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Should Angel-Backed Start-Ups Reject Venture Capital?

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SHOULD ANGEL-BACKED START-UPS REJECT VENTURE CAPITAL?

*Darian M. Ibrahim**

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I. INTRODUCTION

The conventional wisdom is that entrepreneurs seek financing for their high-growth, high-risk start-up companies in a particular order. They begin with friends, family, and “bootstrapping” (e.g., credit card debt). Next they turn to angel investors, or accredited investors (and usually ex-entrepreneurs) who invest their own money in multiple, early-stage start-ups. Finally, after angel funds run dry, entrepreneurs seek funding from venture capitalists (VCs), whose deep pockets and connections lead the start-up to an initial public offering (IPO) or sale to a larger company in the same industry (trade sale).

That conventional wisdom may have been the model for start-up success in the past, but this Article challenges its continuing applicability. In particular, this Article argues that some start-ups that attract angel funding should stop there, rejecting offers of venture capital. It challenges the notion that venture capital is a necessary condition for start-up success and argues the counterintuitive proposition that venture capital may actually be *harmful* to entrepreneurs and angel investors in some situations.

At the outset, I observe that angels are now *able* to fund certain start-ups from their early stages to exit, both because start-ups need less money and because angels can provide more of it. First, the cost of innovation is decreasing in some technology sectors, most notably software. Second, the rise of professional angel investment groups allows angels to better tackle deal flow and lowers the transaction costs of pooling capital for larger deals. Angel money can now substitute for VCs funding in some start-ups, and while VCs have traditionally provided unique value-added

* Associate Professor, University of Wisconsin Law School. My thanks to participants in an Emory faculty colloquium, the Illinois Corporate Colloquium, and to Raulee Marcus of the Tech Coast Angels for helpful feedback on this Article. This Article includes summaries of arguments I have made in other work. For brevity, rather than repeat all citations here, the Article refers readers to my previous works where applicable.

services that enable start-ups to go public, that path to exit has not existed for most start-ups since the late 1990s.¹ Further, angels offer *their own* value-added services that enable start-ups to achieve smaller-dollar (relatively speaking) trade-sale exits—the far more common exit route these days and probably the better route for most investors.

After describing new realities that make angel-only financing of start-ups *possible*, I explore three reasons that also make them more *probable* going forward. First, with the negative and perhaps lasting changes to IPO markets over the past decade, trade-sale exits have taken on increased prominence. VCs, however, may actually impede smaller-dollar trade-sale exits that would be desirable to angels and entrepreneurs because they do not produce a large enough return on investment for VCs. As angels and entrepreneurs experience the “lock-in” effect of venture capital (i.e., illiquidity from the VC’s desire to “swing for the fences” on exit), they are more likely to pass on VC involvement in future deals.

Second, from a corporate governance perspective, angel-only start-ups can lower the transaction costs and agency costs of VC involvement. VCs create these problems by investing in preferred stock, as opposed to the entrepreneur’s common stock. Angels, on the other hand, have long held the same common stock as entrepreneurs, which aligns their incentives. It is only with the recent rise of professional angel groups that angels have moved into preferred stock – a move motivated in part by the need to protect themselves from VCs.² Without VCs, angels would only have to worry about protecting themselves against opportunistic entrepreneurs, and angels have informal means of protection available to them that reduce the need for preferred stock’s formal protections. Moreover, without VCs, start-ups could even begin to organize as LLCs rather than C corporations, which would increase investor tax advantages on losses (although increase tax burdens on certain gains).³

Finally, from a social-welfare perspective, angel-only start-ups allow broader geographic distribution of innovation-based gains beyond Silicon Valley. Angel-only start-ups do not have to move their headquarters and operations to be close to VCs. Instead, these start-ups can remain anchored in the states where they began. Indeed, many states have economic development plans that emphasize entrepreneurship.⁴ This Article

1. See *infra* notes 32-35 and accompanying text.

2. See Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1443 (2008) (supporting the proposition that angel groups acquire preferred stock more often than angels traditionally have); Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 973 (2006) (arguing that the risk of VCs’ opportunism may increase the price of angel financing, which suggests a need for angels to defend themselves from VCs).

3. See *infra* note 71 and accompanying text.

4. See, e.g., Terrance P. McGuire, *A Blueprint for Growth or a Recipe for Disaster? State Sponsored Venture Capital Funds for High Technology Ventures*, 7 HARV. J. L. & TECH. 419, 427 (1994) (noting that Massachusetts and Michigan have state venture capital funds to

argues that angel-only financing should be an important part of that conversation.

After exploring these three upsides of angel-only financing for start-ups that can get by with less capital, this Article concludes with two caveats for start-ups that consider going this route. First, there may be adverse tax consequences to employees in start-ups without VC investment in preferred stock, which could mean more difficulty attracting talent. Second, venture *debt*, an important but more obscure source of funding for start-ups, may no longer be available to start-ups that shun VCs, as venture debt's business model depends on venture capital. Despite these caveats (which I show are less worrisome than they initially appear), I predict that we will see more angel-only start-ups going forward, given the previously unexplored advantages that rejecting venture capital can bring.

II. TWO MAIN SOURCES OF ENTREPRENEURIAL FINANCE: ANGEL INVESTORS AND VENTURE CAPITALISTS

Once entrepreneurs attempting to grow their start-ups exhaust the funds available from friends, family, and their own accounts, they turn to professional investors. Most market investors are not interested in funding start-ups due to their lack of a track record, high failure rate, and lack of liquidity. However, two types of investors do specialize in these investments: angel investors and VCs.

Angel investors are typically the first source of outside funding for start-ups. Although it is difficult to pin down exactly who constitutes an angel investor, a broad understanding includes anyone who invests his or her personal funds in a new business.⁵ Conceivably, this makes even family members angel investors, and it does not limit the subjects of their investments to rapid-growth (as opposed to “lifestyle”)⁶ businesses. Therefore, a more limited, more apt definition of angel investor – and the one employed in this Article – is an “accredited investor” who invests in multiple, early-stage start-ups.⁷ Angel investors are usually also ex-entrepreneurs who have successfully exited their own start-ups. For example,

support entrepreneurship that are “widely regarded as the premier programs in the . . . field”).

