in section 141 of the Delaware General Corporation Law. *See* DEL. CODE tit. 8, § 141 (2016).

[339] *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) ("Essentially, the duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally."); Guth v. Loft, 5 A.2d 503, 510 (Del. 1939) ("Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests . . . . The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.").

[340] In Delaware, the duty of care is not codified, but has been developed in case law, and is separate from the duty of loyalty. *See* Smith v. Van Gorkom, 488 A.2d 858, 872–73 (Del. 1985) ("[A] director's duty to exercise an informed business judgment is in the nature of a duty of care, as distinguished from a duty of loyalty."). Under the duty of care, directors have a responsibility to "inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (holding that the duty of care is integral to application of the business judgment rule), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

duties, such as good faith,[341] disclosure,[342] and confidentiality,[343] which CVCs should also bear in mind.[344]

Another way to address potential conflicts of interest that may arise in the board context in the event that a CVC has the right to designate a board member is for the CVC to designate an individual *not* affiliated with the CVC arm in any way. Instead, the CVC may designate one of its co-investors in the syndicate to serve as a board member. Using this tactic would serve two purposes: (1) it would ease any concerns by entrepreneurs about potential competition from the CVC, and (2) the CVC still maintains its right to designate a board member. In order for this to work, however, it would take a high degree of trust between the CVC investor and traditional VC firm investor.

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341 The key difference between good faith in the fiduciary duty context and the implied covenant of good faith and fair dealing in the Uniform Commercial Code context is temporal—the courts analyze the parties' actions at the time of the alleged wrongdoing and review what happened in the past to determine the parties' relationship when the breach occurred in the case of the former. With respect to an implied covenant claim, the courts examine the time the contract was made and whether the parties would have made the decisions they did if the issue discussed arose at that time. Gerber v. Enter. Prods. Holdings, LLC, 57 A.3d 400, 418 (Del. 2013); *see also In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 67 (Del. 2006).

342 *See* Rosenblatt v. Getty Oil Co., 493 A.2d 929, 944 (Del. 1985).

343 *See generally* United States v. O'Hagan, 521 U.S. 642, 652 (1997) (holding that under the misappropriation theory of insider trading, "a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information"); S.E.C. v. Lyon, 605 F. Supp. 2d 531, 542 (S.D.N.Y. 2009) (citing United States v. Falcone, 257 F.3d 226, 234 (2d Cir. 2001) (reaffirming that the duty of confidentiality, in the context of securities laws, exists "where there is explicit acceptance of a duty of confidentiality or where such acceptance may be implied from a similar relationship of trust and confidence between the parties")).

344 Under Delaware law, board members may choose to be a non-voting member. *See* DEL. CODE tit. 8, § 141(d) (2016) ("If the certificate of incorporation provides that 1 or more directors shall have more or less than 1 vote per director on any matter . . . .").

Board members designated by CVCs are *not* there to represent the interest of the parent company. Instead, they have legal fiduciary duties to *all* of the portfolio company's stockholders, and *not* to the parent company. While this is certainly a conflict for board members appointed by traditional VC firms, it is a much bigger issue for CVCs where the parent's corporate interests may be misaligned.

i. Duty of Care

By reviewing board materials carefully, advocating for deliberate review of board actions, voicing support for ongoing review of financial controls, seeking the advice and counsel of other experts as needed,[345] and ensuring the accuracy of board minutes and written board actions, a CVC board designee can discharge his or her duty of care.[346]

345 *Id.* § 141(e). Note that the standard of gross negligence is applied if a board is alleged to breach this particular duty. *In re* Citigroup Inc. S'holder Derivative Litig., 964, A.2d 106, 124 (Del. Ch. 2009). In order to succeed on a claim of breach of duty of care against an individual, the plaintiff must rebut the presumption of the business judgment rule as to the majority of the directors. Hamilton Partners, L.P. v. Highland Capital Mgmt., L.P., C.A. No. 6547-VCN, 2014 WL 1813340 (Del. Ch. May 7, 2014). The court will apply the more stringent standard of entire fairness (where the burden shifts to the board of directors to prove the principles of fair dealing and fair price) in certain circumstances. *See* Weinberger v. UOP, Inc., 457 A.3d 701, 710 (Del. 1983).

