STARTUP FAILURE

Elizabeth Pollman*

Venture-backed startups famously aim for a successful "exit" by going public or selling to another company through an acquisition deal and achieving financial return for all equity holders. A different path, however, is far more common – failure. Despite the large amounts invested in venture-backed startups, and their high average rate of failure, these companies rarely use the formal bankruptcy process that is embraced by other types of distressed companies.

This Article provides an account of startup failure – how law and culture have shaped a system for dealing with startups that cannot reach an exit that will produce a financial return for all participants. This account explains why bankruptcy law does not fit the needs of most distressed startups, what we can learn from exceptions, and how alternative mechanisms serve an important role in the venture capital ecosystem. In particular, soft-landing acquisitions, acqui-hires, and assignments for the benefit of creditors mitigate the potential stigma of failure and allow entrepreneurs, investors, employees, and creditors to "fail with honor" and redeploy their talent and capital into other ventures.

Further, the Article sheds light on rising challenges to the continued functioning of this system for dealing with startup failures amidst evolving practices and regulatory agendas. These challenges could threaten not only the pathway for dealing with failure, but also, more generally, the ecosystem which produces some of the greatest business successes of our time. Existing norms and practices may come under pressure with new entrants into venture-backed investments, higher startup valuations, and larger amounts of funds raised. Looming antitrust changes could close or tighten an important means by which startups find an off-ramp to fail with honor and quickly redeploy talent and technology. Instead of banning tech acquisitions, as some policymakers have proposed, this Article highlights the need for more finely-tuned approaches that appreciate the value of facilitating failure. In addition, corporate law could increase doctrinal clarity for startup boards navigating distress, and as startup activity continues to spread beyond Silicon Valley, states could amend their relevant laws, such as assignments for the benefit of creditors, to foster more efficient failure.

---

* Professor of Law, University of Pennsylvania Law School. For valuable comments and conversations, thanks to Yifat Aran, Brad Bernthal, Hozefa Botee, Brian Broughman, Abe Cable, John Coyle, Jared Ellias, John Mao, Peter Molk, Amy Simmerman, Brian Quinn, Matt Wansley, Yesha Yadav, and participants at the ABA Private Equity and Venture Capital Section Meeting, National Business Law Scholars Conference, Stanford Law Grey Fellows Forum, BYU Winter Deals Conference, UCLA-Bucerius Corporate Law Workshop, University of Washington Faculty Workshop, University of Florida Business Law Conference, University of Texas Business Law Seminar, Tel Aviv University Corporate Law Workshop, Michigan State University Faculty Workshop Series, and the Monash University Law & Business Seminar Series.

Table of Contents

Introduction 3
I. Startups and Bankruptcy 7
A. Why Bankruptcy Does Not Fit Most Startups 8
B. When Startups Use Bankruptcy 14
1. Legal Issues 15
2. Rebirth or Pivot to a New Business Model or Owner 18
3. Debt Problems 19
4. The Big "Startup" 20
II. A System For Dealing with Startup Failures 22
A. M&A Sales 23
B. Acqui-hire Transactions 25
C. Assignment for the Benefit of Creditors 28
D. Wind Downs, Turnarounds, and Additional Alternatives 30
III. A Theory of Startup Failure 32
A. The Advantages of Silicon Valley's Approach to Failure 33
B. The Changing Landscape of Startup Failure 38
C. Policy Implications 41
Conclusion 47

STARTUP FAILURE

Elizabeth Pollman

INTRODUCTION

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

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

---

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

[2] *Id.* at 164.

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

[4] *See, e.g.*, C. Scott Hemphill & Tim Wu, *Nascent Competitors*, 168 U. PA. L. REV. 1879 (2020); Mark A. Lemley & Andrew McCreary, *Exit Strategy*, 101 B.U. L. REV. 1 (2020); Kevin A. Bryan & Erik Hovenkamp, *Startup Acquisitions, Error Costs, and Antitrust Policy*, 87 U. CHI. L. REV. 331 (2020); Colleen Cunningham, Florian Ederer & Song Ma, *Killer Acquisitions*, 129 J. POL. ECON. 649 (2021); David Pérez de Lamo, *Assessing "Killer Acquisitions": An Assets and Capabilities-Based View of the Start-Up*, CPI ANTITRUST CHRON. 50 (May 2020).

[5] *See, e.g.*, Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967 (2006); Brian Broughman & Jesse Fried, *Carrots & Sticks: How VCs Induce Entrepreneurial Teams to Sell Startups*, 98 CORNELL L. REV. 1319 (2013); Robert P. Bartlett, III, *Shareholder Wealth Maximization as Means to an End*, 38 SEATTLE U. L. REV. 255 (2015); Pollman, *Startup Governance*, *supra* note 1, at 189-91, 216-20; Abraham Cable, *Does* Trados *Matter?*, 45 J. CORP. L. 311 (2020); Sarath Sanga & Eric L. Talley, *Don't Go Chasing Waterfalls: Fiduciary Duties in Venture Capital Backed Startups*, https://scholarship.law.columbia.edu/faculty_scholarship/2720/; Casimiro A. Nigro & Jörg R. Stahl, Venture Capital-backed Firms, Unavoidable Value-destroying Trade Sales, and Fair Value Protections, LawFin Working Paper No. 1 (Aug. 28, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3662441.

Most venture-backed startups, however, never reach either of these paths, or if they do it is in a state of distress. Approximately 70% of venture-backed startups fail – the number is difficult to measure, however, and by some estimates it is far greater.[6] In general, a startup can be said to fail when it ultimately fails to attract an acquirer willing to buy the company at a valuation that would provide a return to all equity holders and it falls short of reaching product maturity and business metrics suitable for going to public markets.[7] This can occur for a wide variety of reasons—such as running out of cash, problems in the team, shortcomings with product development or business model, getting outcompeted, a lack of market need, or changed circumstances.[8] In many instances, the startup never reaches profitability, and thus an inability to raise a new round of venture financing or debt means the end of the road for the startup.[9] The participants may not expressly call this a "failure"—and indeed they may work mightily to find a "soft landing" that allows them to characterize it otherwise—but it is distinctly an end that is not a going-public transaction or M&A sale that results in returns to all equity holders. This third and most common path—startup failure—receives little attention in the scholarly literature,[10] yet it is a critical part of the venture capital and startup system.

The consequences of startup failure, and how the law facilitates the process of terminating the lifecycle of the startup, matter for a variety of reasons. First, the ability to withdraw from involvement or recoup some of the investors' capital affects ex ante incentives to invest in a startup. Second, the speed, efficiency, and reputational consequences of startup failure may impact the incentives of entrepreneurs to become founders of new startups and the labor economics of great numbers of entrepreneurs and employees that work in the technology sector. Third, these dynamics affect the flow of talent and technological know-how, as well as the

---

[6] Research Briefs, *353 Startup Failure Post-Mortems*, CB INSIGHTS (Aug. 18, 2020), https://www.cbinsights.com/research/startup-failure-post-mortem/. On average, startups fail around 20 months after raising their first round of financing. The failure rate is worse in some sectors—97% of seed or crowdfunded consumer hardware startups fail—and across all types of startups, the average amount raised before shutting down is $1.3 million but ranges widely. *Id.*

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

[8] *See id.* at 8-14 (identifying six startup failure patterns); Research Briefs, *The Top 20 Reasons Startups Fail*, CBINSIGHTS (Nov. 6, 2019), https://www.cbinsights.com/research/startup-failure-reasons-top/ (identifying twelve startup failure patterns). For a classic work examining dynamic forces of creation and destruction, see JOSEPH SCHUMPETER, THE THEORY OF ECONOMIC DEVELOPMENT (1934) (Redvers Opie trans., Transaction Publishers 2012) (describing "creative destruction," a process in which new technologies, new methods of production, and new means of distribution force existing companies to quickly adapt or fail).

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

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

ability and incentives for entrepreneurs to remain connected with the intellectual property assets they developed or start afresh in new ventures. In short, the ability of startups, and their participants, to fail efficiently and "with honor"[11] helps sustain the system out of which also grows some of the largest successes in the history of U.S. business.[12]

This Article provides a theory of startup failure – why bankruptcy law does not fit the needs of most distressed venture-backed startups, what we can learn from the rare exceptions, and how alternative mechanisms serve a critical role in the venture capital ecosystem.[13] Above all, the Article argues that law and culture can facilitate dealing with startup failure at relatively low cost and this dynamic is important to sustaining a venture capital system that funds large numbers of innovative entrepreneurs.[14]

Further, the Article sheds light on rising challenges to the continued functioning of this system and contributes to several contemporary debates with regulatory and doctrinal significance. For example, recent years have witnessed a number of legislative proposals and arguments to ratchet up antitrust scrutiny on acquisitions

---

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

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

[13] Legal scholarship has provided accounts of various components, such as M&A transactions, *supra* note 5, acqui-hires, *infra* note 170, and ABCs, *infra* note 76, but no prior work has provided a systematic account of startup bankruptcy and the law and culture of startup failure.

[14] A rich literature has explored relationships between formal legal rules and institutions and social norms and informal dispute resolution or transaction regimes. *See, e.g.*, ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES (1991) (arguing that ranchers and farmers in a region of California rely on informal social norms instead of formal legal rules to resolve boundary disputes); Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992) (identifying the crucial role of social norms in resolving merchant disputes in the diamond trade); Eric A. Feldman, *The Tuna Court: Laws and Norms in the World's Premier Fish Market*, 94 CALIF. L. REV. 313, 313 (2006) (examining "whether, when, [and] why informal norms rather than state-created law prevail in certain settings"); Ronald J. Gilson, Charles F. Sabel, Robert E. Scott, *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine*, 110 COLUM. L. REV. 1377 (2010) (examining how parties "braid" formal and informal mechanisms for enforcing contractual commitments). For explorations of law and culture in the startup ecosystem of Silicon Valley, see *infra* notes 226 and 227. This Article aims to provide an original account in this tradition focused on startup failure.

by large technology companies.[15] Some have even called for effectively banning Big Tech from making acquisitions.[16] Such proposals raise a concern, however, even beyond dampening entrepreneurial investment and innovation,[17] that has gotten little attention: they could drain the startup and venture capital ecosystem of an important pressure release valve that helpfully gives many startups soft landings and recycles talent and technology. That is, new approaches or heightened antitrust review and enforcement may be necessary, but this Article highlights that attention should also be paid to finely tuning regulatory responses so as not to impede the flow of dealing with large numbers of startup failures that do not pose significant competition issues.

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

The Article proceeds as follows. Part I offers an explanation of why bankruptcy does not fit most startups given the nature of their business, financing, and the ecosystem in which they exist. Further, using a sample of recent venture-backed bankruptcy filings, it explores the drivers for the exceptions of when startups do resort to the formal bankruptcy process. Part II sets out the system of alternatives—that is, the range of options for dealing with failed startups outside of the formal bankruptcy system. Building on this descriptive foundation, Part III provides an original account of the functioning and rationales underlying the system of alternatives, and argues it plays an important role in the healthy functioning of the venture capital and startup sector. Further, the Part explores developments that are shifting the landscape of venture capital investing and suggest that this system may

---

[15] *See, e.g.*, S. 225 – 117th Congress (2021-2022), Competition and Antitrust Law Enforcement Reform Act of 2021, https://www.congress.gov/bill/117th-congress/senate-bill/225/text?r=56&s=3 (proposing, among other things, shifting burden of proof to companies for mergers over $5 billion, that cause market concentration, or involve competitor acquisitions); H.R. 3826 – 117th Congress (2021-2022), Platform Competition and Opportunity Act of 2021, https://www.congress.gov/bill/117th-congress/house-bill/3826/text?r=1&s=8 (proposing, among other things, a ban on acquisitions by covered platforms unless the acquirer can prove that the assets do not compete with the platform, increase the platform's market position for any sales on or related to the platform); *see also* Lemley & McCreary, *supra* note 4, at 1, 94-97 (arguing that startups' focus on exit is "pathological" and proposing a range of responses including "changing antitrust laws to focus on who is acquiring startups" such as creating a presumption in the merger review process to block dominant firms from acquiring startups with complementary technologies).

[16] *See* S. 1074 – 117th Congress (2021-2022), Trust-Busting for the Twenty-First Century Act (Apr. 12, 2021), https://www.congress.gov/bill/117th-congress/senate-bill/1074/text?r=18&s=7; *U.S. Senator Wants to Ban Big Tech from Buying Anything Ever Again*, REUTERS (Apr. 12, 2021), https://www.reuters.com/technology/us-senator-wants-ban-big-tech-buying-anything-ever-again-2021-04-12/ (discussing Senator Josh Hawley's proposed bill that would ban all M&A deals by any company with a market capitalization greater than $100 billion).

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

come under pressure to deal with the size, type, or number of failures. The Part concludes by highlighting wide-ranging doctrinal and regulatory implications.

I. Startups and Bankruptcy

For many insolvent or financially-distressed businesses, bankruptcy provides an important process for dealing with failure and preserving going-concern value or liquidating efficiently under the supervision of a bankruptcy trustee or court. It has long been understood that financial distress can lead to conflicts among creditors that can otherwise spur the inefficient liquidation of a business.[18] The bankruptcy system provides an important means of helping to solve this collective action problem among creditors by allowing for a stay while determining whether the firm is worth saving, and providing tools and procedures for liquidating or reorganizing.[19] Chapter 7 is understood to provide an orderly process to shed assets and obligations and liquidate. Chapter 11 is thought to preserve the going-concern surplus of a financially-distressed business, and for small business owner-operators it is particularly important for providing increased liquidity and a forum for renegotiating debts.[20]

By one count, since 1980, Chapter 11 has been used to reorganize more than $2.6 trillion in inflation-adjusted liabilities.[21] Large public corporations drive a large portion of these Chapter 11 bankruptcies, and it is also used by a significant number of small businesses.[22]

There is one type of business that rarely uses the formal bankruptcy process, however—venture-backed startups. Despite failing at famously high rates, startups are not frequent bankruptcy filers. This Part offers an explanation of why this is so

---

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

[19] Alan Schwartz, *A Normative Theory of Business Bankruptcy*, 91 VA. L. REV. 1199, 1200-04 (2005) (arguing that an efficient bankruptcy system improves the borrower's investment incentives and can reduce the cost of capital); *cf.* Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648, 651-53 (2010) (highlighting that corporate reorganizations often have "heterogeneous creditors whose rights against the business are deeply fragmented" and pose an "anticommons problem" instead of a "tragedy of the commons").

[20] Baird & Morrison, *supra* note 18, at 2310. The literature on entrepreneurship and personal or small business bankruptcy is voluminous. *See, e.g.*, Kenneth M. Ayotte, *Bankruptcy and Entrepreneurship: The Value of a Fresh Start*, 23 J. L. ECON. & ORG. 161 (2007); John Armour & Douglas Cumming, *Bankruptcy Law and Entrepreneurship,* 10 AM. L. & ECON. REV. 303 (2008); Frank M. Fossen, *Personal Bankruptcy Law, Wealth, and Entrepreneurship: Theory and Evidence from the Introduction of a "Fresh Start" Policy*, 16 AM. L. & ECON. REV. 269 (2014).

[21] Jared A. Ellias, *The Law and Economics of Investing in Bankruptcy in the United States*, forthcoming *in* NACIIL Annual Report 2020, Distressed Debt Trading: Brave New EU Legal Rules in Relation to Bold New Strategies (Eleven Intl. Publishing), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3578170 (crediting UCLA-LoPucki Bankruptcy Research Database). On the importance of reorganizations for large public companies, see Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1 (2007).

[22] *See* Baird & Morrison, *supra* note 18, at 2310-11 (noting that a large portion of Chapter 11 bankruptcies are small businesses and for these "the relevant unit of analysis is the owner and operator of the business, not the business itself").

and provides findings from recent venture-backed startup bankruptcies to shed light on what circumstances tend to push startups toward the formal bankruptcy process.