5. For a fuller description of angels and VCs, including literature citations, see Ibrahim, *supra* note 2, at 1406-07.

6. A typical lifestyle business is a “mom-and-pop” shop that does not have – or desire – a rapid-growth trajectory, but instead starts small and stays small.

7. Individual investors with over \$1 million in net worth count as accredited investors. The Dodd-Frank Act changed the definition to exclude an individual's primary residence from the net worth calculation, thus reducing the number of individuals who count as accredited investors. *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub. L. No. 101-203, § 413 (a), 124 Stat. 1376, 1577 (2010) (“The Commission shall adjust any net worth standard for an accredited investor . . . so that the individual net worth of any natural person, or joint net worth with the spouse of that person, at the time of purchase, is more than \$1,000,000 . . . excluding the value of the primary residence of such natural person . . .”). The Dodd-Frank Act also requires the SEC to review the accredited investor definition every

Facebook's angel investors include Peter Thiel (co-founder of PayPal) and Reid Hoffman (co-founder of LinkedIn).⁸ Angels invest in both technology-based and non-technology based start-ups.⁹ They might invest alone or with an informal syndicate of other angels, per the traditional practice, or, increasingly, as members of organized angel investment groups that have sprouted up throughout the United States over the past decade.¹⁰

While angels invest their personal funds in early-stage start-ups, VCs are professional investors who put other people's money to work once start-ups have had some time (usually a year or two) to develop.¹¹ VCs are actually the general partners of large funds organized as limited partnerships, with endowments and pension funds serving as the funds' limited partners.¹² Limited partners' committed capital is drawn upon as needed to invest in particular start-ups.¹³ VCs have backed most start-ups that have gone on to fame and fortune over the past several decades, including Facebook (VCs Accel Partners and Greylock Partners) and Google (VCs Kleiner Perkins and Sequoia Capital).¹⁴ Both VCs and angel investors contribute important value-added services, such as seasoned advice and connections, in addition to money.

III. DO START-UPS NEED VENTURE CAPITAL?

A. *Conventional Wisdom*

The conventional wisdom is that while angels are a plus, start-ups *need* venture capital to succeed. This is because VCs have deeper pockets than angels and because, as mentioned, they contribute important value-added

four years and make adjustments "as the Commission may deem appropriate for the protection of investors, in the public interest, and in light of the economy." *Id.* at § 413 (b).

8. Ryan Mac, *Ryan Hoffman and Peter Thiel in Conversation: Their Biggest Misses*, FORBES (May 2, 2012), <http://www.forbes.com/sites/ryanmac/2012/05/02/reid-hoffman-and-peter-thiel-in-conversation-the-biggest-misses/>.

9. Robert Wiltbank, *At the Individual Level: Outlining Angel Investing in the United States*, UNIV. OF ILL. AT URBANA-CHAMPAIGN'S ACAD. FOR ENTREPRENEURIAL LEADERSHIP HISTORICAL RESEARCH REFERENCE IN ENTREPRENEURSHIP, 4, available at http://www.marketingtechie.com/articles/angel_investing.pdf (observing that angels invest in "computer-related, health-care-related, or non-technology investments," depending on their particular areas of expertise).

10. See *infra* note 28 and accompanying text.

11. See Ibrahim, *supra* note 2, at 1450 (noting that angel groups, like angels, "still invest[] their own money").

12. Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1, 8 (2012).

13. See *id.*

14. Eric Savitz, *Facebook: Some Venture Investors are Moving On*, FORBES (Aug. 20, 2012, 5:58 PM), <http://www.forbes.com/sites/eric savitz/2012/08/20/facebook-some-venture-investors-are-moving-on/> (noting that Accel Partners and Greylock Partners have sold positions in Facebook since its initial public offering); see also <http://googlepress.blogspot.com/1999/06/google-receives-25-million-in-equity.html> (noting the early investments in Google by Kleiner Perkins and Sequoia Capital).

services, especially those designed to position the start-up to go public. First, VCs offer considerable funding for growing start-ups – including an initial investment of millions of dollars.¹⁵ Further, VCs and their syndicate partners typically follow on these initial investments several times over, to the tune of tens of millions of dollars, as the start-up progresses.¹⁶ These large-dollar contributions allow capital-intensive start-ups to move through their initial development stage into product testing, then expansion mode, and eventually to exit.

Second, VCs offer value-added services designed to transform start-ups from small, technology-proving enterprises into large companies delivering those technologies to a large marketplace. While the entrepreneur's talents may have been crucial to envision and prove the start-up's technology at inception, professional managers are often needed once the start-up enters its expansion phase.¹⁷ VCs have connections, through past working relationships and otherwise, with professional managerial talent specializing in these transitions.

Because VC money and value-added services are thought to be so valuable, I have written about how angels structure their investments in start-ups to invite follow-on VC participation.¹⁸ For starters, before the rise of angel groups, angels routinely accepted the same common stock as entrepreneurs.¹⁹ Traditionally, angels have also often foregone board seats and other contractual protections that VCs demand.²⁰ At first glance, this seems odd since angels need *more* protection than VCs, not less, because they invest when the start-up is brand new. However, the answer to the puzzle of non-aggressive angel contracts becomes clear when considering that angels are contemplating their interactions not just with entrepreneurs and other angels, but with the potential VCs they hope will later become investors.

15. Jeffrey E. Sohl, *The U.S. Angel and Venture Capital Market: Recent Trends and Developments*, 6 J. PRIVATE EQUITY 7, 15 (2003) (noting that typical investment sizes for later-stage VC investments were between 10 and 15 million dollars and “steadily increasing”).

16. See Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 304 (2003) for a more thorough discussion of VC financing stages.

17. eBay, for example, primarily sought venture capital because it recognized that a VC's connections and expertise would be essential in securing a seasoned CEO and other executives. RANDALL E. STROSS, *EBOYS: THE TRUE STORY OF THE SIX TALL MEN WHO BACKED EBAY AND OTHER BILLION-DOLLAR START-UPS* 22 (2000).