346 If there is a good faith effort to discharge the duty of care, then the business judgment rule applies. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). If there is not a good faith effort then a more stringent standard applies, such as the entire fairness standard. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 371 (Del. 1993). The duty of care focuses more on process than substance. *See, e.g.*, *In re* Trados, 73 A.3d 17 (Del. Ch. 2013) (in which the court scrutinized the actions of the board of directors in a merger action). Note that even if directors breach the duty of care, there is a statutory limitation of liability for directors under section 102(b)(7) of the Delaware General Corporation Law (which only exculpates directors not anyone else). DEL. CODE tit. 8, § 102(b)(7) (2016). Furthermore, there are indemnification statutes, such as the one codified in Delaware's General Corporation Law section 145, which allows corporations to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding,

Recent court cases out of the Delaware Court of Chancery highlight the need to abide by the duty of care.[347] For example, in *In re Rural Metro Corp.*,[348] the opinion illustrates the need for active and engaged directors in any sale process, which includes taking steps to ensure that all conflicts are identified, disclosed, and discussed.[349] Directors must be proactive in asking questions about any existing potential conflicts, the implications of such conflicts, and how they will be addressed.[350] Put simply, directors must focus on the process of making a decision.[351]

whether civil, criminal, administrative or investigative (other than an action by or in the right of the corporation) by reason of the fact that the person is or was a director, officer, employee or agent of the corporation and permits corporations to insure their directors in the event of a breach of duty of care. *Id.* § 145(a).

347 As alluded to in the discussion in *supra* note 346, even though directors are exculpated pursuant to the section 102(b)(7) of the Delaware General Corporation Law, financial advisors can still be liable for aiding and abetting a breach of the duty of care by the directors. *See In re* Rural Metro Corp. (Rural Metro), 88 A.3d 54, 85–86 (Del. Ch. 2014).

348 In *Rural Metro*, the court found that if a "third party knows that the board is breaching its duty of care and participates in the breach by misleading the board or creating the informational vacuum, then the third party can be liable for aiding and abetting." *Rural Metro*, 88 A.3d at 97.

349 *Id.* at 105–06.

350 *See id.*

351 By focusing on the process of making decisions, directors exercise their fiduciary duty of care. "Directors should:

- be active and engaged;
- obtain access to relevant information;
- obtain input from relevant board committees and board advisors;
- actively deliberate decisions, asking relevant questions and discussing the information provided;
- examine available alternatives; and
- resist the pressure for a quick decision."

WILSON SONSINI GOODRICH & ROSATI, WSGR ALERT: CRITICAL ISSUES FOR BOARDS OF DIRECTORS 1 (2011), https://www.wsgr.com/publications/PDFSearch/wsgralert-board-of-directors-critical-issues.pdf [perma.cc/BK4Z-RDNL].

In the case of CVCs, one example of a potential conflict of interest occurs when the startup directly competes with the parent company of the CVC. If that is the case, then the CVC board designee needs to identify the conflict, disclose the nature of the conflict, and discuss appropriate next steps. If the startup is contemplating the parent company as a potential acquirer, the CVC board designee must recuse herself from the decision-making process. Even if the parent company is not a possible buyer, the CVC-designated board member has a conflict if potential buyers are competitors of the parent company. The board minutes of the startup should reflect a clear record of the discussions that transpired, including a careful review of the facts, steps it took to make the decision, and the decision that the board made as a result of that deliberation. By taking these steps, the board demonstrates a good faith effort to discharge its duty of care, as defined above. As a result, should stockholders decide to sue the company, the company will be subject to the standard of the business judgment rule (where the onus is on the stockholder to prove wrongdoing) instead of the more stringent standard of entire fairness.[352]

A director may be unable to fulfill his or her duty of care in any meaningful way depending on the number of boards on which he or she serves, since serving on a board of a private company typically means that board members meet at least once a quarter if not monthly. Therefore, setting a limit on the number of boards on which a person can serve would be prudent, especially if a CVC arm of a public company is big and active like GV is. As the corporate venture capital arm of a public company continues to grow, it may entail hiring more investment professionals.

ii. Duty of Loyalty

The duty of loyalty involves protecting confidential information and communications by establishing clear

352 *See* discussion *supra* note 346.

procedures, being aware of potential conflicts of interests[353] for the CVC designee or other directors or their affiliates, and ensuring the disclosure of all material facts regarding a particular transaction. Furthermore, interested directors (whether the CVC designees or others) should limit their participation in deliberations or voting regarding a transaction. The applicable Delaware statute[354] does not necessitate the recusal of an interested director provided that certain conditions are met, including disclosure of the material facts by the director regarding his or her relationship or interest to the board of directors or committee and the stockholders entitled to vote on the matter.[355] In addition, the contract must be fair to the corporation at the time it is approved by the board, committee, or stockholders.[356]

