WHAT'S WRONG WITH A WASHOUT?:
FIDUCIARY DUTIES OF THE VENTURE
CAPITALIST INVESTOR IN A WASHOUT
FINANCING

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I. INTRODUCTION

The boom of Internet companies in the past few years has put venture capital in the spotlight. Success stories were being built near daily with the ubiquitous start-up companies that go public, reaping the huge financial rewards of an IPO. The investment returns of venture capitalists are the envy of average investors. Moreover, the unprecedented length of economic growth has advanced the notion of the “new economy” or “third industrial revolution.” At Harvard Business School, first-year students are now required to take a class entitled The Entrepreneurial Manager, instead of General Management, which had been required for decades. Behind all this excitement stand the venture capitalists, the risk-takers who have backed the companies driving the new economy. Despite the general euphoria over the venture-backed companies, there is a dark side to venture capital financing—washout financing.

Washout is a slang term, and there are many. Although there is no consensus on the term, the outcome is relatively the same. A venture-backed company that is in extreme distress

1. See, e.g., Daniel Primack & Jennifer Strauss, First–Half Disbursements Continue Venture Capital’s Record Setting Pace, VENTURE CAPITAL J., Oct. 1, 2000, 2000 WL 8741374 (noting that VCs “invested a record-breaking $43.39 billion in 3,322 companies during the first half of 2000” and stating that “[t]he public markets may tremble, and the e-commerce boom may fail, but it seems that nothing short of an all-out fiscal depression is going to prevent venture capitalists from continuing to plug record amounts of private funding into innovative new companies”).

2. See, e.g., Oxygen Leads Internet Collapse, FIN. NEWS, Feb. 5, 2001, 2001 WL 12505299 (reporting that Oxygen Holdings “set a new record after its soared a staggering 2,775% on its first day”); New-Issue Fallout, FORBES, Mar. 5, 2001, available at 2001 WL 2184043 (“The 1990s turned average buy-and-hold investors into IPO gamblers, seduced by the triple-digit gains many new issues posted on their first day of trading. Unfortunately, one-fifth of shares that began public trading in the 1990s have declined more than 90% from their offering prices.”).

3. See Mark Walsh, Venture Capital Investors Crowd Internet Gateway: Traditional Firms Shift Focus to Web; Unusual Players Jump into Game, CRAIN’S N.Y. BUS., Jan. 17, 2000, available at 2000 WL 9439788 (reporting the huge pay-offs for VCs, like the $608 million one VC earned during the first nine months of 1999).


6. In the course of research, the many different terms used to describe the same basic form of financing included “restart,” “restructuring,” “burnout,” “cramdown,” “down round,” “downside” and “dilutive.” See generally Joseph W. Bartlett & Kevin R. Garlitz, Fiduciary Duties In Burnout/Cramdown Financings, 20 J. CORP. L. 593 (1995). For the purposes of this paper, I will use the term “washout.”
receives much-needed investment money from the venture capital investor. In the process, the founders are usually fired (if they are still in management), and their equity stake is diluted, or “washed out.” Usually, the washed out founders accept the dilution as a part of the necessary financing. However, in 1997, three Silicon Valley venture capitalists agreed to pay $15 million to settle a lawsuit by two entrepreneurs that they had washed out.

This settlement highlighted an increasingly important area of contention in an increasingly important industry; the dynamics of the parties' relationships. Both the venture capitalists and the founding entrepreneurs were shareholders in the venture-backed companies, and both parties usually also serve as board of directors of the company. As venture-backed companies raise successive rounds of financing, it is often the case that the venture capital investors will be the controlling shareholders, enabling them to engineer a washout financing. From this setting, the quarrel begins.

This article analyzes the issues of a washout financing and asserts that the majority of case law and academic opinion is on the side of the venture capitalist. Part I provides background on venture capital and the mechanics of a washout financing, as well as giving details about the Alantec, Inc. dispute. Part II discusses the motivations, interests and worries of the venture capitalist and the entrepreneur when faced with a washout financing situation. Part III examines the fiduciary duty issues that a venture capitalist may face from a suit arising out of a washout financing. Part IV analyzes the leading cases for fiduciary duty in an entrepreneurial firm context. Part V presents and discusses academic theories, which serve to justify judicial non-interference of washout financings.