A. Why Bankruptcy Does Not Fit Most Startups

Although a developed bankruptcy system is considered crucial to entrepreneurship and the business environment, venture-backed startups rarely turn to the formal bankruptcy process. There are several reasons likely driving this result that reflect the nature of the startup business, financing, and ecosystem.

First, many startups experiencing financial distress do not have significant commercial liabilities that need to be satisfied.[23] The primary expense for many startups are the employees themselves.[24] Instead of representing an outstanding debt, the employees are in many ways the key source of value in the startup—together they represent the team's talent and technological know-how. Startup employees are typically at-will and do not have employment agreements that create fixed ongoing obligations for the company. Bootstrapped or distressed startups might be late in making payroll payments, and in that way the employees could become creditors, but in many instances, startups use remaining cash to pay off employees first, and might also do lay-offs or refresh equity incentives.[25] Depending on the startup, it may also have real estate leases, cloud-server contracts, or other similar operational expenses—but these often also do not represent significant outstanding debts.[26]

Second, many startups have a capital structure that does not push toward bankruptcy. Startups rarely raise debt financing from traditional banks, which typically do not lend to startups, especially in their early stages, because they lack a track record and tangible assets, and have a high failure rate and negative cash flow.[27] Startups can burn through millions of dollars before getting to profitability with a revenue-generating product or service. The most significant asset of many startups is intangible intellectual property in the form of patents or trade secrets, which are more difficult to foreclose on and realize value from.[28] For most banks,

---

[23] Derek Liu, *Buying Distressed Tech Start-ups*, BAKER MCKENZIE (May 4, 2020), https://www.bakermckenzie.com/en/insight/publications/2020/05/buying-distressed-tech-startups.

[24] *Id.*

[25] Startup directors may be personally liable for unpaid wages and compensation to employees, and related issues to payroll, and thus might be sensitive to risk exposure. *See* Stephen O'Neill & Thomas Hwang, *What Executives Should Know When Their Company Is on the Brink*, at 2, DORSEY (2017), https://www.dorsey.com/-/media/files/uploads/images/11917-resource-guide-for-dos-when-cos-are-on-brink-of-insolvency-handout.pdf?la=en; see also James Wilson, *Shutting Down a Startup: How to Protect Yourself and Your Investors from Liability*, SILICON VALLEY BANK, https://www.svb.com/startup-insights/startup-strategy/startup-shutdown-when-fails (quoting advice to "[p]ay off employees first").

[26] *Id.*

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

[28] Darian M. Ibrahim, *Debt As Venture Capital*, 2010 U. ILL. L. REV. 1169, 1175 [hereinafter Ibrahim, *Venture Debt*]; Ronald J. Mann, *Secured Credit and Software Financing*, 85 CORNELL L.

the high risks and limited rewards simply do not weigh in favor of lending to startups.[29]

Venture capital arose to fill this financing need for high-growth technology startups.[30] VCs are professional investors who put other people's money to work, typically by acting as general partners of funds organized as limited partnerships that invest in a portfolio of startups.[31] The passive limited partners include wealthy individuals and institutions seeking access to a high-growth alternative asset class, such as pension funds, endowments, foundations, banks, and insurance companies.[32] Venture capital funds have a fixed term, typically ten years, and the venture capital firm makes money by receiving an annual management fee plus a percentage of the profits.[33] Investing in entrepreneurial ventures, particular those involved in technology, pose a range of well-known challenges, however—uncertainty, incomplete contracting, information asymmetry, and agency costs.[34]

In response to these challenges, VCs typically seek convertible preferred stock that comes with voting rights, liquidation, preferences, and other protective terms.[35] Furthermore, they use staged financing that can incrementally transfer control and threaten abandonment if the company falters.[36] As a result, the big picture of venture capital investors is that they are typically equity holders who contract for *debt-like* protections against downside risk.[37] Newer entrants to the venture capital ecosystem, such as private equity, mutual funds, sovereign wealth funds, and the like, have participated in venture capital financing rounds using the same practices—and are thus also equity holders of preferred stock.[38]

The other typical source of financing to startups, particularly in their early stages, are angel investors. These wealthy individuals, often with backgrounds as successful entrepreneurs, are frequently the first source of outside funding to the

---

REV. 134, 138-53 (1999) [hereinafter Mann, *Software Financing*] (describing practical and legal obstacles to liquidating software collateral).

[29] Ibrahim, *Venture Debt*, *supra* note 28, at 1175; Xuan-Thao Nguyen and Erik Hille, *Patent Aversion: An Empirical Study of Bank Financing with Patent Collateral, 1980-2016*, 9 UC IRVINE L. REV. 141 (2018).

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

[31] Gilson, *supra* note 30, at 1068, 1069 (explaining that VCs are "tailored to the special task of financing [the] high-risk, high-return activities" of startup companies, which are "peculiarly suited to commercializing innovation").

[32] *Id.* at 1070.

[33] *Id.* at 1071-72.

[34] GOMPERS & LERNER, *supra* note 27; 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); Pollman, *Startup Governance*, *supra* note 1, at 172.

[35] D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 346-54 (2005); Bratton, *supra* note 9.

[36] *Id.* at 323-24; *see also* Robert P. Bartlett III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 68 (2006) (discussing staged venture capital financing); Pollman, *Startup Governance*, *supra* note 1, at 173 (describing structure of venture capital financings and governance practices).

[37] Bratton, *supra* note 9, at 939-44 (describing why venture capitalists use preferred stock and how they contract for protections from downside failure).

[38] Pollman, *Startup Governance*, *supra* note 1, at 175.

startup.[39] Angels typically invest relatively small sums and receive common stock or use convertible notes or similar debt instruments that provide a means of making deferred equity investments with minimal transaction costs.[40] Convertible notes are technically debt, but holders typically have the right under such agreements to convert into convertible preferred stock if the company raises additional capital.[41] These arrangements are often entered into by angel investors who do not expect the notes to be repaid—they hope for the startup's success and will then convert into equity, but otherwise expect their investment might be worthless.[42] Some forms of convertible notes used by angel investors have even dispensed with a maturity date and do not accrue interest.[43]

Moreover, a startup typically does not take on more than a relatively small number of angel investors and they are commonly a close-knit group of investors who are involved in the governance of the startup or otherwise maintain relationships with the founder-entrepreneurs.[44] Thus, even for startups that have financed the early stages of the venture through angels using debt instruments, they do not typically represent the type of complex debt structures secured by marketable assets for which the formal bankruptcy system would be useful.[45]

Some startups take on what is known as "venture debt"—loans from lenders that specialize in debt financing for startups.[46] Venture debt differs from conventional business loans because it is less contingent on factors like accounts receivable or inventory, and instead is more focused on the relationship with entrepreneurs and the startup's VC backers.[47]

Indeed, venture lenders are a relatively small bunch of specialists in the ecosystem that do not typically lend to a startup unless it has already been funded

---

[39] *See* Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1406-09 (2008). A notable alternative or additional source of capital and support for early-stage startups is a startup incubator or accelerator program, and they often use similar financing arrangements as angel investors. *See* Brad Bernthal, *Investment Accelerators*, 21 STAN. J.L. BUS. & FIN. 139 (2016).

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

[41] Coyle & Green, *supra* note 40, at 44-45.

[42] *Id.* at 45-46.

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

[44] Liu, *supra* note 23, at 2.

[45] *Id.*

[46] Ibrahim, *Venture Debt*, *supra* note 28, at 1170; s*ee also* Xuan-Thao Nguyen, *Lending Innovations*, 86 BROOK. L. REV. 135, 144-45 (2020) ("While more than 99.9 percent of banks shun lending to startups, . . . there are outlier banks. But only four such outlier banks—out of six thousand banks—devote themselves exclusively to serving startups and high-growth companies in the tech industry.").

[47] CB Insights, *What Is Venture Debt?*, https://www.cbinsights.com/research/report/what-is-venture-debt/; Bernthal, *supra* note 43, at 798-99.

by VCs.[48] These lenders are most likely to enter the picture as a follow-on source of funding early in a startup's development and in anticipation that the startup will receive successive funding.[49] This practice helps to make venture debt's failure rate much lower than venture capital—reports estimate that just 1-8% of venture debt is written off.[50] The most active players are entrepreneurial-focused banks like Silicon Valley Bank (SVB), known as the "800 pound gorilla in the room" in terms of venture debt, with about 70% of the market share,[51] and specialized funds like Trinity Capital, Western Technology Investment (WTI) and TriplePoint Capital.[52] They often take a mix of debt and equity in the startup and thus make money through interest payments, fees, and warrants—the latter of which allow the holder to participate in the upside by taking options in the business typically priced at the most recent venture capital financing round's valuation and convertible into shares during an exit.[53]

Most notably, venture debt is not considered a replacement for venture capital-backed equity rounds.[54] Startups often use it for a quick influx of cash for unanticipated events, extending the cash runway before another venture capital financing round, dealing with short-term market downturns—or as a complementary source of cash that is not as dilutive as venture capital.[55] Facebook, for example, used venture debt to purchase some of its first servers.[56]

Thus, while venture debt exists in a fair number of startups' capital structures, it may not represent a significant amount of the overall source of funds or a large outstanding debt. Startups are often wary of taking on too much venture debt because it can cause difficulty for subsequent attempts at raising venture capital because VCs may balk at funding debt repayment instead of growth opportunities.[57] And startups do often use later rounds of venture capital to pay back venture debt, so it may be ultimately repaid even if the startup later fails.[58] Perhaps most notably, even if the debt is significant, venture lenders may be few in number for a particular company and first in line in priority before the complex structure of preferred and common equity holders.[59] Furthermore, these ventures lenders also often have skill

---

[48] Ibrahim, *Venture Debt*, *supra* note 28, at 1173; *see also* Mann, *Software Financing*, *supra* note 28, at 137 ("The lender relies primarily on a symbiotic relationship with the venture capitalist…").
[49] Ibrahim, *Venture Debt*, *supra* note 28, at 1173, 1186-87.
[50] CB Insights, *supra* note 47.
[51] Ibrahim, *Venture Debt*, *supra* note 28, at 1177.
[52] *Id.* at 1177-78; CB Insights, *supra* note 47.
[53] Ibrahim, *Venture Debt*, *supra* note 28, at 1179; CB Insights, *supra* note 47. The typical term of a venture loan is between twenty-four and thirty-six months, and loans are generally amortized over their term. Ibrahim, *Venture Debt*, *supra* note 28, at 1179. Venture lenders that are banks may also make money from securing deposit accounts from startups. *Id.* at 1189.
[54] *Id.* at 1179.
[55] *Id.*
[56] *Id.*
[57] *Id.* Venture capitalists may also bargain for protective provisions in financing documents that include restrictive covenants about startups taking on debt. Bratton, *supra* note 9, at 943-44, n.157.
[58] Ibrahim, *Venture Debt*, *supra* note 28, at 1187 ("While it is the case that most start-ups fail, lending early in the start-up's development means that follow-on venture capital is usually sufficient to repay loans before VCs stop supporting failing start-ups.").
[59] *Id.* at 1189 ("Instead of (or in addition to) security interests, some lenders would enter into contracts with start-ups that entitled them to first priority in the proceeds from the IP's sale.").

at liquidating intellectual property or connections to other specialists who do and thus, given all of the foregoing, often do not have an incentive to push a startup toward formal bankruptcy.[60]

This last point on startup financing connects to a larger one about the nature of startups: they are often "melting ice cubes" in a venture capital ecosystem of repeat players in which reputation matters. The assets or value in the startup is typically a mix of the team's talent and technological know-how, intellectual property or other intangible assets and, depending on the type of business, network effects of a growing enterprise.[61] These can disappear quickly once it becomes known the startup is in distress.[62] Talented employees can flee, often unbound by noncompete agreements.[63] Competitors monitor these situations and actively recruit talent from failing businesses.[64] The stock options, restricted stock units, and common stock often held by employees and founders is usually worthless in distressed situations.[65] Separating founders, in particular, from their intellectual property can destroy potential value,[66] yet they are also not typically locked into the enterprise beyond a sense of moral duty or emotional connection. Furthermore, intellectual property and

---

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

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

[62] Liu, *supra* note 23, at 7 ("Highly skilled tech employees are highly sought after…and the spectre of either a failing company or a disappointing exit transaction may cause many to look at other opportunities.").

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

[64] Liu, *supra* note 23, at 7.

[65] *Id.*; Yifat Aran, Note, *Beyond Covenants Not to Compete: Equilibrium in High-Tech Startup Labor Markets*, 70 STAN. L. REV. 1235, 1269 (2018) (discussing how if an employee's stock options are "out of the money" or underwater from the strike price, the employee is likely to return to the labor market particularly if her base salary falls below market rate).

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

other intangible assets can be hard to value and asset specific,[67] making the prospective value of a bankruptcy proceeding even more uncertain than usual and diminishing as the founders and employees who know how to realize value from it leave.

Not only is the startup a melting ice cube, it is embedded in a network of reputational concerns and constraints. Angel investors, venture capitalists, and venture lenders are all repeat players in venture lending and investing.[68] Opportunistic conduct is constrained by reputational concerns. Particularly in a competitive environment for getting into startup deals, and given the "symbiotic" relationship between venture lenders and VCs, it is not worth squeezing the last dollar back from a startup if it affects one's own reputation.[69] Venture lenders can take security interests in assets to protect themselves. VCs and founders "would rather not glorify their failure with an embarrassing public auction."[70] And, as one bankruptcy lawyer noted, "It's pretty taboo in the Valley to use the term Chapter 11."[71]

Furthermore, VCs typically invest in portfolios of startups with the aim that a small number will deliver home runs that drive much of the returns for the fund—this principle is known as the "power law" of venture capital.[72] Once they perceive the company is unlikely to drive such outsized returns, board members affiliated with VC funds may have incentives to shut down startups or find other exit paths that will not require their continued attention.[73] Startups may be unprofitable and

---

[67] *See* Brady et al., *supra* note 61, at n.2 ("Intellectual property assets usually have a very limited value outside of the business because of the specificity of the intellectual property to the company.").
[68] *See* Pollman, *Startup Governance*, *supra* note 1, at 204 ("VCs and other startup investors are repeat institutional players in a reputation-based market for investments."); Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 254-55 (1998) (arguing that VC opportunism is constrained by reputational concerns).
[69] *See* Steve Blank, *When Founders Go Too Far*, HARV. BUS. REV., Nov.-Dec. 2017, at 99-100 ("Whereas once too many start-ups chased limited amounts of capital from a relatively small number of VC firms, today, some would argue, too much capital is chasing few quality start-ups."); SCOTT KUPOR, SECRETS OF SAND HILL ROAD: VENTURE CAPITAL AND HOW TO GET IT 20-22 (2019) (noting that in the post-2005 era of VC, the amount of capital required to start a company has declined, available capital has increased, and information about building a startup has become widely available, prompting VCs "to compete for the right to fund entrepreneurs").
[70] Erin Griffith, *Startups Rarely File for Bankruptcy. Could that Change?*, FORTUNE (Apr. 21, 2017), https://fortune.com/2017/04/21/plastc-bankruptcy/.
[71] *Id.*
[72] PETER THIEL, ZERO TO ONE: NOTES ON STARTUPS, OR HOW TO BUILD THE FUTURE 86-87 (2014) (discussing the "power law" and noting that "the best investment in a successful fund equals or outperforms the entire rest of the fund combined"); *see also* KUPOR, *supra* note 69, at 84 (noting that "depending on how well the GP is doing converting her other portfolio companies into profit, she might think differently about liquidity with respect to your company. How the fund is doing may also influence your GP's willingness to invest additional money in your startup or . . . seek an exit."); Bob Zider, *How Venture Capital Works*, HARV. BUS. REV., Nov.-Dec. 1998, at 131, 136 ("Given the portfolio approach and the deal structure VCs use, . . . only 10% to 20% of the companies funded need to be real winners to achieve the targeted return rate . . . . In fact, VC reputations are often built on one or two good investments.").
[73] Abraham J.B. Cable, *Opportunity-Cost Conflicts in Corporate Law*, 66 CASE W. RES. L. REV. 51, 53 (2015) ("An opportunity-cost conflict arises when corporate fiduciaries operate under strong

have insufficient cash to fund operations going forward through a bankruptcy. Existing investors already accounted for this possibility by purposely staging rounds of financing at the outset to allow for the possibility of abandonment and may not wish to inject more capital.[74] A long, drawn out bankruptcy process is often the last thing a VC wants to be involved in given opportunity costs and potential reputational harm.