The CVC world is especially rife with conflict because, in many cases, the parent companies of the CVCs are very involved in their management. The board designees from CVCs must make decisions in the best interest of all stockholders in the company and not solely in the interests of the parent companies of the CVCs. This can be a difficult line to toe, especially given the various legal ways in which CVCs are structured. For example, if CVCs are part of a

[353] If there is a conflict of interest in the context of a board decision or transaction, directors are not protected by the business judgment rule and liability would not be limited by statute. *See* DEL. CODE tit. 8, § 102(b)(7) (2016). Note that conflicts of interest can arise whether the individual director has a personal interest or not, such as in the case of a CVC board designee who is not serving the interest of the parent company on the board but rather owes a duty to all stockholders of the company.

[354] *See id.* § 144.

[355] *See id.* § 144(a)(1), (2). Historically, many firms have advised that a conflicted board member should be recused from voting, but the author has had conversations with attorneys practicing in this area that they have increasingly seen Delaware lawyers advising that even conflicted board members should vote so long as there is full disclosure.

[356] *See id.* § 144(a)(3).

business unit, as is the case with General Mills,[357] the board designees of such CVCs are employed by the parent companies. In contrast, in the case of CVCs which are wholly-owned subsidiaries of parent companies but with some level of independent decision-making, there may be a layer of autonomy that does not exist when a CVC directly reports to the parent company in some way. Therefore, although in theory board designees of CVCs should represent the interests of all stockholders of the private companies in which they invest, CVC board designees may only be considering the one that pays the bills—the parent companies of the CVCs.

Despite the potential for conflicts of interest, however, there are still good reasons for the entrepreneurs who are receiving investments from CVCs to have CVC-designated board members. Because board members have fiduciary duties, the entrepreneurs can use those duties as a tool if CVCs behave badly. For example, if a CVC realizes that its portfolio company poses a fundamental business threat to its parent company, the CVC board designee could hypothetically vote to shutter the company thereby potentially acting against the interest of the stockholders of the company. At that point, the entrepreneurs and the company's legal counsel could remind the CVC that they have fiduciary duties that require them to act in the interest of all stockholders. If they fail to adhere to such duties, they will increase their chances of being subject to lawsuits in the future.

C. The Reputation Market

A third challenge with CVCs is that throughout their history they have generally been looked upon with disdain and suspicion by venture capital funds and, to a lesser extent, entrepreneurs as well. This makes it difficult for CVCs to meet the reputational aspects of private ordering.

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357 *See* discussion *supra* Section III.C and accompanying notes (briefly describing the structure of General Mills' corporate venture capital arm).

Although the life spans of CVCs have lengthened over time, historically they have had shorter life spans than their venture capital fund counterparts. Accordingly, CVCs may not have a track record of VC deals from which either entrepreneurs or venture capital funds can analyze to determine whether they would be good partners in a financing. Also, unlike successful venture capital funds, where the success of one fund has an iterative effect and makes it easier to fundraise for future funds, CVCs are dependent on their parent companies to continue funding their portfolio companies. Lastly, if a CVC has only recently joined the VC landscape, its reputation may be based on what this Article will characterize as a "reputational halo effect" that originates from the brand of the parent company. This reputational halo effect may be both good and bad. For example, a CVC could cultivate the reputation of being an advocate for entrepreneurs by having it more widely known that it leverages its parent companies' extensive networks and infrastructure to help them. At the same time, however, no matter what the brand of the company, big companies are generally viewed as slow moving and bureaucratic and this perception could then be attributed to CVCs. This, in turn, leads to the notion that CVCs are difficult to work with or do not have a vested interest in seeing the entrepreneur succeed because their performance has an insignificant impact on the parent company's bottom line.