18. For a fuller account of this argument, including literature citations, see Ibrahim, *supra* note 2, at 1428-30. It should be noted that the entrepreneurial finance model in the United States is largely one of private ordering. By contrast, in the United Kingdom, the Alternative Investment Market (AIM) is a public market matching risk capital and entrepreneurs. I plan to compare these two models of venture capital in a forthcoming paper.

19. *See id.* at 1422.

20. *Id.* at 1423.

Angels have traditionally designed their investment contracts in a non-aggressive way in order to attract VCs. “VCs are flooded with funding proposals, and accept maybe one . . . percent” of the serious ones.²¹ A start-up with angels on the board, with preferred stock, and other bells and whistles is unattractive to VCs, as VCs will be forced to “unwind” aggressive angel preferences to strike the VCs’ standard deal. In other words, VCs will take their usual board seats, preferences on liquidation, and so forth in each investment. If angels are already getting what the VCs want, the VCs must convince the angels to restructure their deal or the VCs will get less. Because this negotiation and unwinding is costly and time-intensive, VCs considering numerous investment candidates may pass on these particular start-ups.

Things are a bit different for angel groups. Their members invest more capital slightly later in the process than traditional angels and have relationships with VCs – all of which make their participation worth the extra hassle.²² Angel groups are more plugged into local VC communities, either through pre-existing relationships or because a steady deal flow quickly makes them repeat players in start-up financing. Because of the angel group-VC relationships and angel group members’ greater sophistication, these angels may value the start-up more realistically for their investment, thus doing some of the legwork that VCs would otherwise have to do to get the entrepreneur to be more realistic about the start-ups’ current value.²³ VCs may even refer early-stage deals to angels, and then screen the start-up again after the angels’ investment helps the start-up develop. For these reasons, VCs view angel groups like other VCs, and allow them to contract with the start-ups accordingly.²⁴

B. *New Realities*

While the conventional wisdom, as outlined above, is that angels and entrepreneurs will need to attract VCs for their deep pockets and connections, new realities could lead to a new trend: start-ups that choose to accept angel backing only. The first new reality is that deep pockets may no longer be as important to the start-up equation. In one important technology sector—software—the cost of innovation has come down dramatically over the past decade. As one prominent VC recently wrote, “[t]he software VC business has been fundamentally altered by the massive decrease in the cost of building and launching a software based business.”²⁵

21. *Id.* at 1428.

22. For a discussion of VCs’ aversion to aggressive angel deals, see *id.* at 1429.

23. VCs’ most common complaint about traditional angels is that they, like entrepreneurs, overvalue early-stage start-ups. See Ibrahim, *supra* note 2, at 1429.

24. Still, even the newer angel group contracts do not contain all of the typical VC contract provisions. *Id.* at 1446-47.

25. Fred Wilson, *There are Two Venture Capital Industries*, AVC: MUSINGS OF A VC IN NYC (Sept. 16, 2010), http://www.avc.com/a_vc/2010/09/there-are-two-venture-capital-industries.html.

The hottest technology sector of late seems to be media and entertainment, based on the examples of companies such as Facebook and Twitter.²⁶ Purely digital media and entertainment start-ups can similarly be launched with very little capital.²⁷ While scaling them to the mass marketplace requires more capital, that can be sought post-exit (for example, by selling shares in an IPO).

At the same time that innovation costs are decreasing, angel capital appears to be increasing. Angels now have the resources necessary to fund software and digital media start-ups from their early stages to exit without VC dollars. The past decade has seen the formation of hundreds of professional angel investment groups throughout the country.²⁸ These groups attract the most serious angels in a community and enable them to pool their capital with fewer transaction costs.²⁹ This leads to a larger pool of angel money that can be made available to start-ups selected by the angel group members to receive funding.³⁰

Of course, there are other technology sectors where venture capital is still very much a necessity. These capital-intensive fields (as opposed to “capital-efficient” fields like software) include the life sciences and clean technology industries.³¹ Start-ups in these fields have substantially larger capital requirements than angels can provide, even with their capital pooled in angel groups. My points are only that 1) *certain* start-ups can now make do with less funding, and 2) certain angels can now provide more of it. This combination of factors has led to the new possibility of angel-only start-ups, at least as far as funding is concerned.

Even if angels are now capable of funding certain start-ups alone, VCs will still assert their necessity for the value-added services they provide, such as ramping up the company for an IPO. As I have argued elsewhere, however, VCs can no longer credibly claim that their involvement will increase the probability of an IPO exit.³² IPO markets have not rebounded since the gold rush of the late 1990s and 2000. After 271 VC-backed IPOs

26. This is not a claim for which I have empirical evidence, only anecdotal evidence.

27. See Email from Fred Wilson, a prominent angel investor, to author (Sept. 10, 2012) (noting that media start-ups like Facebook and Twitter “can be started for almost no money”) (on file with author).

28. See ANGEL CAPITAL ASSOCIATION, <http://www.angelcapitalassociation.org/directory/> (last visited Feb. 13, 2013), for a current listing of angel groups that are members of the Angel Capital Association, the North American trade association of angel groups.

29. See Ibrahim, *supra* note 2, at 1443 (the most serious angels may flock to angel groups because of “increased opportunities for interaction with other angels and venture capitalists, the chance to fund larger deals through the pooling of resources, and the ability to invest in amounts large enough to justify the transaction costs of preferred stock”).

30. *Id.* at 1445 (“The increased opportunities for pooling also may facilitate larger investments.”).