These explanations go beyond the disadvantages of bankruptcy that generally apply to businesses such as the costs of administering the case and the long time frame[75]—although these too may certainly contribute to why startups are unlikely to use the formal bankruptcy system. In sum, for most failing startups the bankruptcy system is not a good fit because of the nature of their business and capital structure, and even when it might hold value there are reputational and cultural factors that push against its use.

B. When Startups Use Bankruptcy

Although startups' use of the formal bankruptcy process is relatively rare compared with the overall number of firms that struggle toward a soft-landing style exit or fail outright, it happens nonetheless. Under what circumstances does this tend to occur?

The literature on venture-backed startups in bankruptcy is sparse. The most notable study, by Professor Ronald Mann, collected a data set of firms from a wide range of geographies in software, biopharmaceutical, and communications that had received a venture-capital investment between 2000-2002—during or shortly after the dot-com bust—and were "out of business" by 2004, and found that 22% of the failed firms had bankruptcy filings.[76] Software firms in the data set filed for bankruptcy at a significantly lower rate.[77] Although Professor Mann's motivation

---

incentives to withdraw human and financial capital for redeployment into new investment opportunities."). Startups that have reached a point in their life cycle in which a big exit has become unlikely, but which continue to operate are sometimes referred to as "zombie" companies or "the walking dead." *See* Rory Carroll, *Silicon Valley's Culture of Failure…and 'The Walking Dead' It Leaves Behind*, GUARDIAN (June 28, 2014), https://www.theguardian.com/technology/2014/jun/28/silicon-valley-startup-failure-culture-success-myth.

[74] *See* Eisenbach, *supra* note 60 (explaining that a Chapter 11 bankruptcy might be "problematic" for a startup when "there is insufficient cash to fund operations going forward, no significant revenues are being generated, and debtor in possession financing seems highly unlikely unless [a] buyer itself would make a loan"); *see also* Bratton, *supra* note 9, at 893 (explaining that VC defend against downside risk ex ante by "staging the drawdowns of funds over time and conditioning the funding commitment on performance targets").

[75] Dov R. Kleiner et al., *Non-Bankruptcy Alternatives to Chapter 11 Restructurings and Asset Sales*, THOMSON REUTERS PRACTICAL LAW (2017), https://www.kkwc.com/wp-content/uploads/2017/06/Non-Bankruptcy-Alternatives-to-Chapter-11-Restructurings-and-Asset-Sales....pdf.

[76] Ronald J. Mann, *An Empirical Investigation of Liquidation Choices of Failed High Tech Firms*, 82 WASH. U. L. Q. 1375, 1384-85 (2004) [hereinafter Mann, *Liquidation Choices*] ("Out of the 161 bankruptcy filings, there were 68 firms (42%) in Chapter 11 at some point in the process and 93 firms (58%) that were exclusively in Chapter 7.").

[77] *Id.* at 1437.

for the study was to test a hypothesis that firms with patents would be less likely to file for bankruptcy, he instead found that the relation between a failed firm's patent portfolio and its likelihood of filing for bankruptcy was "essentially random."[78] The data instead pointed to the following reasons for filing for bankruptcy: redeploying assets to a more productive use, avoiding or transferring some interest important to a sale of the firm, and resolving litigation.[79] Further, Professor Mann found that California tech firms "systematically use bankruptcy less than firms in other states," because the state offers a streamlined alternative process for an assignment for the benefit of creditors ("ABC").[80]

Building on these intriguing findings from around the dot-com bust era, this Section uses a hand-collected set of recent filings to report on a current examination of drivers for venture-backed startups to use the formal bankruptcy process.[81] Together, the various categories of potential drivers that this new examination sheds light on—legal issues, rebirth or pivot to a new business model or owner, debt problems, and the big "startup"—reflect the evolving startup landscape and underscore that choosing bankruptcy is still not the norm.

1. Legal Issues

One set of venture-backed startups that have made formal bankruptcy filings in recent years have involved significant legal issues. While it is certainly not new for startups to face legal difficulty, innovative startups of the twenty-first century have frequently made headlines for their entanglements with the law and aggressive regulatory stances.[82] Whereas many of the dotcom startups of the 1990s focused on

---

[78] *Id.* at 1387-88.
[79] *Id.* at 1420-37.
[80] *Id.* at 1377.
[81] This Part draws on information available from bankruptcy proceedings involving: 38 Studios, LLC; A123 Systems LLC; Abound Solar, Inc.; Aero, Inc.; Alliance of American Football, LLC; Altrec.com Outdoors; Amp'd Mobile Inc.; Aquion Energy, Inc.; Aura Financial LLC; Avaya Inc.; BCause LLC; BrewPublik, Inc.; CloudMine; CODA Automotive, Inc.; Crescent Dunes Solar Energy Project; Crosscode, Inc.; Dart Music, Inc.; Earth Class Mail, Inc.; Evergreen Solar, Inc.; Fisker Automotive; Gawker Media LLC; Immune Pharma Ltd.; ImmunSYS Inc.; Julep Beauty, Inc.; Jumio; Juno USA, LP; Knotel Inc.; Leap Transit Inc.; Lily Robotics, Inc.; Metricom, Inc.; Mobile Gallop LLC; MoviePass Inc.; Munchery; Nasty Gal; NeuroproteXeon, Inc.; NovaSom Inc.; NS8 Inc.; OneWeb Global Limited; OptiScan Biomedical Corp.; Poler Inc.; Proteus Digital Health, Inc.; ProtoStar; Quirky, Inc.; Sandbox VR; Satcon Technology Corp.; Scoobeez Global, Inc.; Searchmetrics GmbH; Sienna Biopharmaceuticals, Inc.; Sinemia, Inc.; Sizmek, Inc.; Solyndra; SpectraWatt Inc.; Sugarfina USA LLC; Suitable Technologies Inc.; SunEdison, Inc.; TerrAvion, Inc.; The Loot Company; uBiome, Inc.; Unlockd Media, Inc.; Vector Launch, Inc.; WiseWear Corp.; XFL.
[82] *See* Elizabeth Pollman, *The Rise of Regulatory Affairs in Innovative Startups*, *in* HANDBOOK OF LAW AND ENTREPRENEURSHIP IN THE UNITED STATES (D. Gordon Smith, Christine Hurt & Brian Broughman eds., forthcoming 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2880818 [hereinafter Pollman, *Rise of Regulatory Affairs*] (describing developments contributing to the rise of regulatory affairs in innovative startups); Elizabeth Pollman & Jordan M. Barry, *Regulatory Entrepreneurship*, 90 S. CAL. L. REV. 383 (2017) (describing "regulatory entrepreneurship" in which pursuing a line of business in which changing the law is a significant part of the business plan).

creating a new virtual world and Internet commerce, many of the recent batch of startups have turned their attention to disrupting industries embedded in existing regulations.[83] More generally, startup culture has fostered a growth-at-all-costs mentality and a willingness to take legal risks.[84] All of these various developments can land startups in legal hot water that is difficult to resolve, particularly if they have not gained enough traction to have collected a war chest to fight legal battles outside of bankruptcy.

Consider uBiome, a medical diagnostics startup, founded in San Francisco in 2012.[85] It started with an at-home testing kit for customers to receive information about their gut bacteria, or "microbiome," and then moved into other sorts of medical tests that required a doctor's order. By 2018, the company had raised three major rounds of venture capital financing, including a reported $83 million Series C round.[86] Just a year later, the company faced FBI enforcement scrutiny for predatory billing practices.[87] According to one news report, "uBiome was routinely billing patients … multiple times without their consent, prompting insurance plans to start rejecting these claims. The company also pressured its doctors to approve tests with minimal oversight…The practices were in service of an aggressive growth plan that focused on increasing the number of billable tests served…"[88] After the FBI raided the offices of uBiome, the company's co-founders resigned.[89] Subsequently, the company filed for Chapter 11, and after failing to secure lending to continue operations, it requested the court to allow it to cease operations and liquidate.[90]

Other examples highlight that a range of legal issues might drive a startup into using a formal bankruptcy process, from losing a single "bet-the-company" legal issue to facing a string of lawsuits that could spark concern about whether the company was using imprudent or wrongful business practices. Illustrating the former type of circumstance is Aereo, the streaming television startup-up, that "set off one of the largest legal battles in the history of television."[91] The company captured broadcast signals on its antennas and transmitted them to subscribers for

---

[83] Pollman, *Rise of Regulatory Affairs*, *supra* note 82.
[84] *Id.*
[85] Alex Knapp, *Health Testing Startup Ubiome Files for Chapter 7 With Plans To Shut Down*, FORBES (Oct. 2, 2019), https://www.forbes.com/sites/alexknapp/2019/10/02/health-testing-startup-ubiome-files-for-chapter-7-with-plans-to-shut-down/?sh=3c9992554b4a.
[86] *Id.*; uBiome, CRUNCHBASE, https://www.crunchbase.com/organization/ubiome (noting uBiome raised over $100 million in funding and last had a Series C financing round).
[87] Knapp, *supra* note 85; Dept. of Justice, uBiome Co-Founders Charged With Federal Securities, Health Care Fraud Conspiracies, Mar. 18, 2021, https://www.justice.gov/usao-ndca/pr/ubiome-co-founders-charged-federal-securities-health-care-fraud-conspiracies. In addition, by 2021, the SEC charged the co-founders with "defrauding investors out of $60 million by falsely portraying uBiome as a successful start-up with a proven business model and strong prospects for future growth." U.S. Securities & Exchange Comm'n, SEC Charges Co-Founders of San Francisco Biotech Company With $60 Million Fraud, Mar. 18, 2021, https://www.sec.gov/news/press-release/2021-49.
[88] CB Insights, 353 Startup Failure Post-Mortems (Aug. 18, 2020), https://www.cbinsights.com/research/startup-failure-post-mortem/.
[89] Knapp, *supra* note 85.
[90] *Id.*
[91] Emily Steel, *Aereo Concedes Defeat and Files for Bankruptcy*, N.Y. TIMES (Nov. 21, 2014), https://www.nytimes.com/2014/11/22/business/aereo-files-for-bankruptcy.html.

a fee.[92] Challenged by competitors, the company litigated its business model all the way up to the U.S. Supreme Court, which ruled that Aereo violated copyright laws with its business model.[93] The case was sent back to lower courts and the company spent several months trying to find a way to continue its operations.[94] The company's CEO finally conceded in a blog post that the company's legal and regulatory challenges were too difficult to overcome.[95] It filed for bankruptcy to "maximize the value of its business and assets"—to try to put an end to its court battles and salvage the value left in the business.[96]

An example of the latter scenario is Nasty Gal, the fashion e-commerce company founded in Los Angeles and famous for its "GirlBoss" founder. The company was plagued with a long string of lawsuits and litigation threats that came amidst operational and liquidity struggles and a reportedly "toxic" culture.[97] In 2011, the Hells Angels brought a trademark infringement suit against Nasty Gal.[98] In 2014, the company faced a copyright infringement suit.[99] By 2015, the company was the defendant in a series of lawsuits alleging that Nasty Gal wrongfully discharged employees for health conditions and pregnancy.[100] That year, the CEO-founder ceded her executive role.[101] The company faced another copyright infringement suit the following year, and filed for bankruptcy, citing difficulty with "managing and controlling Nasty Gal's aggressive growth…and significant liquidity issues" in light of the company's struggles to raise additional capital or find a buyer.[102] Within weeks of entering Chapter 11, the company struck a deal to sell its brand name to a British retailer for $20 million, a fraction of the company's

---

[92] *Id.*

[93] *Id.*; Am. Broadcasting Cos., Inc. v. Aereo, Inc., 573 U.S. 431, 436 (2014).

[94] Steel, *supra* note 91.

[95] *Id.*

[96] *Id.*; Declaration of Ramon A. Rivera, Secretary, Treasurer, and Chief Financial Officer of Aereo, Inc. In Support of First Day Pleadings, U.S. Bankr. S.D.N.Y. (Nov. 20, 2014) ("Although the legal and regulatory framework is shifting in the Debtor's favor, the timing of a decision from the FCC is uncertain. Faced with mounting litigation costs and operational concerns…the Debtor's board of directors determined that it would be in the best interests …to commence these Chapter 11 proceedings in order to obtain necessary breathing room while it seeks to effectuate a sale of all or substantially all of its assets, or to achieve a recapitalization or similar restructuring transaction.").

[97] *Nasty Gal: A History of Legal Battles*, THE FASHION LAW (Feb. 3, 2017) (on file with author); Sarah Chaney, *How Nasty Gal Went From an $85 Million Company to Bankruptcy*, WALL ST. J. (Feb. 24, 2017), https://www.wsj.com/articles/how-nasty-gal-went-from-an-85-million-company-to-bankruptcy-1487932201. A similar "bet-the-company" strategy that landed in bankruptcy is Unlockd, an app company that fought Google in litigation to secure preliminary injunctions against its removal from Google's platform, but it was not enough to save the company, which ultimately filed for Chapter 11. CB Insights, 11 Lessons From Startup Chapter 11s, June 6, 2019, https://www.cbinsights.com/research/bankruptcy-startup-lessons/.

[98] *Nasty Gal: A History of Legal Battles*, *supra* note 97.

[99] *Id.*

[100] *Id.*

[101] *Id.*

[102] Declaration of Joe Scirocco In Support of Emergency First Day Motions for Relief, U.S. Bankr. C.D. Cal (Nov. 14, 2016).

one-time $200 million valuation.[103] In this way, with its mix of operational and legal woes, Nasty Gal also exemplifies the topic we turn to next—the use of bankruptcy proceedings as a pivot when other options are not available.[104]

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

Another theme that emerges from recent startup bankruptcies is that formally filing for a Chapter 11 reorganization can serve as a fail-safe device when a company hits the rocks and other options are unavailable. For companies that were heavily funded or have promising technology, filing for bankruptcy might effectively buy the company some additional runway to find a new business model or owner to give the company a rebirth.[105]

Consider, for example, Aquion Energy. The company raised nearly $200 million from Bill Gates, the prominent venture capital firm Kleiner Perkins, the oil-and-gas giant Shell, and other investors, to work on developing an inexpensive saltwater battery for renewable energy sources like wind and solar.[106] The technology development was on track, but revenue growth was slow from its strategy of going after niche markets, and the company was burning significant capital as it tried to ramp up materials production and manufacturing.[107] The company needed more money and more often than venture capitalists are generally willing to provide—it was an unusually capital-intensive business.[108] In addition, its technology faced competition from lithium-ion battery technology, manufactured by large industry players that might have been offering significant discounts as they aggressively pushed for market share.[109] Aquion was unable to raise the capital it needed to continue operating as a going concern.[110]

In the face of these challenges, the company had concluded that it needed to find a M&A exit—likely a multinational company that had an interest in putting Aquion's technology into their own product line or system.[111] But the company was running out of cash before it could find and close such a deal, so it turned to the

---

[103] Chaney, *supra* note 97; Kayleen Schaefer, *What Comes After Scandal and Scathing Reviews? Sophia Amoruso Is Finding Out*, VANITY FAIR (Apr. 26, 2017), https://www.vanityfair.com/style/2017/04/sophia-amoruso-girlboss-netflix-nasty-gal.

[104] *See* Valeriya Safronova, *Nasty Gal's Path to Bankruptcy*, N.Y. TIMES (Nov. 11, 2016) ("[T]he picture that's emerging is one of rapid growth, built largely around the personality of Nasty Gal's founder and undercut by mismanagement and legal stumbles.").