The fact that there is very little to no available information about CVCs available also compounds the challenges with the reputation market. This lack of information makes it extremely difficult to assess what kind of monetary and non-monetary contributions CVCs provide. Under the current requirements of Regulation S-K and Regulation S-X, public companies that make CVC investments disclose the information in ways that are not transparent.[358] For example, the information about corporate venture capital is referenced in the notes to

[358] *See* 17 C.F.R. pts. 210, 229 (2017).

consolidated financial statements or obliquely referenced in the management's discussion and analysis or risk factors section. In fact, entrepreneurs may rely on the media's interpretation of the limited information that is available. For example, in the case of Campbell Soup Company, one of the five case studies discussed in Section III.C *supra*, media reports largely disclosed, in the first instance, its CVC activity through Acre Venture Partners.[359]

There are three possible ways to combat this lack of information about CVCs that is critical to making a reputational assessment. The entrepreneur should ask for (1) the amount of assets under management; (2) the amount of money that the CVCs have left to invest (i.e., dry powder); (3) the total number of investments (while also noting which ones are active); (4) how many board positions (either on the board or as a board observer) the investment professional of the CVC holds; (5) the investment preferences of the CVC fund; and (6) recent investments of the CVC. The information that this Article advocates for is already available—just not to everyone and not in any consistent manner. Resources like PitchBook are available for a fee that startups may not be able to afford. At the very least, however, entrepreneurs should seek this information in making decisions about potential investors when there is not information about them in the marketplace. In this way, the fifth prong of private ordering—implicit contracts regarding the reputation market—can be met.

Second, the parent companies of the CVCs can voluntarily disclose information about their CVC activities. Although this type of disclosure is not required under law, it helps CVCs—particularly those that are not as well-known as Intel Capital or GV—to build a reputation for transparency. This transparency in turn may create a sense of trustworthiness. In their public company filings, the parent companies of CVCs may choose to include information ranging from the amount allocated to the CVC to which companies they are

[359] *See* discussion *supra* Section III.C and accompanying notes.

investing in to how many board seats or board observer roles each investment professional has. For example, in Forms 10-K[360] and 10-Q,[361] the information about a public company's CVC activities—whether forming a CVC or investing in private companies or serving on the board of a private company—can be made in Items I. Business and IA. Risk Factors. Under Item 8.01 Other Events of the Form 8-K, the public company may disclose "information…not otherwise called for by this form, that the [public company] deems of importance to security holders."[362] In this way, potential and current investors as well as employees can get a better grasp on what CVCs do and how big a role they play in their parent company. This information has the added benefit of being helpful to startups who may be considering investments from the public companies who are making CVC investments.

Although not required under Regulation S-X, in the notes to financial statements, the parent company could break down equity investments in private companies in a way that is clear and understandable. For example, if equity investments are grouped under "Other Long-Term Assets," which include both debt and equity investments, then that information needs to be broken out to describe what portion constitutes debt as compared to equity. In part, recently issued accounting pronouncements not yet adopted, such as Accounting Standards Update No. 2016-01 ("ASU 2016-01"),[363] may provide additional information for startups as well.

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360 *See Form 10-K, Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, SEC. & EXCH. COMM'N, http://www.sec.gov/about/forms/form10-k.pdf [perma.cc/W9NL-4SWA].

361 *See Form 10-Q*, SEC. & EXCH. COMM'N, http://www.sec.gov/about/forms/form10-q.pdf [perma.cc/PX4A-6BH8].

362 *See Form 8-K, Current Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, SEC. & EXCH. COMM'N, https://www.sec.gov/about/forms/form8-k.pdf [perma.cc/72PX-ZU3Y].

363 FIN. ACCOUNTING STANDARDS BOARD, ACCOUNTING STANDARDS UPDATE: RECOGNITION AND MEASUREMENT OF FINANCIAL ASSETS AND

Third, entrepreneurs seeking venture capital money can also perform due diligence on CVC investors through the venture capital fund with which they partner with. These funds will have knowledge of how CVC-designated board members act in situations where there are conflicts of interest if the CVC has participated in VC financings in the past. Even if the venture capital fund does not have such knowledge of the CVC, it has the ability to reach out to its network to get more information.

CONCLUSION

CVCs are playing an increasingly important role in venture capital financings. In order to ensure that the current venture capital structure works within the private ordering framework, CVCs may need to assess what aspects of venture capital funds they wish to adapt to and which parts of their role in the venture capital investing cycle will remain uniquely theirs.

The fourth wave of CVC is not over yet. As the newest CVCs mature it would be helpful to look at their impact on private ordering over a longer time period. In particular, this Article urges that any future study of CVCs examine how CVC board designees address conflicts of interest. As this Article has suggested, CVCs and their parent companies must strive to institute a set of best practices that will better serve the private companies they invest in and lead to more productive relationships with the venture capital funds with which they invest.

FINANCIAL LIABILITIES (2016), http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176167762170 [perma.cc/4C2F-R3A2].