31. Darian M. Ibrahim, *Financing the Next Silicon Valley*, 87 WASH. U. L. REV. 717, 748 (2010).

32. For a fuller account of this argument, including literature citations, see Ibrahim, *supra* note 12, at 10-13.

in 1999 and 263 in 2000, the numbers dropped to *six* and *twelve* IPOs in 2008 and 2009, respectively.³³ The financial crisis reduced investor appetite for new issuances, and though the numbers for 2010 and 2011 are better (75 and 53 VC-backed IPOs, respectively),³⁴ they still represent only a small fraction of start-ups that angels and VCs fund. They still represent only a small fraction of start-ups that angels and VCs fund. By contrast, the number of trade-sale exits is steadily rising over the same time period – 237 in 1999 and 317 in 2000, jumping to 442 in 2010 and 458 in 2011.³⁵

Whether the number of IPOs will ever fully rebound to previous levels remains to be seen. Passed after the IPO gold rush, the Sarbanes-Oxley Act of 2002 (SOX) has been blamed for making IPOs too expensive for most young tech firms.³⁶ While small public companies have now been exempted from the particularly onerous accounting rules of SOX section 404,³⁷ the accounting firm Grant Thornton argues that the IPO crisis began even *before* Sarbanes-Oxley.³⁸ Grant Thornton cites the regulatory change of recording stock spreads in increments of \$0.01 per share instead of the former fractional system with spreads of \$0.25 per share.³⁹ Market makers and traders used to cover smaller public companies because of the greater profit margin in smaller spreads, even at smaller volumes, but now, as Grant Thornton argues, “[i]n a hyper-efficient market, where trading spreaders and commissions are approaching zero, the company needs to be large enough to attract research and investors.”⁴⁰ Other post-gold rush rules including the “Manning Rule,” Order Handling Rules, and Regulation FD (Fair Disclosure)⁴¹ may have also contributed to a forever-changed IPO market.

Finally, the highest-profile VC-backed IPO to take place in some time – Facebook – has been a flop. Facebook went public on May 18, 2012 with

33. See 2012 NATIONAL VENTURE CAPITAL ASSOCIATION YEARBOOK, NVCA 52 (April 2012) [hereinafter NVCA YEARBOOK 2012], available at http://www.nvca.org/index.php?option=com_content&view=article&id=257&Itemid=103.

34. *Id.*

35. *Id.* at 55.

36. See, e.g., Dale A. Oesterle, *The High Costs of IPOs Depresses Venture Capital in the United States*, 1 ENTREPRENEURIAL BUS. L.J. 369, 370 (2006) (“The higher ongoing costs are a significant bone of contention, particularly with the implementation of Section 404 of the Sarbanes-Oxley Act of 2002.”).

37. The Dodd-Frank Act added section 404 (c) to SOX. This provision permanently exempts small companies (those with a public float less than \$75 million) from SOX section 404 (b). In 2010, the SEC amended its rules to conform them to the new section 404 (c). See SEC Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers, 17 C.F.R. §§ 210, 229, 249 (2010).

38. David Weild & Edward Kim, *Market Structure is Causing the IPO Crisis—and More*, GRANT THORNTON 7 (June 2010), <http://www.gt.com/staticfiles/GTCom/Public%20companies%20and%20capital%20markets/Files/IPO%20crisis%20-%20June%202010%20-%20FINAL.pdf>.

39. See *id.* at 10.

40. *Id.*

41. *Id.*

an offering price of \$38 per share, which valued the company at a staggering \$100 billion.⁴² On Friday September 7, 2012, the stock closed at a mere \$18.96 per share.⁴³ While the story is still to be written on everything that went wrong with this offering, one thing is clear – the Facebook flop is not the picture-perfect exit that will pave an easy road to public offering riches for other start-ups. Further, venture capital is becoming even more a model segregated between top funds, which raise considerable capital to invest in the hottest start-ups, and lower-tier funds, which (by number) fund the vast majority of start-ups, but whose ability to raise and invest funds is down considerably.⁴⁴ In the aggregate, the National Venture Capital Association (NVCA) reports that the “activity level of the U.S. venture capital industry is around half what it was at the 2000-era peak.”⁴⁵ Less funding for the majority of start-ups means even fewer IPO prospects.

With IPOs now more scarce, the trade-sale exit (being acquired by a larger company in the same industry) becomes the start-up’s most promising exit opportunity. As discussed in the next Part, it is not nearly so clear that start-ups *need* VCs to obtain trade-sale exits, and for reasons that will be explored below, VCs may actually be detrimental to achieving desirable trade-sale exits from the entrepreneur’s and angel’s perspectives.

IV. WHY ANGEL-ONLY START-UPS MAY NOT ONLY BE POSSIBLE, BUT ALSO PROBABLE

Having established that some angel-only start-ups are *possible*, the question remains: are they *preferable*, either from an investor perspective, a social welfare perspective, or both? This Section gives three reasons why some start-ups that attract angel financing should stop there, rejecting offers of venture capital that may come their way. Before proceeding, however, it is important to note that at this point my argument for angel-only start-ups is purely normative. That is, it is prescriptive, not descriptive. I am not trying to show that angel-backed start-ups *do* reject venture capital; I am only making the counterintuitive argument that some of them *should*. With the purely normative nature of my argument in mind, here are three advantages to start-ups that choose to reject venture capital.

42. Sean Hollister, *Facebook sets IPO at \$38 a share, confirming a valuation of \$100 billion*, THE VERGE (May 17, 2012, 4:18 PM), <http://www.theverge.com/2012/5/17/3027211/facebook-confirms-100-billion-ipo-at-38-a-share>.

43. *FB Historical*, YAHOO! FINANCE, <http://finance.yahoo.com/q/hp?s=FB&a=08&b=7&c=2012&d=08&e=7&f=2012&g=d> (last visited Feb. 5, 2013, 5:10 PM).

44. NVCA YEARBOOK 2012, *supra* note 33, at 10 (“A significant portion of the [VC] fundraising [in 2010 and 2011] was done by several large, established firms. For many venture firms, especially those without established successful track records, it was very difficult to raise money.”).

45. *Id.* at 9.

A. *Advantage #1: Earlier Trade-Sale Exits*

When start-ups take on venture capital, they change the exit equation considerably. While the conventional wisdom is that VCs push for earlier exits to return money to fund investors, and entrepreneurs resist because they extract private benefits from running their start-ups without public markets or a larger company to answer to, I challenge that argument in a recent Article.⁴⁶ Following the lead of prominent angel investor Basil Peters,⁴⁷ I contend that it is the exact opposite: entrepreneurs (and angels) actually prefer earlier exits, while VCs want to wait for something more.