[105] Startups could similarly pivot through an ABC process, as illustrated by consumer electronics startup Jawbone, once valued at $3 billion did with the assistance of well-known startup liquidators Sherwood Partners. *See* Reed Albergotti, *Jawbone to Be Liquidated as Rahman Moves to Health Startup*, THE INFORMATION (July 6, 2017), https://www.theinformation.com/articles/jawbone-to-be-liquidated-as-rahman-moves-to-health-startup.

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

[107] *Id.*

[108] *Id.*

[109] *Id.*

[110] James Ayre, *Aquion Energy Files for Chapter 11 Bankruptcy*, CLEAN TECHNICA (Mar. 15, 2017), https://cleantechnica.com/2017/03/15/aquion-energy-files-chapter-11-bankruptcy/.

[111] Temple, *supra* note 106.

bankruptcy system to extend its time to find an exit or pivot.[112] Before filing, the company reportedly fired 80% of its workforce and ceased its operations.[113] Aquion spent the next several months restructuring, shedding some of its debts, and ultimately finding a buyer for $9.2 million that was willing to invest millions more to put the company on a new track with a new business strategy of selling directly to big grid operations in China.[114] After the bankruptcy and sale concluded, the founder of Aquion reflected that through the process it had become "a very different company, and one better positioned to succeed in the brutal storage business."[115]

A similar example is Earth Class Mail, an Oregon-based startup that originally started with the name Document Command and a business model of digitizing user's paper mail by hand: "taking over the post office of the world."[116] It did not take long before digitizing thousands of pieces of physical mail became an untenable business model and the company's funding dried up.[117] Eventually the company filed for bankruptcy, from which it pivoted with a new buyer—a technology investment firm—that transitioned the company to a B2B business model with business customers and new technological support.[118]

3. Debt Problems

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

For example, 38 Studios, a video game startup founded by a retired Red Sox pitcher, accepted a $75 million loan from the state of Rhode Island to fund its development of an ambitious multiplayer online role-playing game.[119] The state gave the large loan to the startup in exchange for the company's promise to create 450 jobs in Rhode Island.[120] Taking public money instead of traditional venture capital put the company in an unusually difficult position as it was required to continue to add jobs in the state even as it ran low on cash, and it had taken on special obligations of home mortgages for relocated employees.[121] Moreover, once it hit financial distress, the company faced an even bigger problem—it also had

---

[112] *Id.*
[113] Ayre, *supra* note 110; *see also* Bankrupt Aquion Energy Hit With WARN Complaint, LAW 360 (Mar. 31, 2017), https://www.law360.com/articles/908646/bankrupt-aquion-energy-hit-with-warn-complaint (noting that the company laid off more than a hundred employees and was hit with a lawsuit alleging that it had not given workers adequate notice).
[114] Temple, *supra* note 106.
[115] *Id.*
[116] CB Insights, 11 Lessons, *supra* note 97.
[117] *Id.*
[118] *Id.*
[119] Todd Wallack, *38 Studios Files for Bankruptcy*, BOSTON.COM (June 8, 2012), https://www.boston.com/news/technology/2012/06/08/38-studios-files-for-bankruptcy.
[120] *Id.*
[121] *Id.*

1,000 additional creditors, including workers who were collectively owed more than $150 million.[122] The company said it was "unable to find a solution" to the "stalemate" reached in negotiations with the state, investors, and others—and it laid off more than 400 employees and filed for Chapter 7 bankruptcy to liquidate its assets and figuratively throw in the towel.[123]

Another example of a startup's debt problems leading to bankruptcy is Cloudmine, a Philadelphia-based startup that raised approximately $15.6 million to develop a cloud-based healthcare platform.[124] The business model was capital-intensive in its early stages with a long lag-time before the promise of becoming highly profitable.[125] The company took on venture capital, primarily from East Coast-based firms, as well as debt from lender Comerica bank, which ultimately "declared a default and swept the company's bank account," pushing the company to file for Chapter 7 bankruptcy to liquidate its assets—likely intellectual property related to its software.[126] The company's capital-intensive business model combined with its particular mix of investors and asset-based lenders may have contributed to its difficulty in staying afloat and its turn to bankruptcy once the lender declared a default.[127]

4. The Big "Startup"

Finally, the last main category or trend that emerges from examination of startup bankruptcies is the circumstance of startups in distress that raised mega rounds of funding. In previous times, it was unusual for a startup to raise hundreds of millions or even $1 billion or more while private. Such levels of fund-raising for venture-backed startups have occurred more often in recent years as companies stay private longer and raise larger rounds of financings.[128] These behemoth companies strain the label "startup" and when they encounter financial difficulty, many of the typical pathways for dealing with failure for smaller startups such as an acqui-hire or ABC are ill-suited to the circumstances.

OneWeb is an example of this phenomenon. Founded in 2012, the company aims to use a large network of broadband communication satellites to provide

---

[122] *Id.*

[123] *Id.*

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

[125] *Id.*

[126] *Id.*

[127] An interesting twist on this theme may be instances in which customers file an involuntary petition seeking to push a startup into Chapter 7 bankruptcy. *See, e.g.*, Customers Try To Push Bitcoin Startup into Chapter 7, 2014 WL 1924102 (May 15, 2014), In re HashFast Techs. LLC et al., No. 14-20725, petition filed (Bankr. N.D. Cal. May 9, 2014) (noting that customers filed an involuntary petition in an attempt to force a bitcoin mining hardware startup into Chapter 7 bankruptcy).

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

"high-speed services capable of connecting everywhere, to everyone."[129] The company raised—and burned through—$3.4 billion from Airbus, SoftBank Group, and the government of Rwanda, among other investors, by the time it filed for Chapter 11 bankruptcy.[130] The company faces enormous regulatory and operational challenges, as well as competition from SpaceX, led by Elon Musk, which has a similar worldwide internet concept.[131] After failing to obtain new funding from investors during the early days of the covid-19 pandemic, OneWeb laid off about 85% of its workforce and filed for bankruptcy to "pursue a sale of its business in order to maximize the value of the company."[132] The company emerged from its bankruptcy protection status several months later, owned by a new consortium of investors consisting of the U.K. government and Indian conglomerate Bharti Enterprises.[133]

Solyndra provides another example. Founded in 2005, Solyndra sought to deliver less expensive, easier to install, polysilicon-free, cylindrical solar panels.[134] By 2009, Solyndra raised $681.2 million in venture capital financing and $119.1 million worth of debt financing before receiving a $535 million conditional loan guarantee from the U.S. Department of Energy in March 2009.[135] Shortly thereafter, the Wall Street Journal listed the company at the top of the "The Next Big Thing: Top 10 Cleantech Companies."[136]

However, Solyndra's troubles began even before the federal loan was approved. One of the company's primary selling points was that Solyndra's units did not use the expensive polysilicon components relied on by traditional panels.[137] But in early 2008, after years of increase, the price of polysilicon dropped drastically.[138] Chinese firms began to enter the U.S. solar power market and undercut Solyndra's

---

[129] Stanley Reed, *Britain Gambles on a Bankrupt Satellite Operator, OneWeb*, N.Y. TIMES (July 10, 2020), https://www.nytimes.com/2020/07/10/business/britain-oneweb.html.
[130] *Id.*
[131] *Id.*
[132] Lauren Muskett, *SoftBank-Backed Satellite Startup Files for Bankruptcy*, CFO (Mar. 30, 2020), https://www.cfo.com/bankruptcy/2020/03/softbank-backed-satellite-startup-files-for-bankruptcy/#:~:text=Lauren%20Muskett,of%20the%20COVID%2D19%20pandemic.
[133] Reed, *supra* note 129; Darrell Etherington, *OneWeb Emerges From Bankruptcy, Aims to Begin Launching Satellites Again on December 17*, TECHCRUNCH (Nov. 20, 2020), https://techcrunch.com/2020/11/20/oneweb-emerges-from-bankruptcy-aims-to-begin-launching-satellites-again-on-december-17/; Jonathan O'Callaghan, *U.K. Government Wins Controversial Bid for Bankrupt Mega Constellation Firm OneWeb*, FORBES (July 3, 2020), https://www.forbes.com/sites/jonathanocallaghan/2020/07/03/uk-government-wins-controversial-bid-for-bankrupt-mega-constellation-firm-oneweb/?sh=7f85c0435b9d.
[134] Matthew L. Wald & Michael Kanellos, *F.B.I. Raids Solar Firm That Got U.S. Loans*, N.Y. Times (Sept. 8, 2011), https://www.nytimes.com/2011/09/09/business/solar-company-is-searched-by-fbi.html.
[135] Company Profile of Solyndra, PITCHBOOK, https://my-pitchbook-com.proxy.library.upenn.edu/profile/40658-59/company/profile#insights (last visited May 17, 2021).
[136] *Top 10 Cleantech Companies*, WALL ST. J. (March 8, 2010), https://www.wsj.com/articles/SB10001424052748704548604575097791980259602.
[137] Saqib Rahim & Peter Behr *How Well Did DOE Know Solyndra's Technology – and Its Market Vulnerabilities?*, N.Y. TIMES (Sept. 15, 2011), https://archive.nytimes.com/www.nytimes.com/cwire/2011/09/15/15climatewire-how-well-did-doe-know-solyndras-technology-a-88462.html.
[138] *Id*.

unit production cost.[139] Although Solyndra began 2010 with momentum and hosted President Obama at its Fremont factory, by the end of the year it was apparent the company would not be able to repay the federal loan.[140] Despite efforts to restructure and Solyndra taking on an additional $75 million in debt, the company eventually defaulted and laid off 1,100 employees.[141] By September 2011, Solyndra filed for Chapter 11 bankruptcy.[142] The filing was quickly followed by an FBI raid of Solyndra's Fremont headquarters, as well as Congressional investigations.[143] The unusual size and source of its funding, with a significant public dimension and political implications, likely contributed to its turn to the formal bankruptcy process.

* * * * *

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

II. A System For Dealing with Startup Failures

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

This Part sets out the various pathways to get rid of a startup that is struggling to raise more funding or that has lost its early hopes or promise for a big exit. A range of options exists, and a rich literature examines many of these individually, yet has not before been explored in the big picture—as a system for dealing with failed startups. Scholars have long theorized bankruptcy as a system and recognized

---

[139] Wald, *supra* note 126.
[140] *Id.*
[141] *Id.*
[142] Tom Hals, *Solyndra bankruptcy plan approved over U.S. objections*, REUTERS (Oct. 22, 2012), https://www.reuters.com/article/us-solyndra-bankruptcy-approvalenv/solyndra-bankruptcy-plan-approved-over-u-s-objections-idUSBRE89L15L20121022.
[143] Wald, *supra* note 126.

its important contribution to the institutional framework for entrepreneurship.[144] This Article argues that the alternatives to bankruptcy that venture-backed startups commonly use can be understood in a similar way and as critically important to sustaining the system of venture capital and startups.

A. M&A Sales

Once a startup founder, CEO, or board realizes that its current path is not working, it will often consider pivoting to a new business model or raising a round of funding from new investors.[145] If those are not viable, a startup will often try to find a buyer.[146]

Selling the company through a M&A deal is generally the first preference for most startup participants in a venture that does not have a likelihood of continued lifespan as an independent venture-backed startup. As the company begins to search for a deal, there might still be some hope for success and a payout for founders and employees. Even if the company cannot find a deal that will bring financial success for all participants, founders and employees might at least be enticed by some deal "carrots,"[147] employment at the acquiring company, or the ability to craft a narrative of success for their individual career paths.[148] Investors might be able to recoup at least some of their investment and redeploy their time and capital into more promising ventures.[149]

M&A deals can often be difficult to parse as successes vs. failures—participants often characterize them as a successful or at least semi-successful exit even if the company is sold for a fraction of the amount of money raised and burned, and some equity holders do not get a return or any of the deal proceeds. Achieving a M&A exit might understandably be appreciated not only because it recovers some capital for investors, but also as a validation that the startup produced something of value.[150] These deals can pose difficult situations for startup boards navigating their

---

[144] *See, e.g.*, Johan Eklund, Nadine Levratto & Giovanni B. Ramello, *Entrepreneurship and Failure: Two Sides of the Same Coin?*, 54 SMALL BUS. ECON. 373, 374 (2020) ("In this respect, the institutions, by managing bankruptcy, are no longer devoted to simply protect the economy or even to somewhat setting limits on the behavior of failed entrepreneurs, but rather operating the delicate issue of regulating a physiological event with the general aim of providing the proper stimuli to the market, for fostering as soon as possible the reshuffling of skills and resources into new, hopefully successful, entrepreneurial activities. In other words, the institutional framework sets up part of the incentives affecting entrepreneurial action and is thus relevant not only for failed entrepreneurs but for the whole market.").
[145] EISENMANN, *supra* note 7, at 250-54.
[146] *Id.* at 254.
[147] *See* Broughman & Fried, *supra* note 5.
[148] *See id.* at 1326 (finding that in 45% of trade sales VCs give at least one type of carrot such as sale bonuses or carve-outs to common shareholders); EISENMANN, *supra* note 7, at 255-56 (discussing founder perspectives on M&A deals when a startup is failing).
[149] *See* EISENMANN, *supra* note 7, at 263-64; Cable, *supra* note 73, at 53.
[150] *See, e.g.*, Puri & Zarutskie, *supra* note 10, at 2276 (finding that "[t]here is no significant difference in the size of VC- and non-VC-financed firms at acquisition or IP" and "[t]hus, it does not appear that venture capitalists are disguising failures as acquisitions").

fiduciary duties.[151] The tensions and disputes that these exits raise between the different startup participants often arise because perceptions of success vary, and financial or personal interests may not align.[152]

The typical choice of deal structures is either: (a) a purchase of the equity of the startup company (either via a stock purchase or a merger) or (b) an asset purchase.[153] A stock purchase or merger can potentially be done quickly—assuming internal shareholder approvals are in place and the deal falls below the threshold for antitrust filings, a deal could even close on the same day that it is signed.[154] Employee and customer flight away from the startup can be minimized.[155] As one startup lawyer explained, "This speed becomes an incredible advantage in the melting ice-cube situation of a distressed startup: the management teams can negotiate without any publicity regarding the financial distress, and the transaction can be presented to the world as a fait accompli."[156]

Asset purchases are, by contrast, typically slower to negotiate and execute but they allow for customizing the assets and liabilities to be transferred—subject to the two notable exception doctrines of successor liability and fraudulent conveyance.[157] Some deals are asset purchases that do not keep much of the company intact and might be better thought of as liquidations and wind-downs. A vivid example of this is the recent mega failure of Quibi, the streaming video-service startup which rapidly torched nearly a billion dollars to launch the service and then realized that it had crashed and burned when it could not get enough subscribers to use the service after the free trial ended.[158] In a written statement, the co-founders, Jeffrey Katzenberg and Meg Whitman, explained: "Quibi was a big idea and there was no one who wanted to make a success of it more than we did. We exhausted all options and came to the difficult decision to wind down the business."[159] Quibi returned some of the cash left on hand to its investors, and then sold its content rights to Roku, after reportedly finding no other deals to sell the

---

[151] *See, e.g.*, Brian Broughman & Jesse Fried, *Renegotiation of Cash Flow Rights in the Sale of VC-Backed Firms*, 95 J. FIN. ECON. 385 (2010); Jesse Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967 (2006); Robert P. Bartlett, III, *Shareholder Wealth Maximization as Means to an End*, 38 SEATTLE U. L. REV. 255 (2015); Cable, *supra* note 73; Pollman, *Startup Governance*, *supra* note 1.

[152] *See* EISENMANN, *supra* note 7, at 256 (explaining that founders may not want a deal that yields little or no personal financial upside and requires working for the acquirer); Pollman, *Startup Governance*, *supra* note 1, at 160-61 (describing how vertical and horizontal conflicts or misalignments between startup participants grow over time).

[153] Liu, *supra* note 23, at 2; *see also* Cable, *supra* note 5, at 328 (noting acquirers "have a strong preference for mergers or asset sales . . . rather than acquiring stock from individual shareholders").

[154] *Id.* at 2-3.

[155] *Id.* at 3.

