Why have venture capitalists become so founder-friendly?

May 16 2024, by Nate Luce

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Companies backed by venture capitalists ("VCs") have a disproportionate influence on our economy; they provide funding to less than 0.25% of new businesses, but more than 47% of US companies that went public between 1995 and 2018 were venture backed. VCs chart the course of innovation by taking the concept of risk vs. reward to the extreme, assuming massive risks to achieve outsized rewards.

Historically, VCs have mitigated risk through active governance—taking seats on the boards of their portfolio companies, staggering investments over multiple rounds, and replacing founders with outside executives when companies begin to scale. They do this, according to scholars, to account for adverse selection and moral hazard. Founders know more about their company's prospects than a VC, and they may operate their company for their own benefit.

That strategy appears to have changed in recent years, to the extent that VCs choices can no longer be explained by scholars' traditional, "monitoring" models of VC governance. Founders are more likely to control their boards and own larger shares of equity. They hold onto CEO positions for longer as well; some VCs have gone so far as to implement no-removal policies. What happened?

"Risk-Seeking Governance," a paper co-authored by Brian Broughman at Vanderbilt Law School and Matthew Wansley at Cardozo School of Law, offers an explanation for this sea-change, along with a new "risk-seeking" model for VC behavior.

The study is available as a working paper in the *SSRN Electronic Journal*.

"We are motivated by a fact that is universally acknowledged but not fully appreciated: The returns to venture investing follow a power law," the authors write.

Incentivizing risk to maximize potential returns

The most successful VC firms generate more skewed returns, with more failures but one or two companies that provide exponential returns on investment. Generating skewed returns is not simply a matter of deal selection, but also impacts how such firms are governed after investment.

To incentivize the necessary level of risk-taking, VCs have adopted a "founder-friendly" posture, offering founders larger returns on successful exits, greater job security, more control, and soft landings in the event of failure. Certain behaviors have remained in the VC playbook, but the rationale has shifted; VCs purchase preferred stock not only to mitigate losses in the event of a company's failure, but also to reward founders who are willing to take big risks. VCs are increasingly competing on non-price dimensions. When bargaining with a risk-averse founder, VCs who have cultivated a founder-friendly reputation have a competitive advantage.

The authors factor these nonprice considerations into a model that "helps explain why startups increasingly pursue high-risk strategies." Founders react to this new form of governance by accelerating growth through "blitzscaling" (hiring candidates without vetting them, bringing unfinished products to market), expanding operations at a loss, predatory pricing, and even selling illegal products with the hope that widespread adoption will force a change in the law.

"Risk-Seeking Governance" details the authors' risk-seeking model, contrasting it with the historic "monitor" model used by scholars to explain VC and founder behaviors. It details how this new normal contributed to several high-profile scandals involving VC-funded companies—specifically Uber, WeWork, and FTX—where VCs were unable or unwilling to prevent misbehavior by founders.

"The risk-seeking model explains that VCs behave more subversively—they skip monitoring, indulge self-dealing, and push managers to take risks. VCs and founders both get what they want out of the implicit bargain. But other shareholders and society more generally, may be stuck bearing unbargained-for risks."

The effects of a founder-friendly startup ecosystem

Risk-seeking governance "seems to be working" on important fronts: Institutional investors continue funding VC activity, and founders enjoy measurable benefits. Angel investors who hold equity without those benefits may raise an issue with the new state of affairs, but they can diversify their risk, and in certain circumstances, sell their shares in a secondary market. Employees with equity have fewer options to reduce their exposure to the aggressive, high-risk strategies of their employers. For society-at-large, this form of governance could be costly if it is expected to monitor the activity of private companies in lightly regulated industries.

"We doubt that there is a simple policy intervention that could harness the strengths of risk-seeking governance while curbing its excesses," the authors conclude. "But we hope that by providing a more accurate account of how VCs behave, we have helped to illuminate the choices that we face."

More information: Brian J. Broughman et al, Risk-Seeking Governance, *SSRN Electronic Journal* (2023). DOI: 10.2139/ssrn.4344939

Provided by Vanderbilt University