Trade sales valued at even a few million dollars benefit early investors like entrepreneurs and angels because they paid so little for their stock. Angel and entrepreneur common stock is cheap for two reasons: 1) common stock has fewer preferences; and 2) entrepreneurs and angels invest when the start-up is very young and unproven, which translates to a low valuation.

Unlike VCs, entrepreneurs and angels also have important *non-financial* objectives in mind. Some successful entrepreneurs are “serial” entrepreneurs, meaning that they go on to found multiple start-ups.⁴⁸ Early trade sales give serial entrepreneurs both financial and human capital to redeploy. Angels, likewise, invest for more than money, including the thrill of being part of a new venture, but without the responsibility that comes with being on the entrepreneurial team.⁴⁹ Angels get the greatest chance to participate in venture development in an early-stage start-up. Once the start-up ramps up and VCs are involved, the angels’ roles become passive, waiting for an exit and monetary return. Therefore, the angel who likes to be an active participant prefers a quick trade-sale exit that allows her to fund—and participate in—other ventures.

The VC picture is quite different. First, VCs do not invest for non-financial reasons, and even if they enjoy participation in venture development, that participation takes place in the later stages. From a financial perspective – which is the sole reason why VCs invest – the same trade sale that paid off big for common stockholders pays off far less for VCs as preferred stockholders. The VC stock was bought at a time when the start-up was more developed (and thus more expensive), and preferred stock’s preferences don’t come cheap.⁵⁰ The different economics for VCs lead them to pass on the small-dollar trade sales and “swing for the fences in

46. For a fuller account of this argument, including literature citations, see Ibrahim, *supra* note 12, at 27-29.

47. BASIL PETERS, *EARLY EXITS: EXIT STRATEGIES FOR ENTREPRENEURS AND ANGEL INVESTORS (BUT MAYBE NOT VENTURE CAPITALISTS)* (1.2 ed. 2009).

48. For an interesting take on first-time versus serial entrepreneurs, see Fred Wilson, *First Time vs. Serial Entrepreneurs*, AVC: MUSINGS OF A VC IN NYC (May 1, 2011), http://www.avc.com/a_vc/2011/05/first-time-vs-serial-entrepreneurs.html.

49. For a fuller account of the angel participation argument, including literature citations, see Ibrahim, *supra* note 2, at 1437-40.

50. *See id.* at 1414-15.

the hopes of an IPO or larger trade sale. . . .”⁵¹ The effect is to “lock in” entrepreneurs and angels beyond their desired exit timeframes.

Although the NVCA does not publish statistics on the average age of a start-up at trade sale, it does publish the average age at IPO. Start-ups exited through IPO at an average age of 4.3 and 5.3 years in 1999 and 2000, respectively.⁵² In the last three years, however, those times have *doubled* (10.3 years in 2009; 9.2 years in 2010; and 8.2 years in 2011),⁵³ suggesting that the lock-in effect of venture capital may be very real.

Because IPOs and high-dollar trade sales are more difficult to achieve than small-dollar trade sales, even after waiting, the entrepreneur’s and angel’s returns might not materialize at all. In fact, because of the liquidation preferences embedded in VC preferred stock, angels and entrepreneurs may be shut out of the gains from any eventual exit.⁵⁴ Therefore, VC involvement can 1) contribute to a net entrepreneurial loss to society by keeping entrepreneurs and angels locked into one enterprise; and 2) be harmful to other investors. In sum, from an investor perspective, and even perhaps a social welfare perspective, the lock-in effect of venture capital is the first reason that angel-backed start-ups should think twice about bringing in VCs.

B. Advantage #2: Corporate Governance: Reduced Transaction Costs and Agency Costs

The second reason that angel-backed start-ups should consider rejecting VCs is that, from a corporate governance perspective, VC investment involves high transaction costs and agency costs due to VC investment in preferred stock, as opposed to common stock.⁵⁵ As explained below, dual-class stock creates corporate governance problems that do not exist in start-ups with only a single class of stock. Worse corporate governance is detrimental to the start-up’s investors and perhaps to society as a whole, to the extent that we believe that entrepreneurial firms have a broader social value in terms of job creation, economic growth, and otherwise.

First, as I have previously argued, the VC’s preferred stock adds significant complexity to the relationship, increasing the costs of VC investment.⁵⁶ Under costly contracting theory, VCs’ larger investments and

51. Ibrahim, *supra* note 12, at 29.

52. See NVCA YEARBOOK 2012, *supra* note 33, at 52.

53. *Id.*

54. See Brian J. Broughman, *The Role of Independent Directors in Startup Firms*, 2010 UTAH L. REV. 461, 466 (2010) (explaining that a liquidation preference means that when the start-up “is sold or dissolved, preferred stockholders are entitled to be paid the full amount of their liquidation preference before common shareholders receive anything. The liquidation preference usually equals the amount invested (‘1X preferences’) but can be a multiple of that amount and may include unpaid dividends.”).

55. Ibrahim, *supra* note 2, at 1422.

56. *Id.* at 1434.

fund investors justify taking preferred stock.⁵⁷ But this also adds transaction costs for entrepreneurs and angels at the time of contracting. Standard form contracts found in law firm databases and available on the NVCA websites minimize these transaction costs,⁵⁸ but each VC round will involve different preferences relative to previous and future rounds, and these must still be negotiated.