[156] *Id.*

[157] *Id.* Successor liability laws can allow the liabilities of the target to follow the assets under certain circumstances. Fraudulent conveyance laws can allow creditors to claw back assets or unwind transfers if they can prove that assets were transferred for less than fair value when the target was insolvent or near insolvent, with the effect of unfairly depriving creditors.

[158] Benjamin Mullin & Lillian Rizzo, *Quibi Was Supposed to Revolutionize Hollywood. Here's Why It Failed.*, WALL ST. J. (Nov. 2, 2020), https://www.wsj.com/articles/quibi-was-supposed-to-revolutionize-hollywood-heres-why-it-failed-11604343850.

[159] *Id.*

company as a whole.[160] The example highlights the difficulty of finding buyers and how they often drive the choice of deal structure.

As a sign of the need for a systematic way to efficiently sell startups that have in some sense failed but still have some value, online marketplaces have sprung up which let companies list themselves for sale.[161] While big startup exits grab news headlines, sites like MicroAcquire provide a "quiet world of tiny acquisitions."[162] In just the first year of operation, MicroAcquire had 25,000 potential buyers sign up and it facilitated the acquisition of over one hundred startups on its marketplace.[163] The startups listed for sale are usually four to five years old, and their names are not publicly disclosed until they have fielded interest from buyers.[164] More than half of the acquired startups during this period had less than $100,000 in annualized recurring revenue.[165] MicroAcquire is not the only marketplace—others like Flippa and Empire Flippers serve a similar function.[166]

However, a company might search for a buyer, the process of trying to sell the company may be contentious and risky, particularly past the early stage of a startup. Some potential acquirers will express interest to learn more about the startup's strategy, intellectual property, or performance—and will waste the startup's remaining time and money, potentially dooming it to a worse fate.[167] If the process is not successful at finding a buyer, the startup may be perceived as "damaged goods" in the market.[168] Raising bridge financing to fund the company while it searches for a buyer can put the existing investors in conflict over "cram down" or "down round" terms that significantly dilute non-participating investors and raise issues for VC board members wearing two hats as "dual fiduciaries."[169] Despite these challenges, selling the company is generally the best outcome for a failed startup to make a graceful exit.

B. Acqui-hire Transactions

Some companies cannot find a buyer for a M&A deal but do find a different option available: an "acqui-hire." An acqui-hire is an acquisition that is carried out predominantly to hire a team of talent.[170] In a sense it is "an extreme form of an

---

[160] *Id.*; Amol Sharma, Benjamin Mullin & Cara Lombardo, *Roku Nears Deal to Buy Rights to Quibi's Content*, WALL ST. J. (Jan. 3, 2021), https://www.wsj.com/articles/roku-nears-deal-to-buy-rights-to-quibis-content-11609725389.

[161] Kia Kokalitcheva, *MicroAcquire's Marketplace Helps Small Businesses Get Acquired*, AXIOS (Oct. 9, 2020), https://www.axios.com/microacquire-small-business-acquisition-dfdcd6cf-58d0-4fdc-9030-2de81a507084.html.

[162] *Id.*

[163] *Id.*

[164] *Id.*

[165] *Id.*

[166] *Id.*

[167] EISENMANN, *supra* note 7, at 255.

[168] *Id.* at 256.

[169] *Id.* at 257; Steven E. Bochner & Amy L. Simmerman, *The Venture Capital Board Member's Survival Guide: Handling Conflicts Effectively While Wearing Two Hats*, 41 DEL. J. CORP. L. 1, 3 (2016).

[170] John F. Coyle & Gregg D. Polsky, *Acqui-Hiring*, 63 DUKE L.J. 281, 283-84 (2013).

asset sale."[171] In many of these transactions, the buyer has little interest in the assets or projects of the startup—the target is instead the people.[172]

By way of context, competition for engineering talent has long been fierce in Silicon Valley and in the technology sector more broadly.[173] With an acqui-hire, the acquirer/employer not only gets the benefit of bringing new talent on board, but an experienced team that already knows how to work together on technology development.[174] Hiring a team with particular expertise can also help an acquirer move quickly into a new space of innovation.[175] For example, when Apple was building its cloud-based music service, it bought Lala, a startup that had been an early pioneer in music streaming.[176] Shortly after, Lala's founder left Apple and a bunch of fellow former Lala engineers followed him to start a new company related to video and photo sharing technology that eventually failed.[177] For a small fraction of the reported Lala deal price, Apple acqui-hired the team back and got nearly two dozen employees, seasoned at working together, all at once.[178] For the acquirer/employer, the opportunity to enter into an acqui-hire transaction is at core a "make vs. buy" decision for engineering and entrepreneurial talent.[179]

For a startup without a better M&A deal on the table, an acqui-hire can represent a soft landing for founders and employees. For founders, an acqui-hire can provide the optics of an acquisition and thus an "exit" on their resumé.[180] The value of having a transaction that can be characterized as an exit can be of personal benefit in terms of psychic reward or relief, but also in terms of reputation that could be of potential monetary value in the future should founders or employees wish to become entrepreneurs again.[181] Depending on the acquirer and the level of

---

[171] Liu, *supra* note 23, at 4.

[172] Coyle & Polsky, *supra* note 170, at 283; *see also* Cable, *supra* note 5, at 328 ("In Silicon Valley, acquisitions are often focused on acquiring talent rather than hard assets or specific technology—'the buyer wants the team.'").

[173] *See, e.g.*, ANNALEE SAXENIAN, REGIONAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE 128, at 35 (1996) (describing vigorous competition for engineering talent in Silicon Valley as early as the 1970s); Ronald J. Gilson, *The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete*, 74 N.Y.U. L. REV. 575, 593 (1999) (describing the legal infrastructure of California's longstanding policy rendering noncompetes unenforceable and its culture of "open social and professional relations" that foster job networking and talent acquisition); LOBEL, *supra* note 63, at 11-26 (discussing "the talent wars" in the technology sector).

[174] Coyle & Polsky, *supra* note 170, at 294.

[175] *Id.*

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

[177] *Id.*

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

[179] EISENMANN, *supra* note 7, at 267.

[180] Coyle & Polsky, *supra* note 170, at 320-21 (discussing the "social status that entrepreneurs derive from being able to claim that they sold their company").

[181] *Id.* at 314-17.

incentive compensation allocated for the founders and employees, these individuals may or may not find the employment opportunity particularly attractive. They might prefer to join another startup or company rather than work for the acquirer, which is often a large technology company, but for some the lure of a juicy pay package or at least a relatively good story to tell about what happened to the startup is enough to push toward an acqui-hire. For investors, if a traditional M&A deal is not available, and the founders and employees are not formally locked-in, an acqui-hire may be the only path available to potentially recoup some capital and be able to say the portfolio company had an exit.[182]

Notably, there is no universal structure for acqui-hires.[183] They are commonly done as an asset purchase with offers of employment to the target employees that the buyer wants, together with a relatively small amount of consideration to the target entity itself.[184] On the small side, an acqui-hire could be as simple as a cash payment in consideration for the startup's covenant not to sue the buyer and incentive packages for the employees being brought on board.[185] On the larger side, the deal could be structured as a stock purchase or merger and might involve some intellectual property.[186] The distinctive feature of the acqui-hire is that the main target asset is talent—thus the deal structure will include two pools of compensation, one for compensating the employees being hired and one for deal consideration in the form of cash or buyer's stock.[187] The allocation of the aggregate consideration between the two pools is the key economic issue, with the buyer and target employees typically aligned in preferring to allocate more to the compensation pool.[188] After closing, the buyer typically redeploys the newly hired employees onto its own projects.[189]

Sometimes an acqui-hire will include only part of a startup's team. This reality evidences the diverging interests among startup participants that must be navigated to resolution. As entrepreneurs at ChangeCoin, a startup that let people tip each other with bitcoin, explained: "We've explored dozens of options [to stay in business] thoroughly over the past few months, and came up empty. It's time. Among other complications, the monthly costs to maintain the servers, services, and customer support to keep the site running are not insignificant. Furthermore, the potential legal liabilities that may arise make a volunteer effort unappealing."[190] It accepted Airbnb's offer to acqui-hire the majority of its team.[191] The acqui-hire

[182] *Id.* at 321-22 ("From the perspective of an angel investor or a VC . . . it is better to be able to say that a portfolio company was acquired by Google than to say that it failed, even if the economics between the two outcomes are not materially different.").
[183] *Id.* at 296.
[184] Liu, *supra* note 23, at 4.
[185] Coyle & Polsky, *supra* note 170, at 296.
[186] *Id.*
[187] *Id.* at 297-98.
[188] *Id.* at 299.
[189] *Id.*
[190] ChangeTip Founder, *ChangeTip Shutting Down*, REDDIT (2016), https://www.reddit.com/r/changetip/comments/5dn3rc/changetip_shutting_down/ [hereinafter ChangeTip Founder Statement].
[191] Biz Carson, *Airbnb Just Brought on a Team of Bitcoin Experts from a Tiny Startup*, BUS. INSIDER (Apr. 12, 2016), https://www.businessinsider.com/airbnb-buys-bitcoin-startup-changecoin-2016-4.

did not include any intellectual property or assets, and the company explained that it would subsequently shut down.[192] This example highlights the space that an acqui-hire often occupies in the system of options for dealing with a failed startup—often worse than a traditional M&A deal but better than a liquidation—and sometimes featuring aspects of either or both.

C. Assignment for the Benefit of Creditors

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

An assignment for the benefit of creditors, or "ABC," is a state law insolvency proceeding in which a debtor's assets are assigned by contract to an assignee acting like a trustee over those assets.[193] ABCs can be faster, cheaper, less public, less work for corporate directors and officers, and less subject to oversight compared with a formal bankruptcy proceeding for a liquidation.

ABCs are generally implemented under a state statutory scheme—but not all states have them and those that do vary widely.[194] As a general matter, the process involves the company choosing an ABC firm to work with as its assignee and then the ABC firm liquidates the assets for the benefit of creditors.[195] The company debtor in an ABC does not continue its operations or reorganize—and, notably, it does not receive a discharge of its debts.[196] Board and shareholder consent is typically required.[197] As usual in startup matters, the potential for diverging interests among startup participants lurks, and concern can arise about the decision to enter into an ABC or about the alignment of interest between the ABC firm's priorities and those of other startup participants.[198] The assignee serves as a

[192] *Id.*; ChangeTip Founder Statement, *supra* note 190 ("In the spring of 2106, ChangeTip's employees were acqui-hired by Airbnb, where most of us work today. Since then, we've been searching for the best outcome for ChangeTip, and unfortunately the only remaining option is to shut it down.").

[193] Kleiner et al., *supra* note 75, at 1, 5.

[194] *See id.* at 5-6; *see also* Mann, *Liquidating Choices*, *supra* note 76, at 1377, 1398 (discussing the startup-favorable ABC law in California).

[195] Kleiner et al., *supra* note 75, at 5.

[196] *Id.* There is no automatic stay; litigation could continue against the debtor-assignor. Likewise, there are no "free-and-clear sale order" from a bankruptcy court. Andrew De Camara, *The 1, 2, 3s of ABCs*, TURNAROUND MANAGEMENT ASSOCIATION (July/Aug. 2018), https://turnaround.org/jcr/2018/07/1-2-3s-abcs; *see also* Liu, *supra* note 23, at 4 ("The downside is that because the technical sale occurs between the assignee and the buyer, the buyer is often stuck with very limited representations to the assets and little if no post-closing recourse. As such, ABCs are likely best reserved for extreme situations where the purchase price is so low as to be unable to satisfy a fairly large number of lenders and/or trade creditors.").

[197] Notably, buyers cannot assume secured debt without the secured creditor's consent, nor is there the possibility for a cramdown as in a Chapter 11 bankruptcy.

[198] *See, e.g.*, Berg & Berg Enter., LLC v. Boyle, 100 Cal. Rptr. 3d 875, 880-81 (2009) (holding that creditor failed to plead a cognizable claim for breach of fiduciary duty against startup directors who decided to do an ABC instead of pursuing the creditor's bankruptcy plan to protect net operating losses through a chapter 11 reorganization); EISENMANN, *supra* note 7, at 270 (providing example

fiduciary to all creditors.[199] Once the assignee is selected, it is effectively like turning over the keys to the company—the assignee manages the liquidation process, not the board or officers.

For startups, there are well-known professionals who are in the business of serving as ABC assignees. One firm in particular, Sherwood Partners, has handled ABCs, receiverships, and bankruptcies of startups for almost thirty years.[200] The firm has been called the "undertakers of Silicon Valley"—and one of its partners, "the Terminator of startups."[201] In his words, they are not undertakers, but an ABC is like a "private funeral" in which the company is quietly shut down.[202] Venture lenders such as Silicon Valley Bank and WTI are also experienced repeat players at foreclosing on startup assets, particularly technology-related, and working with liquidators like Sherwood Partners.[203]

The existence of specialized players in the startup ecosystem to facilitate ABCs underscores the need for efficient ways to get rid of failing startups. An ABC process is less time consuming for founders, directors, and officers, who might otherwise have to engage in an out-of-court workout or formal bankruptcy—instead, with an ABC they can hire a specialized firm to handle the liquidation process and devote their attention to other ventures and new opportunities.[204] It is usually quicker than a bankruptcy and the specialized players have industry expertise and connections that may enable them to recover more value than would be recaptured by a bankruptcy trustee assigned by a court.[205]

One potential downside of an ABC as compared with a formal bankruptcy is that assets are generally sold "as is" and there are a lack of bankruptcy protections for buyers.[206] The reputation of established ABC firms can help give buyers some

---

of a bank lender that retained an ABC firm for a startup and noting the founder's perspective that the liquidation prioritized paying back bank loan but not trying to obtain more to pay back all vendors and return capital to shareholders).

[199] Kleiner et al., *supra* note 75, at 6; *see also* Credit Managers Association of Southern California v. National Independent Business Alliance, 162 Cal. App. 3d 1166, 1170-72 (1984) ("Under the common law of assignment, the assignee stands in the place of the assignor .... [A]s trustee for all the creditors, [assignee] was charged with the duty to defend the property in its hands against all unjust adverse claims.").

[200] Adrian Daub, *The Undertakers of Silicon Valley: How Failure Became Big Business*, THE GUARDIAN (Aug. 21, 2018), https://www.theguardian.com/technology/2018/aug/21/the-undertakers-of-silicon-valley-how-failure-became-big-business.

[201] *Id.*

[202] *Id.* ("The clean-up crew stays deliberately out of sight.").

[203] There are also specialists in monetizing patent portfolios and customer lists, such as Hilco Streambank. *See* Fiona M. Scott Morton & Carl Shapiro, *Strategic Patent Acquisitions*, 79 ANTITRUST L.J. 463, 469 (2014) ("Increased opportunities for patent monetization, particularly in the information technology sector, have resulted in the rise of institutions to facilitate the sale of patents.").

[204] EISENMANN, *supra* note 7, at 270.

[205] *Id.*

[206] Sherwood Partners, ABC 2.0, https://www.shrwood.com/Users/Documents/Default/ABC_20.pdf (last visited Feb. 15, 2022) (describing key points of ABC 2.0 insurance as "an added benefit to the ABC") [hereinafter ABC 2.0].

confidence to fill this gap.[207] Moreover, a recent development has arisen to further close the gap between ABCs and bankruptcy in terms of protections for buyers: "ABC 2.0 Insurance."[208] This product, not yet discussed in legal scholarship, bears some similarity to another recent phenomenon of private insurance, representations and warranty insurance in private M&A deals, which "allows sellers to minimize risk at exit and allows buyers to mitigate risk aversion in selecting investments.[209] ABC insurance focuses instead on "fill[ing] the risk gaps and provid[ing] a menu of analogous protections to a bankruptcy for buyers."[210] That is, insurance in the ABC context allows private players to provide buyers a substitute for bankruptcy protection from liability risk. The development evidences private-ordering solutions to replicate the benefits from a formal legal process and help position ABCs as a more complete and efficient solution for liquidation.