II. VENTURE CAPITAL FINANCING

A. Background on Venture Capital Financing

Venture capital, as we know it, does not have a long history. The first venture capital company was not formed until 1946. 

The industry remained rather immature until the late 1970s and 1980s when changes in regulation and the evolution of the limited partnership spurred the flow of capital to the venture capital market. After a recessionary slowdown in venture capital investment in the early 1990s, the venture capital market has exploded in the past decade.

Venture capital financing, or private equity, is another choice of financing for companies, which do not or cannot obtain funds from bank loans, private placement, or public equity market. A company may seek venture capital funding to establish and grow a high-risk business venture which otherwise has little financing alternatives. The venture capital market may be the only viable source of financing for these types of firms because they usually have no collateral and no prospect of operating at a profit any time in the near future. Venture capitalists do not invest their own personal funds. They invest the funds from limited partnerships under their control. As the general partner of these limited partnerships, the venture capitalist receives a fee and a portion of the profits from the investments. Venture capitalists generally are willing to take the time and effort to understand these risks and exert influence on company decisions by taking an “equity stake in the firms they finance, sharing in both the upside and downside risks.” In short, venture capitalists make long shot bets on companies that show a promise of future payoff.

Venture Capital Industry] (summarizing the history of venture capital).

10. See George W. Fenn et al., Board of Governors of the Federal Reserve System, The Economics of the Private Equity Market, 168 Staff Studies Series, 9–11 (1995). Some of the factors that slowed the development of the venture capital investments during the 1970s were a recession and a weak stock market. See id. at 9. In addition “[p]ension fund managers had long regarded venture capital investments as a potential violation of their fiduciary responsibilities.” Id. at 11.


12. It should be noted that, within the venture capital industry, private equity connotes financing to later stage companies (i.e., companies which are closer to either being acquired or going public). See Robert D. Stillman, Alternate Exit Strategies for International Private Equity, 13 AM. U. INT’L L. REV. 133, 136-37 (1997).

13. See Fenn et al., supra note 10, at 17.

14. See id.

15. See id.

16. See id. at 1–4.

17. See id. at 4.

18. See id.

“The initial financing is designed to provide only sufficient funds for the venture to reach certain design or manufacturing milestones.” Once those milestones are reached, the venture-backed company typically applies for additional financing from its current investors, and if necessary, new investors. “The stock structure is then adjusted to reflect the ratio of new funds to company value, and the bargaining power of the various parties involved.” If all goes well, the private financing is eventually replaced with a public stock offering, or acquisition by another company.

In this manner, venture capital fills an important niche in corporate finance. The impact of venture capital on the economy can be seen by the companies, which began with the aid of venture capital money. These firms include Federal Express, Apple Computer, Intel, Microsoft, Starbucks and Au Bon Pain, just to name a few.

B. Financing Mechanisms

Venture capitalized companies do not always end as success stories. Venture capital remains a very risky investment arena. To manage the risks, nearly all venture capital financing utilizes the following mechanisms to exercise control: 1) the use of convertible securities; 2) syndication of investment at each stage; and 3) the staging of capital investments. When an entrepreneur and venture capitalist negotiate a deal, they will sign an extensive financing agreement that contains many covenants and restrictions, as well as the terms of the financing. The venture capitalist does not only provide money, but under the various agreements will have the right to play an active role. Representatives of the venture capital firm will visit their

21. See id.
22. Id.
23. See id.
24. See Gompers, Venture Capital Industry, supra note 9, at 18 Table 2.
25. See id. at 10 (stating that 6.8% of all venture-backed projects accounted for almost 50% of the return to venture capital funds, and, of all projects, 34.5% experienced either a partial or total loss of invested capital).
27. See, e.g., id. (illustrating the many different types of covenants and restrictions that can accompany a financing agreement with a venture capitalist).
portfolio companies periodically, review monthly reports, provide advice, help in recruiting key management, and analyzing new market opportunities, as well as providing access to a wide array of professionals, from accountants to lawyers.  