Second, the VC's preferred stock creates considerable agency costs for entrepreneurs and angels, including the risk of opportunism.⁵⁹ Jesse Fried and Mira Ganor have discussed the unusual governance scheme in start-ups. That is, while common shareholders control most corporations, VCs control start-ups through their preferred stock, at least after a few rounds of financing.⁶⁰ While it might appear that fiduciary duty law might constrain VCs from abusing this control, an important Delaware case suggests otherwise. In *Orban v. Field*, the Delaware court allowed VCs to sell a start-up for an amount less than their liquidation preference, leaving the common shareholders without a payout.⁶¹

Entrepreneurs and angels might look to so-called "independent" directors on start-up boards to protect them against VC opportunism, but it is unclear whether a director can be truly independent if appointed by the VC. Angel investors may be further harmed by "pay-to-play" provisions that VCs employ, meaning that maintaining one's equity stake in the start-up depends on continuing to make follow-on contributions.⁶² Because angels have historically stepped aside once VCs enter, pay-to-play provisions could significantly diminish the angels' equity stakes.

Start-ups designed to be angel-only could look very different from a governance perspective. One option would be to continue organizing these start-ups as corporations, as is standard practice, but with all investors taking common stock. Traditional angels have long taken common stock because they could not justify the transaction costs of preferred stock.⁶³ Angel groups, on the other hand, have begun to take preferred stock because their pooling of resources justifies its transaction costs.⁶⁴ Further, angel groups may deem preferred stock necessary to protect against opportunism from VCs. Without VCs in the picture, however, an-

57. *Id.*

58. My thanks to Bill Carney for making this point.

59. For a fuller account of this argument, including literature citations, see Ibrahim, *supra* note 12, at 24-27.

60. Fried and Ganor, *supra* note 2, at 990-91.

61. *Orban v. Field*, 1997 Del. Ch. LEXIS 48, at *32 (Apr. 1, 1997) (finding no breach of the duty of loyalty to the common shareholders because they had no legal right to receive any portion of the sale proceeds).

62. See Robert P. Bartlett, III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 57 (2006) (discussing pay-to-play provisions).

63. See Ibrahim, *supra* note 31, at 742-43.

64. Ibrahim, *supra* note 2, at 1450.

gel groups could follow traditional angels and take the less expensive common stock.

Even without VCs to worry about, common-holding angels would still be vulnerable to entrepreneurial opportunism. But, as I have argued, traditional angels have long employed informal mechanisms for mitigating this risk – both pre- and post-investment.⁶⁵ Angel investing is local in nature and based on relationships. Angels prefer to invest in start-ups founded by entrepreneurs they know or in their areas of expertise.⁶⁶ This preexisting knowledge reduces angel uncertainty and the entrepreneur’s informational advantage. Angels also learn of investment opportunities from business contacts.⁶⁷ These contacts serve an important screening and sorting function for angels being pitched by numerous start-ups. In addition, the close, informal post-investment relationship between angels and entrepreneurs likely reduces angels’ agency cost concerns, even without detailed contracts.

Angels should rethink the start-up’s dominant choice of organizational form – the C corporation. In a widely cited article, Victor Fleischer explains why start-ups have long organized as C corporations despite double taxation and the inability of shareholders to use significant corporate losses during the early years (e.g., R&D expenses).⁶⁸ One reason requires a look at the ultimate investors in VC funds. As mentioned earlier, VC funds are limited partnerships, so any gains and losses that flow through the start-up to the VC fund also flow through the VC fund to the fund’s limited partners. The majority of these limited partners are tax-exempt entities such as pension funds and endowments.⁶⁹ These investors do not care about flow-through losses because they have no tax liability to offset; however, they do try to avoid flow-through gains, which are unrelated business taxable income (UBTI) that can trigger an audit.⁷⁰ Therefore, these investors prefer start-ups to be C corporations, trapping gain and loss at the start-up level. VCs will aim to please their investors, and start-ups will aim to please the VCs. Hence the traditional preference for the start-ups organized as C corporations.

Without VCs, however, the above-described tax rationale for organizing start-ups as C corporations would vanish. Start-ups would be free to choose another legal form – an “uncorporation” such as an LLC – which might be preferable.⁷¹ In an LLC, angels could use early flow-through losses in a start-up to offset gains from other investments. Further, using an unincorporate form like an LLC could reduce agency costs between an-

65. *See id.* at 1431-34.

66. *Id.* at 1431.

67. *Id.* at 1432.

68. *See* Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-ups*, 57 TAX L. REV. 137, 142 (2003).

69. *Id.* at 158.

70. *Id.* at 158-59.

71. *See* LARRY E. RIBSTEIN, *THE RISE OF THE UNCORPORATION* 227-28 (2010).

gels and entrepreneurs, assuming that they would own the same class of membership interests. An unincorporation would also require distributions to angels sufficient to pay taxes on any gain attributable to the start-up, reducing the amount of free cash on hand for entrepreneurs to squander or misappropriate.⁷² Forced payments such as distributions and interest payments can therefore reduce agency costs.

On the other hand, an unincorporate form would be worse for successful start-ups whose stock is held for over five years. As C corporations, the stock of those start-ups would be subject to favorable capital gains tax treatment under Internal Revenue Code Section 1202.⁷³ Angels and entrepreneurs considering a change in the standard organizational form should weigh these potential tax costs and benefits. The broader point of this Section is that without VCs, angels may benefit from the possibility of substantially decreased transaction and agency costs.

C. *Advantage #3: Broader Distribution of Innovation-Based Gains*

The third advantage of angel-only start-ups, as I have previously argued, is that they allow broader geographic distribution of innovation-based gains to regions beyond Silicon Valley.⁷⁴ While Silicon Valley possesses some of the most high-quality entrepreneurs, anecdotal data reveals that other U.S. regions are also home to high-quality entrepreneurs who end up relocating to Silicon Valley to be close to financing sources.⁷⁵ In other words, not all start-ups begin in Silicon Valley, but the best ones are likely to move there to be close to VC funding as they grow. This may or may not be a net loss to society, but from a distributional perspective, it is a net loss to non-tech regions looking to participate in the entrepreneurial economy.