D. Wind Downs, Turnarounds, and Additional Alternatives

For startups that have so little of value that it is not even worth an ABC, the company may simply sell off any assets directly and shut down the business and carry out a voluntary dissolution.[211] A corporate dissolution is a formal process under state corporate law to end the corporation's legal existence after winding up its affairs.[212] It typically requires board and shareholder approval,[213] and subsequently continues to involve at least one director to supervise the process and someone to manage the operational tasks of wind down and liquidation, though professional firms can sometimes serve in this role.[214] When properly conducted, the dissolution of the corporation can provide directors with protection from personal liability once it has been completed.[215]

---

[207] As evidence of this perception, ABC firms and bankruptcy courts are sometimes discussed in equivalent terms in this regard. *See, e.g.*, EISENMANN, *supra* note 7, at 270 ("[S]ophisticated buyers of expensive assets will typically prefer to work with either an ABC firm or a bankruptcy court. . . [t]he buyers want to avoid legal complications that will ensue if the assets they acquire are secured by another claim; ABC firms and bankruptcy courts take care to ensure that assets aren't encumbered in this way.").

[208] ABC 2.0, *supra* note 206.

[209] Sean J. Griffith, *Deal Insurance: Representation and Warranty Insurance in Mergers and Acquisitions*, 104 MINN. L. REV. 1839, 1847 (2020).

[210] ABC 2.0, *supra* note 206.

[211] O'Neill & Hwang, *supra* note 25, at 7 (discussing pros and cons of formal dissolution pursuant to section 280 under the Delaware General Corporation Law, and informal wind down).

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

[213] *See, e.g.*, Del. Code Ann. tit. 8, § 275 (providing procedures for dissolution).

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

[215] *Id.* The dissolution and winding up of Delaware corporations may be done with or without court supervision. Del. Code Ann. tit. 8, §§ 280, 281 (2010). Once a Delaware corporation has dissolved, it may prosecute and defend suits for a period of three years, or longer pursuant to court order, after

Finally, startups that are navigating choppy waters in search of an exit might have a few additional alternative paths available: recapitalizations and distressed turn-arounds, and going public via a special purpose acquisition company (SPAC).[216] Neither of these paths have been heavily used but bear brief discussion as they add to a full picture.

On the first, there is a small but growing group of investors that do "turn-around" or "distressed venture capital" that reflects the influx of private equity players and specialized VC funds in recent years into the venture ecosystem.[217] Often when these distressed investors enter the startup, they buy out incumbent shareholders to acquire a majority stake, they recapitalize the company, and restructure its operations.[218] Thus, although often accomplished through a secondary transaction in which the startup maintains continued existence, the deal may be regarded as an offramp for startup participants in a distressed venture.

Regarding SPACs, while the transaction structure is an alternative to an IPO, it is one that is sometimes used for companies that otherwise struggle to get to the public markets and may not be an exit that provides returns to all equity holders. In this way, not all SPACs are startup failures, but it may be a potential pathway for dealing with some failed startups that might not otherwise be able to exit via a traditional IPO on favorable terms. For instance, shared workspace company WeWork engaged in a botched attempt at an IPO, followed by a bailout from private investors, layoffs, and litigation.[219] It subsequently entered into a de-SPAC deal at a reported equity valuation of $7.9 billion, which was less than the amount invested by one its main investors, and far less than its hopes of going public at a valuation of $47 billion.[220] The SPAC sector has attracted regulatory scrutiny and

---

which time the corporation can no longer sue or be sued in its corporate capacity. Del. Code Ann. tit. 8, § 278 (2010).

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

[217] Julian Giessing, *Distressed Venture Capital*, MEDIUM (Jan. 27, 2020), https://medium.com/@julian.giessing/distressed-venture-capital-38c6be0e186e.

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

[219] Sarah E. Needleman & Eliot Brown, *WeWork to Cut Around 17% of Workforce*, WALL ST. J. (Nov. 21, 2019), https://www.wsj.com/articles/wework-to-cut-around-17-of-workforce-11574355656.

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

controversy, however, and the continued use of this structure faces an uncertain fate.[221]

* * * * *

The above discussion has highlighted alternatives to the bankruptcy system that consist of a variety of paths and options for dealing with startups that are not going to reach successful exits with big returns for participants. Through M&A deals, acqui-hires, ABCs, and other arrangements, we observe in the real world the "ex post" bargaining theorized to be a critical part of dealing with problems in venture capital contracting.[222]

Stepping back, we can see that giant startup successes are relatively straightforward insofar as creditors are fully paid back and all equity holders share in the gains.[223] It is the vast number of startups that instead reach a middling level of success or failure, depending on one's perspective, that pose some of the greatest complexities as they are less amenable to advance specification by contract.[224] Failure may also be more challenging than it appears at first sight—although security interests and liquidation preferences may clearly spell out priorities and obligations,[225] the startup board must decide when it is time to pull the plug and how to do so, whether in the form of a formal, potentially drawn out and public proceeding or through a discretely managed "private funeral" in which directors, founders, and employees can quietly disperse.

III. A Theory of Startup Failure

Building on the previous discussion, this Part sets out a theory of the purpose and functioning of the system of failure options set out above and argues that it serves an important role in the startup and venture capital ecosystem.[226] Further, the discussion examines how recent developments may spell trouble for the existing system to deal with the size, type, and number of failures ahead in the same ways

---

[221] *See, e.g.*, Dave Michaels et al., *SPAC Hot Streak Put on Ice by Regulatory Warnings*, WALL ST. J. (Apr. 16, 2021), https://www.wsj.com/articles/spac-hot-streak-put-on-ice-by-regulatory-warnings-11618565403.
[222] *See* Bratton, *supra* note 9, at 896.
[223] *Id.* On navigating governance challenges and conflicts in mature, late-stage startups, see Pollman, *Startup Governance*, *supra* note 1, at 209-16.
[224] Bratton, *supra* note 9, at 896.
[225] *See id.* ("Total failure is similarly cut and dried – the contracts trigger liquidation for the benefit of the venture capitalist subject to the constraints of the bankruptcy system."); *see also* Richard M. Hynes, *Reorganization as Redemption*, 6 VA. L. & BUS. REV. 183, 212 (2011) (noting that venture capital investment "comes with real options" because "the early investment allows the firm to expand to meet new demand, or the firm can shut down if business is failing").
[226] For big picture explorations of other aspects of the venture capital industry and its "power law" business model, startup communities, and innovative regions, see, for example, ANNALEE SAXENIAN, REGIONAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE 128 (1996); BRAD FELD, STARTUP COMMUNITIES (2016); SEBASTIAN MALLABY, THE POWER LAW: VENTURE CAPITAL AND THE MAKING OF THE NEW FUTURE (2022); NICHOLAS, *supra* note 30; MARGARET O'MARA, THE CODE: SILICON VALLEY AND THE REMAKING OF AMERICA (2019).

that it has in the past. The discussion concludes by considering policy implications in corporate law, state insolvency procedures, bankruptcy, and antitrust.

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

Since legal scholars, sociologists, and historians began studying startups and venture capital, a common theme that has emerged is the presence of strong social and cultural norms that reflect thick networks, reputational concerns, and awareness of repeat player interactions.[227] In addition, as described in Part I, venture capitalists use a business model that is based on investing in a portfolio of startups and understanding that a small number of home run successes will likely drive the returns for the fund.[228] Even VC firms with top performances and reputations do not know ex ante which companies will be the home runs, and so they take a portfolio approach to investing, look for companies with the potential for extremely high growth, and expect some failures.

Adding these two themes together reveals the modus operandi of Silicon Valley's approach to startup failures: normalize and redeploy. Venture capital firms do not generally sweat an individual failure—that is part of their business model.[229] To find companies with high potential payoff, they need entrepreneurs with big ideas willing to take risks.[230] They typically expect there may be multiple failures in a fund and it could still be wildly successful overall. Furthermore, to be a top-tier venture capital firm, it must be able to raise successive funds over time. Reputation matters. It is important not to burn bridges with other venture capital firms that may invest again alongside in a syndicate, with venture lenders that might be helpful to another portfolio company, and with entrepreneurs who might talk with other founders or turnaround and start the next hot startup.[231]

Entrepreneurs and many employees, too, benefit from being able to take a swing and miss. Failure might result from a lack of luck or other factors beyond an

---

[227] *See, e.g.*, MARK C. SUCHMAN, ON ADVICE OF COUNSEL: LAW FIRMS AND VENTURE CAPITAL FUNDS AS INFORMATION INTERMEDIARIES IN THE STRUCTURATION OF SILICON VALLEY (1994); Mark C. Suchman & Mia L. Cahill, *The Hired Gun as Facilitator: Lawyers and the Suppression of Business Disputes in Silicon Valley*, 21 LAW & SOC. INQUIRY 679 (1996); NICHOLAS, *supra* note 30; Gilson, *supra* note 30.

[228] *See supra* note 72 and accompanying text.

[229] Daub, *supra* note 200 ("By the time one venture crashes and burns, everyone is already on their way to the next one.").

[230] *See, e.g.*, Puri & Zarutskie, *supra* note 10, at 2248 (finding that "the key firm characteristic on which VC focuses is scale or potential for scale").

[231] *Id.* ("Sure, a 24-year old can run his company into the ground—but he's still a 24-year old, with time and energy for another startup, and then another. And any one of those could pan out and make everybody fantastically rich."); *see also* Ola Bengtsson, *Relational Venture Capital Financing of Serial Founders*, 22 J. FIN. INTERMEDIATION 308 (2013) (on serial entrepreneurship); Bratton, *supra* note 9, at 944-45 (discussing VCs as "reputational intermediaries" and their contracts as "relational"); Brian Broughman, *Relational Contracting and Business Norms in Entrepreneurial Finance*, Indiana Leg. Studies Res. Paper No. 402 (Mar. 2, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3196033 (on "relational bolstering" to embed entrepreneurs into investors' networks).

entrepreneur's control.[232] Research suggests that investors to high-growth ventures understand that past entrepreneurial failure does not necessarily indicate a lack of skill and they can use informational cues to evaluate the merits of future investments.[233] A large number of failed founders try again.[234] One study observed that founders routinely received attractive opportunities after their startup failed and they did not experience significant stigmatization or rejection.[235]

A common refrain among insiders in the startup ecosystem is that it is important for founders to treat others well and execute a "graceful" exit or shutdown to preserve relationships.[236] With relational contracting and a dense network of social and professional ties, the threat of reputational harm and soft mechanisms of accountability might help to enforce norms that encourage prosocial behavior.[237]

Knowing that failing will not harm one's ability to get a "regular" job or try again at entrepreneurship, so long as one aims to treat others well, may help to motivate the decision to launch an innovative startup or go work for one. In many instances, venture capitalists can provide implicit insurance to spread the risk of individual failure by being willing to make introductions to other portfolio companies, early stage investors, and "soft landing" opportunities.[238] Companies and their investors might even facilitate these opportunities for employees of a failed startup as a group.[239] More broadly, because buttressing entrepreneurs' willingness to take on risk is integral to venture capital, it often redounds to a VC

---

[232] Diego Zunino, Gary Dushnitsky & Mirjam van Praag, *How Do Investors Evaluate Past Entrepreneurial Failure?: Unpacking Failure Due to Lack of Skill versus Bad Luck*, ACAD. MGMT. J. at 3 (2021) (arguing "that past failure is not always a negative cue of entrepreneurial skill; rather, it is a noisy cue [because] failure may result not from a lack of skill but sometimes simply because of a lack of luck").

[233] *Id.* at 39 (reporting findings from experimental studies in the equity crowdfunding setting). Although past failure may be a noisy signal, research suggests that entrepreneurs that successfully start a company that goes public are more likely to succeed (30%) than first-time entrepreneurs (18%) and those who have previously failed (20% chance of success). *See* Paul A. Gompers, Josh Lerner, David Scharfstein & Anna Kovner, *Performance Persistence in Entrepreneurship and Venture Capital*, 96 J. FIN. ECON. 18 (2010).

[234] EISENMANN, *supra* note 7, at 282 (reporting survey finding that 48% of first-time entrepreneurs launched another venture within five years of failure).

[235] *Id.* (discussing study by Jason Cope).

[236] *See, e.g.*, EISENMANN, *supra* note 7, at 282 ("For most founders—especially those who preserved relationships with team members and investors by engineering a graceful shutdown—the problem [of failure] doesn't appear to be as acute as many of them feared.").

[237] David Lee, *Quick Thoughts on Acquihires/"Soft Landings"* (Aug. 18, 2012), https://daslee.me/quick-thoughts-on-acquihiressoft-landings/ ("As [prominent VC and angel investor] Ron Conway once told me . . . how a founder conducts herself during either an acquihire or soft landing can determine if they get funding [again]. For example, founders who don't think of their team's welfare first in a soft landing probably won't get funding from their prior investors.").

[238] *See* Carmen Nobel, *Why Companies Fail—and How Their Founders Can Bounce Back*, HARV. BUS. SCH. (Mar. 7, 2011) (discussing research by Shikhar Ghosh finding that "savvy entrepreneurs know that running a company that eventually fails can actually help a career" and "failed businesses yield future networking opportunities with venture capitalists and relationships with other entrepreneurs whose companies are succeeding").

[239] For example, one company reportedly held a "career fair" for its employees at the company office just days after they announced the company was going out of business, and large tech firms such as Apple, Google, and Microsoft attended to meet with employees. *See* Crowe, *supra* note 60.

firm's benefit to cultivate a reputation for supporting entrepreneurs in this way—whether in good times or in bad.[240] This is not to say that "founder friendly" approaches writ large are optimal,[241] that bad behavior goes unpunished,[242] or that all startup founders and employees receive soft landings and take a rosy view of failure;[243] rather, the existence of thick connections in venture capital and startup communities, and a culture that normalizes failure and redeploys talent, helps to lower risk and encourage founders and employees to engage in entrepreneurship.[244]

Viewed in this light, the alternative system discussed in Part II can be understood as producing certain efficiencies for serial entrepreneurship and investment. The low cost, speed, potential for private ordering and light level of legal formality allow startup participants to "fail fast" and for assets and talents to be absorbed or redeployed without significant reputational harm. As one observer commented:

> Silicon Valley thinks it has failure figured out. . . [A] tolerance for things not going quite right is baked into the tech industry. People take jobs and lose them, and go on to a new job. People create products that no one likes, and go on to create another product. People back companies that get investigated by the SEC, and go on to back other companies. . . In Silicon Valley, it seems, there is no such thing as negative experience.[245]

The range of options for failed startups, and their distinctive features, reflects the value of this approach for startup participants. M&A trade sales frequently

[240] The wide influence of the "founder friendly" approach pioneered by prominent VC firm Andreessen Horowitz for its own competitive advantage evidences this dynamic. *See* Blank, *supra* note 69; *see also* Stephanie Gleason & Ted Mann, *Invention Startup Quirky Files for Bankruptcy*, WALL ST. J. (Sept. 22, 2015), https://www.wsj.com/articles/invention-startup-quirky-files-for-bankruptcy-1442938458 (quoting Andreessen Horowitz partner about failed startup Quirky, noting it was a "great idea" and "we stand firmly behind the employees of Quirky and will do everything we can to help them find their next job").

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

[242] *See* Nobel, *supra* note 238 (explaining that "enterprise failure" is "a learning experience that can lead to future opportunities" but an individual entrepreneur's "personal failure" of violating a fiduciary duty, committing a crime, or violating notions of morality and fair play can "damn a career").

[243] *See, e.g.*, Carroll, *supra* note 73 (describing "the psychic toll of unrelenting failure" that some tech entrepreneurs experience); EISENMANN, *supra* note 7, at 249 (discussing how the decision to shut down a failed startup is "fraught with strong emotions").

[244] When the cost of failing is relatively low, the level of "overconfident" individuals willing to engage in entrepreneurship despite the large chance of failure may be stable and benefit society. *See* Antonio E. Bernardo & Ivo Welch, *On the Evolution of Overconfidence and Entrepreneurs*, 10 J. ECON. & MGMT. STRAT. 301, 305, 325 (2004) (providing a "group selection" theory that posits that overconfidence can persist when the cost to the irrational entrepreneur is low and the benefit to society is high).