Control of the company is an important factor. With the classic corporation, the board of directors is in charge of representing the shareholders’ interests in managing the corporation so the shareholders with more than 50% of the company’s voting stock will have effective control of the corporation. In venture capital, things are a bit different. The founders will usually have most, if not all, the common stock. In exchange for cash, venture capitalists, on the other hand, will take equity in the form of preferred stock, with rights to convert to common stock. It is the conversion price which often becomes the benchmark for the company’s valuation. In addition, venture capitalists will contract for special rights to be attached to the preferred stock. These special rights usually include one or more seats on the company’s board of directors. The number of seats depends on the bargaining power of the parties. As is often the case for companies that engage in several rounds of preferred stock financing, each new round requires the addition of one or more new directors designated by investors, which provides the founders with little option but to give the venture capitalist investors a majority of the board directorships, thereby giving the investors effective control over the enterprise.

29. See Gompers, Venture Capital Industry, supra note 9, at 11.
34. See Smith, supra note 32, at 124:

With enough board votes, the investor can simply veto stock sales to new investors. Short of a veto, an investor that is entitled to choose a portion of the board can refuse to reduce its representation. The new investors must then either forgo representation on the board or take board
The mechanics of a washout depend upon this board control. The financing requires the company to issue additional shares, as well as become subject to other covenants and agreements. This will involve board approval, and sometimes, a shareholder vote. As was the case in Alantec, the board can terminate the employment of the officers and issue more shares of stock to others. These abilities are common to all directors. For this reason, a washout need not be explicit within any agreement. As long as they possess board of director control, the investors of the company can garner the required approvals for a washout financing.

C. Staging of Investment

For the purposes of this article, it is the staging of investment which has great significance. Generally, venture-backed companies raise money in stages, or rounds. To receive another round of financing, the company must meet certain goals, or milestones. For example, after the first infusion of cash, the venture capitalist may require the building of a prototype within six months before the next infusion. If everything goes well, the final goal for both the venture capital investor and the founding entrepreneur is to have the company either go public or become acquired. Both exit strategies can lead to large financial gain. However, if the entrepreneur fails to achieve the desired progress, then the venture capitalist may seek to exert greater influence or control over operations, often as a condition to further financing. Most significantly, this staging allows the investor to periodically monitor and re-evaluate its investment. When a company becomes one of the 34.5% of companies which is considered an investment loss to the

positions from the managers.

35. See id. at 119–21.
36. See id.
37. See id. at 133 (discussing the venture capitalists’ right to fire or demote managers); infra Part V.C. (discussing the Alantec case in which the venture capitalists fired the founders and diluted their interests).
38. See id. at 122 (discussing staged financing).
39. See Medearis, supra note 32, at 70.
40. See Oesterle, supra note 33, at 895.
41. See, e.g., John A. Byrne, How a VC Does It, BUS. WEEK, July 24, 2000, at 96, 98 (noting that when Vignette Corporation went public, the venture capitalist firm made a return of $628.3 million on an investment of $3.2 million).
42. See Gompers, Venture Capital Industry, supra note 9, at 2, 3, 11.
investors, the washout decision comes into play. Once a company is in financial distress, the venture capitalist must decide to write off its investment or to try to "save" the company. However, the washout decision is not explicitly addressed in the initial financing agreements. If the venture investors decide to save the company, they use their board control to effectuate a washout. "Saving the company" means implementing dilutive financing. Broadly speaking, every financing is technically dilutive because sales of additional shares reduce the percentage ownership of the existing shareholder base. However, for the purposes of a washout financing, dilution happens because the investors assign a lower valuation to the business, which makes all existing shares worth less. That is, the new financing will sell the additional shares at a valuation for the company, which is lower than in the previous round, reflecting the downturn in the firm's performance. In short, more equity is bought for less money. This is the core concept of the washout. As noted before, many companies end up losing the investment capital of the venture investors, and many companies financed in a down round will still end up failing. So, the washout is still a gamble on a gamble.

D. Alantec as Washout Example

The Alantec Inc. dispute provides a good example for illustrating the mechanics of a washout financing. Still, one must remember that it is a rare case. It is a washout financing that ended with a highly lucrative acquisition exit.