How can angel-only start-ups broaden distributional gains from entrepreneurship? VCs are concentrated in high-tech hot spots, most notably Silicon Valley, because that is where the highest concentration of entrepreneurs are located.⁷⁶ VCs must find entrepreneurs without undue haste because the whole investment-to-exit cycle in a start-up must be completed in the VC fund's life.⁷⁷ Angels, on the other hand, live throughout

72. See Darian M. Ibrahim, *Debt as Venture Capital*, 2010 U. ILL. L. REV. 1169, 1204-05 (2010).

73. See Leandra Lederman, *The Entrepreneurship Effect: An Accidental Externality in the Federal Income Tax*, 65 OHIO ST. L.J. 1401, 1472-73 (2004) (“[W]ith respect to the gain on stock in a small business—already likely subject to the capital gains preference—Code section 1202 allows non-corporate taxpayers to exclude half of the gain on qualified small business stock held for more than five years.”) (citation omitted). *But see* Victor Fleischer, *Taxing Founders’ Stock*, 59 UCLA L. REV. 60, 69-70 (2011) (critiquing the tax benefits of founders’ stock).

74. For a fuller account of this argument, including literature citations, see Ibrahim, *supra* note 31.

75. *Id.* at 731.

76. *Id.* at 746.

77. *Id.*

the country⁷⁸ and invest more as a hobby than a necessity. Angels do not depend on deal flow or the highest concentration of entrepreneurs to enjoy the less-time intensive investment-to-exit process.

Widespread angel investment allows entrepreneurs who enjoy living outside of Silicon Valley to stay there. Angels invest locally because local investment permits easy monitoring, and, as mentioned earlier, an important, non-financial motivation for angel investing is the chance for routine participation.⁷⁹ Economic development gains in new regions can follow.

If local entrepreneurs rely on angels for their first round of funding, it delays their relocation to Silicon Valley, but may not prevent it. VCs may ask start-ups to relocate, even after beginning somewhere else, if they wish to receive VC funding.⁸⁰ Therefore, for start-ups to stay home, they need to have funding sources locally available. Angels serve that purpose, and, should angel investing continue to grow, the “staying home effect” could serve to broaden distributional gains from the innovation economy to more regions to the extent that the companies they invest in are successful.

Successful start-ups could also attract other high-tech employees to their regions;⁸¹ these entrepreneurs might eventually spin off their own ventures there. Similarly, the original entrepreneur might become a serial entrepreneur and found another local start-up, or even become an angel who funds other local start-ups. In sum, start-ups that stay home broaden distribution of our new economy’s gains, and staying home is far more likely without VCs.

V. WARNINGS FOR START-UPS CONSIDERING THE ANGEL-ONLY ROUTE

The preceding Part explored three reasons why start-ups that can get by on angel financing alone should consider going that route. This Part sounds two notes of caution associated with angel-only financing. As I will discuss, while both appear to be serious theoretical concerns, they might be somewhat mitigated in practice.

A. *Warning #1: Potential Adverse Tax Consequences for Start-up Employees*

The first potential warning for angel-only start-ups is that the absence of VC preferred stock in the start-up’s capital structure may harm efforts to recruit new employees or to incentivize existing employees. This is because start-up employees receive common stock, or options to purchase

78. *Id.* at 745-46.

79. *Id.* at 731.

80. Ibrahim, *supra* note 31, at 746.

81. As of now the presence of a highly evolved labor market, in addition to a highly evolved finance market, helps Silicon Valley continue to attract the brightest entrepreneurs. See, e.g., 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, 576 (1999).

common stock, as an important means of compensation.⁸² Existing employees, including the entrepreneur, may continue to receive new common stock or stock options as the start-up progresses to align their incentives with VCs. As Ronald Gilson and David Schizer have explained, employees are taxed on the fair market value of their stock or stock option grants.⁸³ To pay less tax, at least as an initial matter,⁸⁴ employees would likely claim that the value of their grants is low. The dilemma lies in the fact that the VCs are paying very high amounts for their stock at the same time employees are trying to claim that the grants they are receiving are worth far less.⁸⁵ It is only because VCs take preferred stock, with its superior cash flow and control rights, that such a disparity can be justified. But, as Gilson and Schizer observe, this Silicon Valley tax strategy is not “unassailable” – it is only “unassailed.”⁸⁶

Would an angel-only start-up and its all-common stock (or all-one class of LLC interest) endanger these tax advantages to employees? If angels begin paying VC-like prices for their investments, then it is a real risk. Employees receiving a grant of the same class of stock or stock options during or near an angel round could no longer justify a lesser valuation. However, there are several reasons that angel-only start-ups might not harm employee recruitment and retention as much as might first appear.

First, as previously noted, angels typically pay less for their stock than VCs, and therefore any higher values placed on employee common stock would be less than if VCs moved into common stock. Second, Fried and Ganor have observed that the IRS is becoming wise to the practice of low-balling employee grants and is raising penalties for undervaluation.⁸⁷ Third, the low-balling practice may further wither due to the rise of secondary markets for private start-up stock. As secondary sales of a start-up’s common stock increase, they offer better data for valuing new grants than do preferred stock rounds. Electronic marketplaces for secondary transactions such as SharesPost and SecondMarket serve to increase transparency on the prices paid in these secondary sales.⁸⁸ SharesPost, for example,

82. Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 821 (1995) (“[S]tart-ups rely primarily on stock options as a form of employee compensation . . .”).

83. Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 106 HARV. L. REV. 874, 894 (2003).

84. To avoid a large tax bill later, employees make a so-called 83(b) election under the Internal Revenue Code and pay some tax at ordinary income rates when the grant of a non-vested option is made. *Id.* at 894. When the stock is sold or stock option is exercised, additional tax will be due on the appreciation since the time of the initial grant, but at lower capital gains rather than higher ordinary income rates. *Id.* at 890-91.

85. *Id.* at 892.

86. *Id.* at 892.

87. See Fried & Ganor, *supra* note 2, at 1017-18.

88. See Ibrahim, *supra* note 12, at 22.

allows for efficient price discovery by posting detailed information about a start-up's private stock trading on its website.⁸⁹

In sum, angels who fund more common-stock rounds at higher valuations have the potential to reduce the tax subsidy for start-up employees, which would be a disadvantage to an angel-only start-up. Several factors mitigate this concern in practice, however, including the fact that undervaluation of employee grants is likely to become a more difficult practice to justify even with VC involvement going forward.