[245] Daub, *supra* note 200; *see also* EISENMANN, *supra* note 7, at 272 ("Those who've invested in many other startups will see the failure as part of the 'circle of life' and most won't be bitter."); *cf.* Carroll, *supra* note 73 (noting "[v]enture capitalists and angel investors tolerate failure only up to a point").

include deal "carrots" to the common shareholders to get the deal done, even when there is no contractual obligation on the preferred shareholders to share deal proceeds.[246] Acqui-hires, which at first appear a puzzle because employees could simply obtain employment on their own, make sense when understood as a means of avoiding the informal social sanctions of defection and cultural cachet to claim exit.[247] California ABCs and their relatively light level of regulation, with no public court filing required and allowance for assets to be sold without court approval, compare favorably to other states that maintain rigid formalities.[248]

By contrast, bankruptcy does not quickly or quietly mitigate failure for startups.[249] M&A deals, acquihires, and ABCs are significantly more efficient in that sense. As we have seen, Chapter 7 can be particularly ill-suited for many startups because it does not keep the people together with the intellectual property to maximize the sale. It does not allow the company to choose its trustee for liquidating the assets, so it cannot select a sophisticated repeat player who has specialized experience with liquidating intellectual property and will act in a relationship-based manner. Perhaps most importantly, it does not keep the failure quiet. The stigma of filing for bankruptcy may be perceived as the opposite of "failing with honor" that many participants in the startup ecosystem, from investors and founders to employees, seek for their reputations and career trajectories. A private sale or acqui-hire allows the startup participants to take responsibility and craft their own narrative of success.[250] An ABC "allows them to fly under the radar."[251]

Chapter 11, even a 363 sale, presents a major tradeoff in terms of visibility, cost, and timing. The upside is that this process provides a federal forum for dealing with complex litigation, and so for companies like OneWeb that raised over a billion dollars and had non-Silicon Valley type investors it might be a useful option, but to date it has not been viewed as a viable solution for the masses of startups. The time, expense, and visibility have made it "taboo" for many years.[252]

Once one sees the larger picture of the startup and venture capital eco-system that can normalize failure and redeploy talent and assets, an important concern,

---

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

[247] *See* Coyle & Polsky, *supra* note 170, at 286.

[248] *See* Mann, *Liquidating Choices*, *supra* note 76, at 1398.

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

[250] *See* Daub, *supra* note 200 ("'None of this litigation happens in this industry, because nobody wants to be blackballed,' one anonymous lawyer says. Or, as an angel investor puts it, it's important that even a failed venture 'facilitates the founder's story.'"); EISENMANN, *supra* note 7, at 282 (noting founders can take responsibility for failure and "own the narrative" or "spin" their story).

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

[252] *See supra* note 71 and accompanying text.

however, also arises: this system might perpetuate inequities or problematic aspects of some startup activity. To the extent that entrepreneurs are given multiple chances, serial entrepreneurship and the repeated funding of certain entrepreneurs, or soft landings given to existing startup employees, might come at the expense of opening up opportunities for others. Most notably, the venture capital industry and the entrepreneurs it funds has lacked gender and racial diversity.[253] Social networks that facilitate the flow of funds and talent might be beneficial for some people, but pose obstacles or barriers for others that have not been included to date.

Adding to these concerns are reports that some startup founders or CEOs have fostered workplaces with problematic or toxic cultures in which a variety of troubling allegations arise or even illegal activity.[254] When they fail or scandals come to light, these individuals might receive a soft landing or even funding for a new venture instead of accountability.[255] Even more broadly, some might worry that startup culture tends to encourage misconduct.[256]

This Article's discussion underscores the importance of dealing with these issues head-on because they may be perpetuated or amplified. Diversity, equity,

---

[253] Carlos Berdejó, *Financing Minority Entrepreneurship*, WIS. L. REV. 41, 42--56 (2021) (discussing obstacles for minority entrepreneurs to access capital and highlighting the importance of social networks); Benjamin P. Edwards & Ann C. McGinley, *Venture Bearding*, 52 U.C. DAVIS L. REV. 1873, 1881-82 (2019) (discussing the disproportionate VC funding of male entrepreneurs); Jennifer S. Fan, *Innovating Inclusion: The Impact of Women on Private Company Boards*, 46 FL. ST. U. L. REV. 345, 345 (2019) (noting "rampant sexual harassment, the lack of women leaders in technology companies, the relative absence of female venture capitalists, and the dearth of female board members").

[254] Gaby Del Valle, *A WeWork Employee Says She Was Fired After Reporting Sexual Assault. The Company Says Her Claims Are Meritless*, VOX, https://www.vox.com/the-goods/2018/10/12/17969190/wework-lawsuit-sexual-assault-harassment-retaliation; Nathaniel Popper & Katie Benner, *'It Was a Frat House': Inside the Sex Scandal That Toppled SoFi's C.E.O.*, N.Y. TIMES (Sept. 12, 2017), https://www.nytimes.com/2017/09/12/technology/sofi-chief-executive-toxic-workplace.html/; *see also* Pollman, *Startup Governance*, *supra* note 1, at 200-06 (discussing startup scandals and oversight failures and related governance issues); Donald C. Langevoort & Hillary A. Sale, *Corporate Adolescence: Why Did "We" Not Work?*, 99 TEX. L. REV. 1347, 1355-56 (2021) (discussing problematic aspects of some startups' culture and how it can be "the product of the corporate adolescence and cult of personality our 'regulatory' regime has promoted").

[255] *See, e.g.*, Hannah Norman, *Investors Quick to Move Past #metoo for Former SoFi CEO's Second Act*, S.F. BUS. TIMES (July 30, 2018), https://www.bizjournals.com/sanfrancisco/news/2018/07/30/investors-quick-to-move-past-metoo-for-former-sofi.html (discussing how an entrepreneur received financing for a new venture just months after resigning amidst allegations and an investigation into inappropriate workplace conduct).

[256] *Does Startup Culture Encourage Misconduct?*, FORBES (Feb. 2, 2022), https://www.forbes.com/sites/imperialinsights/2022/02/02/does-startup-culture-encourage-misconduct/?sh=5b39edf1682a (discussing whether there is "a failure of scrutiny within the entrepreneurial ecosystem" and "a 'who dares wins' culture that can spill over into rule breaking"); *see also* Langevoort & Sale, *supra* 254, at 1348 (arguing that "the ever-lengthening period of time and the resulting temptations without sufficient grown-up supervision that high-tech companies have . . . runs the risk of a build-up of bad choices and testy behaviors"); Elizabeth Pollman, *Private Company Lies*, 109 GEO. L.J. 353, 383-85 (2020) (discussing how "rule-breaking spirit and conduct has become normalized and even celebrated" in startups).

and inclusion initiatives in the venture capital industry are underway,[257] but much more could be done. Startup employees and the media have played a critical role in drawing attention to companies engaged in problematic activity, and these are important avenues for continuing to bring a measure of accountability, especially in extreme circumstances.[258] A debate about increasing regulatory oversight and enforcement in private markets is additionally in progress.[259] Understanding the decline in governance provided by venture capitalists and the social welfare implications is also a promising area for further research.[260] Attempting to address these issues by adding friction to the system of dealing with startup failures, however, might miss addressing the root causes and undermine a valuable engine in the U.S. economy and the global innovation landscape.

B. The Changing Landscape of Startup Failure

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

Recent years have witnessed the explosive growth of the private markets.[261] In 2021, U.S. investments in venture capital exceeded $300 billion for the first time, nearly doubling the previous year's figure.[262] A significant driver of this growth is the entrance of nontraditional investors to the venture capital space: hedge funds, mutual funds, private equity, and sovereign wealth funds.[263] This development has

---

[257] *See, e.g.*, Piyamvada Mathur, *VC Firms Strive to Improve Diversity with New Industry Certification*, PITCHBOOK (Mar. 17, 2021), https://pitchbook.com/news/articles/vc-firms-diversity-certification; Maryam Haque & Bobby Franklin, *Taking Stock of the VC Industry's Progress on Diversity, Equity, and Inclusion*, TECHCRUNCH (Apr. 27, 2021), https://techcrunch.com/2021/04/27/taking-stock-of-the-vc-industrys-progress-on-diversity-equity-and-inclusion/.

[258] *See, e.g.*, Hillary A. Sale, *The Corporate Purpose of Social License*, 94 S. CAL. L. REV. 789 (2021); Pollman, *Private Company Lies*, *supra* note 256, at 398-400; Jennifer S. Fan, *Employees as Regulators: The New Private Ordering in High Technology Companies*, 2019 UTAH L. REV. 973; Verity Winship, *Private Company Fraud*, 54 U.C. DAVIS L. REV. 663 (2020).

[259] *See, e.g.*, Donald C. Langevoort & Robert B. Thompson, *"Publicness in Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337, 339-40; Fontenay, *supra* note 3; George Georgiev, *The Breakdown of the Public-Private Divide in Securities Law: Causes, Consequences, and Reforms*, 18 N.Y.U. J. L. & BUS. 221 (2021).

[260] Josh Lerner & Ramana Nanda, *Venture Capital's Role in Financing Innovation: What We Know and How Much We Still Need to Learn*, Harvard Business School Working Paper 20-131 (2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3633054 (highlighting the strength of the venture model as well as its limitations such as "the relaxation in recent years of the intense emphasis on corporate governance in by venture capital firms" and the need for additional research).

[261] Pollman, *Private Company Lies*, *supra* note 256, at 370-73.

[262] Jessica Hamlin, *U.S. Venture Capital Shattered Records in 2021*, INSTITUTIONAL INVESTOR (Jan. 6, 2022), https://www.institutionalinvestor.com/article/b1w6kyc497hzrt/us-venture-capital-shattered-records-in-2021.

[263] *Id.*

introduced players into the venture capital system that may not follow the same norms and are not averse to litigation and the formality and visibility of bankruptcy.

Further, with regulatory changes and an unprecedented influx of private capital, startups have increasingly stayed longer in the private market.[264] During the dot-com era, startups that survived to exit would typically be acquired or go public within about five years.[265] In 2021, the median age of companies at IPO stretched to eleven years. With longer timelines of startups staying private, we may also start to see more of the large, "mature" startup failures like WeWork. The alternative system may strain to deal with these kinds of failures.[266] There may not be buyers for a distressed trade sale, or such deals might only be available at fire sale valuations. These startups are generally too big to acqui-hire. Aiming to scale over a long period of time means these startups often have large numbers of employees that are not engineers and do not have the technological skill and tacit knowledge that are highly prized in the labor market for talent. Companies that have stayed private for a long period may also have too many potential assets and liabilities for an ABC to be a good fit.[267] The white hot market for SPACs seen in 2021 may have peaked and, especially in light of widespread losses, there could be increased investor skepticism or new SEC regulation or enforcement.[268]

Another dimension of these changing trends is that startups are reaching higher valuations and raising larger amounts while on the private market. "Unicorns," or startups that have raised a venture financing round with a post-money valuation of $1 billion or more, increasingly attract attention in the venture capital industry and beyond through media coverage.[269] Relatively rare just a decade ago, there are now over 1,200.[270] The median venture capital financing deal size is up for all stages, and it has nearly doubled for late-stage deals over the previous year, which was also record-setting.[271] In 2021, there were more than 1,500 "mega"-rounds of $100

---

[264] De Fontenay, *supra* note 3, at 460; Pollman, *Private Company Lies*, *supra* note 256, at 371.

[265] Jay R. Ritter, Initial Public Offerings: Median Age of IPOs Through 2021 (Dec. 23, 2021) (unpublished tabular data) (available at https://site.warrington.ufl.edu/ritter/files/IPOs-Age.pdf), at tbl.4 (tracking the median age of venture-backed companies at IPO from five years in 1999 to eleven years by 2021).

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

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

[268] *See* Amrith Ramkumar, *The SPAC Ship Is Sinking. Investors Want Their Money Back*, WALL ST. J. (Jan. 21, 2022), https://www.wsj.com/articles/the-spac-ship-is-sinking-investors-want-their-money-back-11642761012.

[269] *See, e.g.*, CrunchBase, The Crunchbase Unicorn Board, https://news.crunchbase.com/unicorn-company-list/ (last visited Feb. 15, 2021) (indicating 1,222 unicorns with $720 billion raised and $4.2 trillion total value); *cf.* Will Gornall & Ilya A. Strebulaev, *Squaring Venture Capital Valuations with Reality*, 135 J. FIN. ECON. 120 (2020) (discussing the rise of unicorns and explaining that post-money valuation does not equate with fair valuation).

[270] Crunchbase Unicorn Board, *supra* note 269.

[271] CB Insights, State of Venture 2021, at 41, https://www.cbinsights.com/research/report/venture-trends-2021/.

million or more[272] These "mega"-rounds made up less than five percent of global venture deals, but accounted for 59% of total dollars—reflecting the market shift towards funding large startups.[273] Although more mature, late-stage startups may be less likely to fail, when they cannot find a successful M&A deal or IPO, they face a particularly challenging situation to navigate.[274] It is harder to get rid of these big "startups" in a low profile manner and they might have larger amounts of debt or complex capital structures that lead to a greater likelihood of using the bankruptcy system.[275]

In addition to new entrants to venture capital investments and major changes in startup timelines, sizes, and valuations, a different development also looms large: increased antitrust scrutiny and regulatory enforcement of large technology company acquisitions. Amid wide-ranging concerns about the power of large technology companies, including so-called "killer acquisitions" in which big companies scoop up nascent competitors, the Department of Justice, Federal Trade Commission, and several states attorneys general have brought major antitrust cases against Big Tech companies and policymakers have proposed a variety of bills that would clamp down on the acquisition of startups.[276]

Although regulatory reform and its potential impact is uncertain, it is clear that M&A transactions are a key pathway to exit for venture-backed startups. M&A exits have long outnumbered IPOs, with recent years approximately a nearly 10:1 ratio.[277] As the above discussion has shown, venture backed startups that reach M&A exits run the gamut in terms of "success" and "failure" – some are home runs which generate large returns for all equity participants, and some are less favorable with not all equity holders getting a payout. Thus, to the extent that Big Tech slows

---

[272] *Id.* at 8.

[273] *Id.*

[274] Pollman, *Startup Governance*, *supra* note 1, at 209-16 (discussing increasing governance tensions and liquidity pressure in late-stage startups, particularly once they reach ten-year mark). Exits at the late-stage might also involve investors, founders, and employees with highly variable outcomes depending on how early they invested in or joined the startup and the terms of their participation.

[275] Daniel Fisher, *The Latest Craze in Silicon Valley: Bankruptcy*, FORBES (Mar. 15, 2017), https://www.forbes.com/sites/danielfisher/2017/03/15/the-latest-craze-in-silicon-valley-bankruptcy/?sh=64542ea11664 ("Venture capitalists who once considered an unthinkable breach of decorum to put a company in bankruptcy now see it as a way to salvage what they can from their would-be unicorns. While most tech startups consist of little more than leased office space, some yoga balls and a bunch of promising ideas, their intellectual property can generate hard cash in an auction.").