Alantec began in 1987 as Kalvij Telecom with an initial investment of $30,000 each from both its founders, Michael

44. See id. at 10, 11.
45. See Bartlett & Garlitz, supra note 6, at 594.
46. See Fredric D. Tannenbaum, Major Battlegrounds in Venture Capital Transactions (Part 2), 45 PRAC. LAW. 79, 81 (1999). Venture capitalists usually require 'anti-dilution' provisions in the initial financing agreement. See id. at 82. These provisions either give, or allow the purchase of, enough shares to keep their ownership percentage constant. See id.
47. See id. at 82–83.
48. See Bartlett & Garlitz, supra note 6, at 616. "For example, assume a business is valued by its stockholders' equity and that account is $1 million with A and B owning 50 percent each. If C buys 25 percent of the common equity for $250,000, that purchase is dilutive since $250,000 should have purchased only 20 percent of the business." Tannenbaum, supra note 46, at 81–82.
49. See Gove, supra note 7 ("The majority of washouts do not succeed: they are simply a means for investors to prop up a company so that either the company or its assets can be sold.").
Kalashian and Jagdish Vij. In 1988, they received their first round of venture capital money of $1.5 million. The company enjoyed early success through development of a multiLAN switch. By the fall of 1990, venture capitalists had invested $16.5 million in Alantec, which provided them with a 90% ownership interest, as well as a majority of the directors on the board. The venture capital investors were dissatisfied with Alantec’s management so Vij and Kalashian were ousted from the company by the end of 1990. At this point, the company was on “the edge of bankruptcy.”

The venture capitalists brought in John Wakerly to develop a new product, the power hub, and decided to invest another $500,000 to support the development of this product.

This next round of financing in February of 1992 became the washout financing. At the time, the founders still owned all of the common stock, representing a combined 8% ownership interest in Alantec. The board decided to approve this new round of financing. They did not want to inform the founders of this new round so they acted surreptitiously. To get around the majority vote of common stock needed to approve the financing, the board had to amend articles of incorporation and issued out common stock to Wakerly and two other employees loyal to the investors. The price of the issued stock was set at $0.005 per share. In June of 1991, another round of financing was done in much the same way. By the end of these two rounds, the founders’ ownership of the company went from 8% to 0.007%.

The new product spearheaded by John Wakerly proved a success and allowed Alantec to go public in 1994. In 1996, the company was purchased by Fore Systems at $70 a share, or for $770 million. At that price, the founders’ share was valued at about $600,000 while their pre-washed out 8% interest would have been worth over $40 million.

50. See Herhold, supra note 8, at C1.
52. See Herhold, supra note 8, at C1.
53. See id.
54. Id. (internal quotation omitted).
55. See Alantec Promotes John Wakerly to Executive Vice President and Chief Technical Officer and David Newman to Vice President of Engineering, BUS. WIRE, Jan. 18, 1994, LEXIS, News Library, Wire Servs. Stories File; see also, King, supra note 51, at B9.
56. See King, supra note 51, at B9; Herhold, supra note 8, at C1.
57. See Gove, supra note 7; see also, Matt Murray, Technology & Health, Fore Systems to Buy Alantec for Stock in Bid to Speed Switch to its Technology, WALL ST. J.,
Kalashian and Vij decided to sue the venture funds for the $40 million they allegedly lost because of the washout financings. Kalashian and Vij alleged that the investors breached their fiduciary duties as board members. After eighteen days of trial testimony, the venture capitalists settled the suit for $15 million.  

III. MOTIVATIONS IN A WASHOUT

Start-up companies are often based on technological innovation and, as a result, lack meaningful tangible assets and net revenues. Their value lies in their potential. It is the ability to unlock this potential which attracts venture capital investment. Founding entrepreneurs come into a firm with certain motivations and expectations. Venture capital investors have their own motivations.

The parties to the Alantec washout financing did not begin as adversaries. Like all venture-backed projects, the parties came together for mutual benefit. Entrepreneurs need capital in order to implement their business plan while venture capitalists seek out entrepreneurs to add value to their enterprises and obtain higher returns.

Many of the terms of a venture capital financing agreement are designed to align the interests of investor and founders. The venture capitalist does this to reduce agency costs and increase efficiency. But, when the company begins to go sour,
the motivations and interests of the investors and founders begin to diverge.

For a venture capitalist, the threat of a company’s failure presents a financial loss. The investor worries that continued investment will simply be throwing good money after bad. A rescue attempt is very risky in an already high-risk investment. Notwithstanding the negative risk, further investment may be the only way to limit the loss. Another round of cash could enable the company to continue its operations long enough to sell off its assets; or the cash may not do any good. To deal with these worries, the washout financing occurs. The venture capitalist requires a much higher equity share to compensate for further risk-taking, and may opt to terminate the founders’ people and bring in new management in order to ensure success or recovery.