B. Warning #2: No (or Less) Opportunity for Venture Debt

The second warning for start-ups that consider going the angel-only route is that another (heretofore unexplored) source of start-up funding – venture *debt*, or loans to start-ups – might no longer be available without venture capital.⁹⁰ Before discussing why this is so, it is necessary to briefly explain why we *ever* see venture debt, even in start-ups that do attract venture capital.

Debt, though vilified after the financial crisis, is an important source of financing for companies. The conventional wisdom, however, is that start-ups will not be able to attract risk-averse lenders.⁹¹ The typical lender prefers borrowers with steady revenue streams and hard collateral, in addition to personal guarantees from the owners. This combination of payment mechanisms reduces the possibility of default. Start-ups, especially in their early stages, appear to be poor borrower candidates in light of these lender preferences.⁹² They often spend far more money than they make,⁹³ “and accounting conventions can make it difficult for start-ups to capitalize these expenditures to strengthen their balance sheets. . . .”⁹⁴ Further, their collateral is typically intellectual property, which is more problematic (for collection purposes, at least).⁹⁵ Personal guarantees are also less likely in technology-based start-ups than in ordinary small businesses because new technologies often do not prove successful.⁹⁶

89. *See id.* at 22.

90. For a fuller account of the venture debt industry, including literature citations, see Ibrahim, *supra* note 72, at 1174-76.

91. *Id.* at 1170.

92. *Id.* at 1175.

93. *Id.* at 1202.

94. *See, e.g.,* Ronald J. Mann, *Secured Credit and Software Financing*, 85 CORNELL L. REV. 134, 155 (1999) (“[Current accounting conventions] make it quite hard to capitalize expenditures on developing software. . . . The result is that a company with a substantial investment in developing a valuable asset still might show almost no assets on its balance sheet.”).

95. *Id.* at 139-53 (discussing practical and legal obstacles to taking software as collateral).

96. *See* Ronald J. Mann, *The Role of Secured Credit in Small-Business Lending*, 86 GEO. L.J. 1, 23 (1997) (arguing that lenders demand personal guarantees from “lifestyle” business owners).

Despite this conventional wisdom, venture debt is a \$1-5 billion dollar per year industry, with a dedicated group of banks and non-banks specializing in start-up lending.⁹⁷ How are risky start-ups able to attract this much funding? The answer is venture capital.⁹⁸ Venture lenders are confident in repayment of their funds due to the deep VC pockets now backing the start-up.⁹⁹ A start-up still remains unattractive from a traditional lending perspective, but venture lenders understand that VC money substitutes for these traditional criteria.¹⁰⁰ That is, venture debt “fund[s] to subsequent rounds of equity” instead of relying on start-up revenues or collateral, functioning similar to a bridge loan.¹⁰¹

Start-ups that stick with only angels have a problem when it comes to venture debt. As a typical rule, angels do not stage their financing as VCs do.¹⁰² If a start-up has only angel investors, then lenders will not see the same source of repayment that exists in VC-backed start-ups. Therefore, it follows that angel-only start-ups have foreclosed not only the venture capital option, but *also* the venture debt option.

This is a real concern, but as with the tax-subsidy concern, is less severe than it initially appears for a few reasons. First, the only start-ups that would consider going the angel-only route are those that can get by with less capital—i.e., those start-ups in “capital-efficient” fields such as software and digital media. These start-ups should not need additional funding sources such as venture debt to grow. Second, as angel investors take on more of the funding load, they may well begin to follow on their investments more than they do now. While traditional angels appear to follow on their own investments out of desperation, rather than desire (e.g., if the start-up cannot attract other funding),¹⁰³ angel group members may now fund multiple rounds out of *choice*. If more angels begin to follow on their own investments, venture debt could simply be repaid from multiple angel rounds rather than VC rounds. Further, since the specialized banks that make smaller venture loans lend not primarily for the interest rates, but to obtain the start-up’s deposit accounts,¹⁰⁴ their motivation for lending would not change if the start-up were angel-only. Finally, the Dodd-Frank Act places new registration burdens on firms that

97. See Ibrahim, *supra* note 72, at 1177-78.

98. *Id.* at 1173.

99. *Id.* at 1184-85.

100. *Id.* at 1184-89.

101. *Id.* at 1173.

102. Ibrahim, *supra* note 2, at 1422.

103. See Robert Wiltbank & Warren Boeker, *Returns to Angel Investors in Groups 8* (Working Paper Series, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1028592 (angels who follow on their own investments usually receive lower returns than angels who do not); See, e.g., *Gentile v. Rossette*, 2010 Del. Ch. LEXIS 123, at *1 (angel investor provided “continual, substantial financial support” to software start-up, without which “the firm would have ceased to exist on any number of occasions.”).

104. See Ibrahim, *supra* note 72, at 1182-83.

do not invest solely in a start-up's equity securities.¹⁰⁵ Venture debt funds invest in debt securities, albeit with warrants (which might be enough to exempt them, as warrants are a form of equity). Therefore, apart from venture debt-specific industry concerns independent of this Article, angel-only start-ups are less likely to need venture debt, and the ones that do might still be able to attract it.

VI. CONCLUSION

This Article began by observing that not all start-ups need venture capital to reach a profitable exit, as they might have in the past. It then went on to detail three main reasons why start-ups that could get by on angel funding alone should consider going that route. Finally, it sounded two cautionary notes about the potential costs of angel-only financing.

Overall, the benefits from angel-only financing for start-ups with lesser capital needs would seem to outweigh the potential costs. However, management of each start-up will have to weigh these costs and benefits itself when it comes time for its next financing round. The main point of this Article is to challenge the conventional wisdom that start-ups with the opportunity for VC funding should unflinchingly accept it. Start-up investors and society as a whole may benefit from less VC investment and more angel-only investment.

105. See Eric Alden, *Primum Non Nocere: The Impact of Dodd-Frank on Silicon Valley*, 8 BERKELEY BUS. L. J. 107, 121 (2011).