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

[277] NVCA, 2021 Yearbook, at 7, https://nvca.org/wp-content/uploads/2021/03/NVCA-2021-Yearbook.pdf (noting a ratio of M&A exits to IPOs of 8.6:1 in 2020); NVCA 2020 Yearbook, at 35-36, https://nvca.org/wp-content/uploads/2020/03/NVCA-2020-Yearbook.pdf (reporting on M&A and IPO exits with a ratio approximating 10:1 in 2019); Jeff Farrah, *Restrictions on Acquisitions Would Stifle the US Startup Ecosystem, Not Rein in Big Tech*, TECHCRUNCH (may 19, 2021), https://techcrunch.com/2021/05/19/restrictions-on-acquisitions-would-stifle-the-us-startup-ecosystem-not-rein-in-big-tech/ (noting long history of

down its acquisitions due to concerns of government scrutiny or breakups,[278] or if government becomes even more active in constraining these acquisitions, that may be closing or tightening an important means by which startups are finding an off-ramp to fail with honor and quickly redeploy talent, technology, and tacit knowledge.[279]

C. Policy Implications

Although startups and venture capital have experienced significant changes in the past decades, they have only grown in importance as an engine of the U.S. economy and innovation. U.S. venture-backed startups employ 2.5 million workers.[280] Among U.S. public companies founded since 1968, venture-backed companies account for 77% of total U.S. market capitalization, 41% of total employees, and 92% of research and development spending.[281] Many of the world's largest companies by market capitalization started in the proverbial garage or dorm room and raised venture capital to develop an innovative product or service and bring it to market.[282] By any measure, startups are a key piece of the dynamic lifecycle of business and the U.S. economic landscape.

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

A natural starting place for inquiry is corporate law. This Article shows that once a startup is getting low on cash and sees signs of trouble, the company will typically take measures to extend its runway, such as by raising a new round of financing or cutting expenses, or it will try to find a buyer (or both). Eventually, the startup might be faced with the decision to liquidate. Along this path, two key doctrinal areas related to fiduciary duties can be implicated:[283] (1) the "insolvency"

---

[278] *See, e.g.*, Vishal Persaud, *Alphabet's M&A Activity Declines as US Files Antitrust Suit*, PITCHBOOK (Oct. 20, 2020), https://pitchbook.com/news/articles/alphabets-acquisition-activity-declines-as-us-files-antitrust-suit.

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

[280] Record Year for U.S. Venture Capital Industry Despite Pandemic and Economic Downturn, NVCA (Mar. 25, 2021), https://nvca.org/pressreleases/record-year-for-u-s-venture-capital-industry-despite-pandemic-and-economic-downturn/#:~:text=In%202020%2C%20U.S.%20venture%2Dbacked,represented%20about%202.5%20million%20employees.

[281] Gornall & Strebulaev, *supra* note 12.

[282] Pollman, *supra* note 1, at 156.

[283] This discussion focuses on Delaware corporate law as most venture-backed startups operate as Delaware corporations; other state corporate law could be examined for similar opportunities for

line of case law;[284] and (2) the case law dealing with conflicts between the preferred and common shareholders in M&A deals.[285] Additional doctrinal clarity in each of these areas could be beneficial for startup boards navigating the challenges of financial distress or finding an exit.

First, the twenty-first century shift away from "the zone of insolvency" doctrine has moved towards greater precision in defining the parameters of when creditors can bring fiduciary claims against directors.[286] Instead of uncertainty around when a company enters a "zone" or state of "deepening insolvency," which could trigger a shift of fiduciary duties being owed to creditors,[287] Delaware courts have drawn a bright line at insolvency and "eliminated any notion of creditors' rights to bring direct fiduciary claims."[288] Current doctrine provides that once a corporation becomes insolvent, creditors gain standing to assert derivative claims for breach of fiduciary duty.[289] Although this doctrinal move to sharpen the line at insolvency might give rise to concerns about "bankruptcy hardball" and opportunism against creditors,[290] it helps to mitigate the cost of ambiguous fiduciary law and reduce litigation abuse against startup directors,[291] thereby contributing to efficiencies in dealing with failing startups and reinforcing business judgment protection for startup boards that face complexity and distress.

One related area that could be further clarified, however, is the test for insolvency itself and, more specifically, how to understand this in the context of venture-backed startups.[292] Delaware corporate law does not use a bright-line test for insolvency and have not defined the "balance sheet" and "cash flow" tests

---

increased doctrinal clarity for boards navigating startup failure. *See* Gregg Polsky, *Explaining Choice-of-Entity Decisions by Silicon Valley Start-Ups*, 70 HASTINGS L.J. 409, 411 (2019) ("[H]ighly sophisticated lawyers, . . . who advise start-ups in Silicon Valley and other hotbeds of start-up activity, stubbornly prefer C corporations."); Cable, *supra* note 13, at n.88 and accompanying text (discussing startup lawyers mostly forming and representing Delaware corporations).

[284] N. Am. Catholic Educ. Programming Found. v. Gheewalla, 930 A.2d 92 (Del. 2007); Quadrant Structured Products Co. v. Vertin, 102 A.3d 155 (Del. Ch. 2014).

[285] In re Trados S'holder Litig., 73 A.3d 17 (Del. Ch. 2013).

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

[287] *See id.* (discussing Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm. Corp., 1991 WL 277613 (Del. Ch 1991)).

[288] *Id.*

[289] *Quadrant*, 102 A.3d at 94 (citing *Gheewalla*, 930 A.2d at 101).

[290] Jared A. Ellias & Robert J. Stark, *Bankruptcy Hardball*, 108 CAL. L. REV. 745 (2020).

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

[292] Scholars and practitioners have identified the difficulty of applying insolvency tests and the lack of uniformity of tests at common law, but have not focused on how these issues could be particularly challenging in the context of venture-backed startups. *See, e.g.*, Robert J. Stearn Jr. & Cory D. Kandestin, *Delaware's Solvency Test: What is it and Does it Make Sense - A Comparison of Solvency Tests under the Bankruptcy Code and Delaware Law*, 36 DEL. J. CORP. L. 165, 165 (2011).

uniformly.[293] Although insolvency tests commonly pose difficulty in application, startups raise particularly vexing issues given how frequently they exist in precarious financial positions with uncertain valuations of assets and forward-looking cash flows. That is, unlike other closely-held business corporations, or public corporations, venture-backed startups distinctively operate in a continual mode of raising staged financing and running down cash reserves, often while having assets that are difficult to value and questions about the "reasonable prospects" of continuing. This utterly commonplace factual scenario opens up the regular possibility of creditor suits for breach of fiduciary duty, and thus also complexity for startups boards making decisions in an environment in which it may not be clear which path would maximize firm value versus value for common shareholders. It appears to be only a matter of time before a significant case involving a venture-backed startup and creditor's claim for breach of fiduciary duty will come before Delaware courts, and this opportunity will be a valuable one for providing guidance and giving startup boards the wide discretion they often need in these circumstances.

Second, this Article's observations about the law and culture of startup failure puts the *Trados* doctrine about the preferred-common shareholder conflict, and need for additional clarity, into broader context. In an important 2013 decision of the Delaware Court of Chancery, *In re Trados*, the court examined a venture-backed startup board's decision to enter into a M&A deal in which the proceeds went to a management incentive plan and the preferred shareholders pursuant to liquidation preferences, with nothing left over for the common shareholders.[294] The startup was unprofitable, its cash balance had declined, and it faced dim prospects for growth after several years of operation.[295] The court ultimately found that the deal was fair to the common shareholders because the stock lacked economic value due to the company's limited prospects, but it sharply criticized the board, especially the conflicted VC directors, for initiating a sale process "to take advantage of their special contractual rights" and without consideration of the common shareholders.[296] The court's decision, and its language about "maximizing the value of the corporation for the benefit of its residual claimants," pushes startup boards in the direction of creating value for the common shareholders.[297]

Scholars have offered a number of critiques and concerns, primarily stemming from the observation that common stock maximization may not be the same as enterprise value maximization.[298] This Article's descriptive account of the system of dealing with startup failure adds institutional detail for understanding why common stock value maximization may also be a difficult rule to navigate in practice. For example, common stock value can potentially be generated by

---

[293] *Id.* at 165-66 ("Unlike federal bankruptcy law, which uses uniform statutory tests to determine solvency, Delaware corporate law has no uniform tests . . . . Delaware case law on solvency is confusing and can lead to inconsistent results.").
[294] 73 A.3d at 20.
[295] *Id.* at 23-25.
[296] *Id.* at 58, 64-66, 76-78.
[297] *Id.* at 41.
[298] For scholarly literature on *Trados*, see *supra* note 5.

pivoting or escalating the initial commitment at the expense of the preferred shareholders and creditors.[299] Often in this situation, the company would need to raise more capital to extend its runway. If the startup is in distress when this occurs, it can potentially raise capital through (1) an inside equity round (and then might face "pay-to-play" issues or other fiduciary conflicts);[300] (2) an outside equity round with unfavorable terms, such as high liquidation preferences (which might impinge on the previous preferred shareholder preferences and generate volatility for the common stock); or (3) venture debt (perhaps using the intellectual property as collateral). These scenarios all pose potential issues of their own and it may be difficult to incentivize individual founders and employees to stay through a pivot or a high-risk, last-ditch effort when their talent is not locked into the company.

Common stock value maximization therefore creates a difficult objective to navigate in this context, and in that sense "exits with honor" serve a similar function on the downside that IPOs can play on the upside —a way out of a complicated governance situation.[301] For example, acqui-hires can lead to exit or shut down of the company with at least a significant portion of the shareholders and stakeholders relatively happy considering the circumstances—they do not necessarily maximize the common stock value from the perspective of an option analysis which assumes it is possible to continue the firm in the status quo,[302] but acqui-hire transactions can protect the human capital and reputation of founders and employees, and provide a separate pool of consideration to motivate the team to stay together instead of individually defecting to new employment. And, so long as the team stays together as an asset, the preferred shareholders might recoup their original investment capital or a small portion, but in either event they get out of a company that is not going to be a home run anyway and save their time and attention for more promising ventures. This analysis suggests that additional doctrinal clarity for startup boards facing these decisions, particularly as to triggers for the onerous entire fairness standard of review, would be valuable for reducing transaction costs and the potential for litigation abuse or hold-up value.[303]

Another area of potential reform could be state insolvency procedures. The use of ABC laws by venture-backed startups has received relatively little attention since the dot-com bust era, but continue to be a useful option for failed startups,

---

[299] *See* Talley & Sanga, *supra* note 5, at 13 (explaining dynamics that make common shareholders favor exit too rarely).

[300] *See, e.g.*, *Inside Funding Rounds in Venture-Backed Startups: The Perils of "Effective Control*", 43 DEL. J. CORP. L. 419 (2019).

[301] *See* Pollman, *Startup Governance*, *supra* note 1, at 215-16.

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

[303] *See* Cable, *Does* Trados *Matter?*, *supra* note 5, at 346-47 (noting that "in the ordinary case, boards are not faced with a choice between sale and pivot" but rather "between sale and dissolution" and so "the next time the court re-visits the *Trados* fact pattern, it should articulate what fair process might mean in the ordinary case"); *id.* at 340 (noting that "the potential plaintiffs" are often the "'cats and dogs'—estranged founders and former employees holding small stakes"). Reinforcing the negotiability of fair value protections could also be beneficial for navigating unavoidable trade sales more efficiently. *See* Nigro & Stahl, *supra* note 5, at 45-46.

particularly in states with favorable laws such as California.[304] States vary widely in their procedures, however, ranging from assignments under common law with little standardization to detailed state statutory provisions for ABCs with significant legal formalities.[305] In some states, such as New York, for example, the assignee must make multiple court filings, including a final report, which adds cost and delay.[306] Efforts at harmonizing the vastly divergent state approaches have not taken off thus far and have not focused on promoting efficiencies for venture-backed startups.[307]

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

Lessons from ABCs might also be valuable for bankruptcy procedures. One proposal from the dot-com bust era, for example, is to adjust Chapter 7 to allow the company to select a private trustee.[308] Companies would still be subjected to the oversight of a bankruptcy court, the publicness of a filing, and so on, but could use experts with experience in the type of assets commonly held by venture-backed startups. Selecting a private trustee does not go very far toward addressing the reasons that the formal bankruptcy system is often not a good fit for startups, but could be value enhancing in some instances. Increased use of formal bankruptcy procedures may be inevitable in any event given the evolving landscape of the venture capital ecosystem, making even small adjustments worth exploring.

Finally, beyond implications for corporate law, state insolvency, and bankruptcy, is a heated debate about ratcheting up antitrust scrutiny of Big Tech acquisitions of startups. This Article highlights the importance of having relatively low-cost means for dealing with large amounts of startup failure and thus raises a concern that has gotten little attention: broad-based responses that have the effect of banning or chilling large technology companies from making acquisitions might not only impact the flow of successful startup exits, but also failures.[309] Although

---

[304] *See* Mann, *Liquidation Choices*, *supra* note 76, at 1398. California courts have also given startup boards wide discretion under the business judgment rule to decide to take this path. *See, e.g.*, Berg & Berg Enter., LLC v. Boyle, 100 Cal. Rptr. 3d 875, 880-81 (2009) (holding that creditor failed to plead a cognizable claim for breach of fiduciary duty against startup directors who decided to do an ABC instead of pursuing the creditor's bankruptcy plan to protect net operating losses through a chapter 11 reorganization).

[305] GEOFFREY L. BERMAN, GENERAL ASSIGNMENTS FOR THE BENEFIT OF CREDITORS: THE ABCS OF ABCS (5th edition) (providing overview of state ABC procedures); Landon, *supra* note 267, at 1472-75 (examining widely varying state ABC procedures).

[306] Landon, *supra* note 267, at 1478.

[307] *See* Geoffrey L. Berman & Catherine E. Vance, *Model Statute for General Assignments for the Benefit of Creditors: The Genesis of Change*, https://dsiconsulting.com/wp-content/uploads/2020/10/MODEL-STATUTE-FOR-GENERAL-ASSIGNMENTS-FOR-THE-BENEFIT.pdf (arguing for adoption of a model statute to harmonize divergent state laws and discussing the proposed model statute's provisions such as requirement for consent to the assignment by a majority of the creditors and court supervision).

[308] Mann, *Liquidation Choices*, *supra* note 76, at 1442-43.

[309] For an argument from the perspective of the harm to platform companies, see D. Daniel Sokol & Marshall Van Alstyne, *The Rising Risk of Platform Regulation*, MIT SLOAN MGMT. REV. ("[T]hese

this does not appear to be the primary aim of the recent crop of legislative proposals, it could be an unintended consequence. It is difficult to know the magnitude of the potential impacts of various legislative proposals on the greater startup and venture capital ecosystem, but it is at least conceivable that some could alter the dynamics for M&A deals and acqui-hires that are not producing returns for all equity holders. For example, large technology companies might respond to the current regulatory environment by slowing down acquisitions and prioritizing ones of most strategic importance, while minimizing acqui-hires and small deals that do not pose the same competition concerns but might raise their total number of deals and attract attention. The existence of Big Tech as an exit path might also contribute to ex ante incentivizes for some entrepreneurs to found startups because they expect that even if they do not have the big success that they hope for, they might at least get a good job at a large technology company and their reputation will not be harmed and might even be improved. Restricting the pathway for soft landings and recycling talent may therefore be counterproductive as it could make entrepreneurship less attractive and venture capital investment less efficient, without tackling the competition concerns at the heart of the current debate.

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

Although a full examination is beyond the scope of this Article, it highlights the possibility of a balanced approach that seeks not to chill acquisitions of truly failed startups that did not otherwise have other independent paths or acquisition opportunities.[310] Moderately successful "beach money" exits, in which founders and employees might get a payout that is relatively small compared to the potential value of the company if it maintained an independent path, are more likely to raise concerns about anticompetitive effects.[311] The challenge is thus to more finely tune regulatory policy to distinguish these various exits as they have different

---

limits [on the merger and acquisition activity of platform companies] can also hamper the ability of platforms to reach scale, to acquire new functionality that they can share with large pools of users, and to obtain the talent and capabilities needed if they are to innovate.").

[310] One preliminary threshold distinction might be first drawn between deals that occur as stock acquisitions or mergers (which might be an acquisition of a viable competitor) and partial asset acquisitions and hiring of personnel (which is much more likely to be a failed startup that does not pose the same sorts of competitive concerns). Another inquiry might be into whether the startup exit produces return to the common shareholders or if it has taken more capital to develop than it receives upon exit.

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

motivations and impacts. Ultimately, more finely-tuned antitrust enforcement of acquisitions of nascent competitors may help fuel the rise of a greater number and diversity of potential acquirers for the next generation of startups.[312]

CONCLUSION

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

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

---

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