The founders, on the other hand, may have worries outside of the purely material. As founders, the company may be seen as their “baby” and would not want to see the company go bankrupt. Moreover, the founders may have already put in significant “sweat equity.” This “sweat equity” is simply the hard work put in to make the project work. Founders may also worry about their continued employment at the company. To ensure the company’s survival, founders will often accept the harsh terms of the dilutive washout financing. To keep their presence, the founder may have little recourse or protection. On this point, they are largely at the mercy of the board of directors, composed of a majority of directors designated by the investors.

These are the general motivations of the parties in a washout. There is usually quite a disparity in bargaining power because the company needs money, and the venture capitalist has it. Moreover, venture capitalists will not invest in a company capitalist is active) meets with the venture capitalist’s expectations. Fourth, the use of convertible securities allows a venture capitalist to salvage some value from failing ventures and usually specifies that the venture capitalist may sell its shares at the same time and on the same terms as the entrepreneurs. Each of these aspects of the venture capital relationship mitigates agency costs to the venture capitalists.

Smith, supra note 32, at 148.

63. See, e.g., supra Part V.C. (describing one such situation in the case of Alantec Inc.).

64. See, e.g., Herhold, supra note 8, at C1 (describing how Alantec founders were ousted and replaced).

65. See id.

66. Bartlett & Garlitz, supra note 6, at 594 (explaining the impact of dilution financing on founders/minority shareholders).

67. See supra notes 32–33 and accompanying text (describing some of the benefits and powers demanded by investors, one of which is a board position).
where existing investors do not participate. Supra note 8. So, founders are caught in a position of great weakness. In the rare situation where a washout rescues a floundering company, the founders may, as in the Alantec dispute, challenge the dilution caused by a washout by suing the venture capitalist. Supra note 7.

IV. LEGAL ISSUES: THEORIES OF LIABILITY

The Alantec settlement unsettled many venture capitalists, as it was the first reported major settlement between venture capitalists and founders. Supra note 7. Though there was no court ruling, the case did raise fears that other founders will also sue the venture capital investors who replaced and diluted them. Supra note 7. The suit by the Alantec founders did show a contour of some of the legal theories under which a venture capital investor may be sued.

Suits against a venture capital investor for a washout would most likely rest upon two possible causes of action based on fiduciary duty. First, there is a breach of fiduciary duty as a board director. Supra note 51. This is the cause of action brought by the Alantec founders. Supra note 51. Second, as a close corporation, a venture-backed company may also make investors liable for breach of fiduciary duty owed as controlling shareholders. Supra note 51. Both of these causes of action are based on the theme of oppression of minority shareholders.

Because the case law in this context has been very fact-driven, it is difficult to predict how a court will analyze an investor’s actions. However, several theories and tests have been developed to deal with the problem of oppression within a close corporation. Supra note 51. Massachusetts and Delaware have produced the

68. The connotation is that current investors will have information already, and must know something that they do not about the company if they will not invest.

69. See Herhold, supra note 8, at C1.

70. See generally Gove, supra note 7 (describing how the settlement may affect future investments).

71. See id.

72. See King, supra note 51, at B9.

73. See id.

74. See, e.g., Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 515 (Mass. 1975) (equating the close corporation to partnerships as related to stockholders’ fiduciary duty to each other).

75. See id. at 513 (discussing the vulnerability of minority shareholders in a close corporation and the manner in which the majority shareholder can oppress the minority); see generally Douglas K. Moll, Shareholder Oppression in Texas Close Corporations: Majority Rule Isn’t What it Used to Be, 1 Hou. BUS. AND TAX L.J. 15–18 (2001) [hereinafter Texas Close Corporations] (discussing “two significant avenues of relief for the ‘oppressed’ close corporation shareholder” developed by state legislatures and courts).

76. See Franklin A. Gevurtz, Squeeze-Outs and Freeze-Outs in Limited Liability Companies, 73 WASH. U. L. Q., 497, 500–01 (1995) (comparing the views expressed by different jurisdictions regarding shareholder oppression, and the use of the reasonable
most influential case law regarding minority shareholder oppression. 77

A. Shareholder Fiduciary Duty: “Incorporated Partnership” Theory

In Massachusetts, where a majority shareholder owes a fiduciary duty to the minority, the courts have developed a balancing approach to minority oppression. 78 The duty between fellow shareholders was based on the “incorporated partnership” theory, 79 which states that the participants in a close corporation choose the corporate form, instead of a partnership, in order to take advantage of limited liability. 80 In other words, shareholders of a close corporation have many characteristics of a partnership 81 and, thus, should owe each other the same duty of utmost good faith and loyalty. 82

The controlling shareholders’ fiduciary duty to the minority is balanced by the majority’s right of self-interest. 83 In light of these concerns, the Massachusetts Supreme Judicial Court

expectation test).


78. See Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 663 (Mass. 1976) (reaffirming the duty owed to minority shareholders recognized in Donahue, but circumscribing it by incorporating a “legitimate business purpose” test).

79. See Donahue, 328 N.E.2d at 512 (comparing shareholders in a close corporation to that of partners); see also J.A.C. Hetherington & Michael P. Dooley, Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem, 63 VA. L. REV. 1, 2 (1977) (“The close corporation is the functional equivalent of the partnership.”).


81. See Bartlett & Garlitz, supra note 6, at 610 (“The court emphasized the illiquidity of the shareholders’ investment and the vulnerability of the minority shareholders to abuse . . . .”) (citing Donahue, 328 N.E.2d at 514–15).

82. The court in Donahue stated that:

Because of the fundamental resemblance of the close corporation to the partnership, the trust and confidence which are essential to this scale and manner of enterprise, and the inherent danger to minority interests in the close corporation, we hold that stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another. In our previous decisions, we have defined the standard of duty owed by partners to one another as the “utmost good faith and loyalty.” Donahue, 328 N.E.2d at 515 (citation omitted).

83. See Bartlett & Garlitz, supra note 6, at 611 (discussing Wilkes and its refinement of the Donahue ruling).
analyzes the actions of the majority with an eye towards two main factors: 1) a legitimate business purpose, and 2) a less harmful alternative course of action. Thus, in a dispute between shareholders, a court “must weigh the legitimate business purpose, if any, against the practicability of a less harmful alternative.”

In determining a legitimate business purpose, the Wilkes court said that the strict good faith standard enunciated in Donahue would hamper a controlling shareholder’s “effectiveness in managing the corporation in the best interests of all concerned.” The court also gave examples of actions that can be classified as legitimate business purposes. These examples include “declaring or withholding dividends, deciding whether to merge or consolidate, establishing the salaries of corporate officers, dismissing directors with or without cause, and hiring and firing corporate employees.”

This balancing approach is inherently fact-specific. The circumstances of individual cases will determine legitimacy, as well as the availability of alternatives. As further guidance, Massachusetts courts have furnished other factors to consider in a breach of fiduciary duty. For one, the minority may have certain expectations of the benefits of ownership in the corporation, which should be protected. Also, controlling shareholders have a fiduciary duty of disclosure to the minority.

Other jurisdictions have followed the Massachusetts example and have established a fiduciary duty among shareholders in a close corporation. Many of these jurisdictions

84. See Wilkes, 353 N.E.2d at 663.
85. Id.
86. Id.
87. Id.
89. See Bodio v. Ellis, 513 N.E.2d 684, 689 (Mass. 1987) (stating that defendant’s breach of plaintiff’s “rightful expectation that he would have equal control with . . . the defendant . . . constituted a violation of the loyalty and fiduciary duty owed between the shareholders”); see also Horton, 1997 WL 778662, at *24.
90. See Wilson v. Jennings, 184 N.E.2d 642, 646–47 (Mass. 1962) (affirming the conclusion that nondisclosure of an employment contract “could be found to be a breach of fiduciary duty of disclosure”).
91. See, e.g., W & W Equip. Co. v. Mink, 568 N.E.2d 564, 570 (Ind. Ct. App. 1991) (“Shareholders in a close corporation stand in a fiduciary relationship to each other, and as such, must deal fairly, honestly, and openly with the corporation and with their fellow shareholders.”); Guy v. Duff & Phelps, Inc., 672 F. Supp. 1086, 1090 (N.D. Ill. 1987) (“At the outset, the majority shareholder of a closely-held corporation clearly has a fiduciary responsibility to the other shareholders.”) (citation omitted); Evans v. Blesi, 345 N.W.2d 775, 779 (Minn. Ct. App. 1984) (“In an analogous case, . . . the Minnesota Supreme Court held that a shareholder in a closely held corporation has a fiduciary duty to deal openly,
have also focused more on shareholder oppression and the reasonable expectations of a minority shareholder. In Texas, “oppressive conduct” will be found if there is a contravention of expectations that were “both reasonable under the circumstances and central to the minority shareholder’s decision to join the venture.” Likewise, the North Carolina Supreme Court has also adopted the reasonable expectations test.

For a founder who has been “washed out” in an Alantec scenario, a cause of action would have to claim that the venture capital investor breached its fiduciary duty as a majority shareholder. In Alantec, the lack of disclosure of the dilution to the founders and termination of employment was the foundation of the breach of the duty of loyalty. An investor defendant would need to prove that the dilution and firing served a legitimate business purpose and that there were no less harmful alternatives available.

B. Director Fiduciary Duty: “Entire Fairness”

The duty of loyalty towards fellow shareholders does not exist in Delaware where, instead, a cause of action for a washout would have to be based on the fiduciary duty that board
directors owe towards all shareholders. 97 Under Delaware law, a director breach of fiduciary duty is a two-part inquiry. First, the plaintiff must rebut the business judgment presumption that the board was acting in the best interests of the corporation. 98 The business judgment rule is “a doctrine that embodies a broad judicial deference to the corporation’s board of directors in determining business policy and conducting corporate affairs.” 99 Second, upon such a showing by the plaintiff, the burden is shifted upon the board to prove the “entire fairness” of the challenged actions. 100

To rebut the business judgment rule, the plaintiff will have to make a showing that the board breached one of the triad of fiduciary duties: good faith, duty of loyalty or due care. 101 For example, a conflict of interest where the defendant lies on both sides of the transaction or received distinct personal benefits from the transaction may rebut the business judgment presumption if the defendant fails to disclose the conflict prior to the transaction. 102 Once rebutted, a court will then turn to “entire fairness.” 103

The analysis of the “entire fairness” test consists of two

97. See, e.g., Orban v. Field, No. 12820, 1997 Del. Ch. LEXIS 48, at *26 (Del. Ch. Apr. 1, 1997) (stating that the common stockholder action was based on the Board’s alleged breach of its fiduciary duty of loyalty to the common stockholders in diluting their ownership below 10%).

98. See Cede & Co. v. Technicolor, Inc., 334 A.2d 345, 361 (Del. 1993) (citation omitted):

The [business judgment rule] posits a powerful presumption in favor of actions taken by the directors in that a decision made by a loyal and informed board will not be overturned by the courts unless it cannot be “attributed to any rational business purpose” . . . Thus, a shareholder plaintiff challenging a board decision has the burden at the outset to rebut the [business judgment rule’s] presumption.

See also Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (noting that in order to protect and promote the full and free exercise of the managerial power granted to Delaware directors, the business judgment rule presumes that in making a business decision, the directors of a corporation acted on an “informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company”). For the purposes of summary judgment, however, “[t]he burden is upon defendants, the party moving for summary judgment, to show that their conduct was taken in good faith pursuit of valid ends and was reasonable in the circumstances.” Orban, 1997 Del. Ch. LEXIS 48, at *29.


100. See Cede & Co., 334 A.2d at 361 (citation omitted); see also infra Part IV.B. (describing the entire fairness standard).

101. See id.

102. See, e.g., id. at 361; Van Gorkom, 488 A.2d at 864 (holding that the Board breached its fiduciary duty in part because of the failure to disclose all material facts).

103. See Cede & Co., 634 A.2d at 361.
aspects: fair dealing and fair price. Fair dealing involves “questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and stockholders were obtained.” Fair price involves “economic and financial considerations of the proposed merger [action], including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company’s stock.” Though there are two aspects to an “entire fairness” analysis, a Delaware court will examine the issue “as a whole since the question is one of entire fairness.”

In the Alantec washout situation, a plaintiff could possibly rebut the business judgment presumption under the theory that a venture capitalist has a conflict as both a shareholder and board director. The difficulty would lie in showing that the washout does not pass the “entire fairness” test. Such a showing would depend on the particulars of the context in which the financing occurred. Again, the facts would drive the analysis.

V. WORRY IS UNNECESSARY: CASE LAW SUPPORTS VENTURE CAPITALISTS

Much has been made about the implications of the lawsuit of Kalashian and Vij against their venture capital investors. The National Law Journal called it a “wake-up call throughout the venture-capital community.” In Red Herring, the leading magazine on technology, business and investment, an article quoted a venture capital principal as saying “[the Alantec settlement] signals open season on VCs.” In this context, articles explaining how venture capitalists can avoid claims of minority shareholders arising from the use of dilutive financing become especially pertinent.

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105. Id.
106. Id.
107. Id.
108. See Bartlett & Garlitz, supra note 6, at 624 (noting that the washout transaction “by definition, is an inside trade”).
109. See Mendel v. Carroll, 651 A.2d 297, 305 (Del. Ch. 1994) (noting that the duty that corporate directors bear in any particular situation requires consideration of the circumstances that give rise to the occasion for judgment).
110. See Gove, supra note 7 (stating that “[the Alantec settlement] has made venture capitalists think twice about investing in turnarounds”).
111. King, supra note 51, at B9.
112. Gove, supra note 7.
113. See, e.g., Richard J. Testa, Cautionary Tales: Timing Considerations and Other Concerns in Financing Leading Up to Initial Public Offerings, in 32ND ANNUAL INSTITUTE
settlement, one journal author predicted that “one celebrated victory for a minor plaintiff in a high-visibility court . . . could energize founders around the country who regard venture capitalists generally as vulture capitalists.”  

However, these immediate worries have proven mistaken. Suits against venture capitalists are not likely to become commonplace. In fact, those in the venture capitalist industry cite to no other major settlement since the Alantec settlement in 1997. In a suit over a washout financing, case law has always favored the venture capital investor. As the Red Herring article posits, most of these types of cases do not even survive a motion for summary judgment. Regardless of jurisdiction, the standards needed to win a cause of action based on breach of fiduciary duty have been interpreted to favor the controlling group. After reviewing the case law of claims arising from dilutive financing by venture capitalists, one can see that Alantec was more a fluke than a “wake-up call.”

A. Massachusetts Law

After reviewing the law in Massachusetts in the previous section, one might think that a washout investor would most certainly become liable under a breach of shareholder fiduciary duty claim. However, the actual case belies the apparent strictness of the legal standards. It would seem that the dilution of the founder’s stock and his firing from management would breach the fiduciary duties to which the controlling investor shareholder is held, especially when such dilution is done secretly. Such covert actions, which only benefit the controlling
shareholder, would seem to most assuredly fail the Donahue/Wilkes standard. Yet, that is not the case.

In *Horton v. Benjamin*, the court found for defendants in an undisclosed stock issuance which diluted plaintiffs’ stock. The plaintiffs and defendants had been shareholders in Vital Technologies, Inc. (“Vital”), a close corporation. Vital was organized to develop and market products involved in food production and processing, vaccinations, and plant technology. The plaintiffs claimed that defendants wrongfully diluted their equity in Vital. The defendants had issued stock to themselves without disclosure to the other stockholders.

The stock issuance to themselves was assumptively *prima facie* actionable, and thus, the defendants needed to demonstrate a legitimate business purpose for their action. The court found that the defendants did meet their burden by showing that the issuance of 22,225 shares of Vital to each defendant was fair compensation for services the defendants rendered to a joint venture the previous year on Vital’s behalf. The circumstances of the situation also played a large role in the court’s decision, and the following represent factual considerations that the court noted. Vital was cash-strapped and could compensate individuals for services only by issuing stock. Vital’s by-laws authorized directors to issue stock and did not require notice to shareholders of meetings of the board of directors. Defendants issued themselves the stock to compensate for past services and as an incentive to continue working on a new development. The value of 22,225 shares of Vital was far less than their normal rate of compensation for services. Finally, the amount of Vital stock issued to each defendant was reasonable. The totality of the circumstances established that the defendants did have a legitimate business objective in the undisclosed stock issuance. Moreover, plaintiffs could not show any less harmful alternatives.

The situation in *Horton* has similarities to the controversy in

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120. *Horton*, 1997 WL 778662 at *21, *27. However, the Court also held that the defendants did breach their fiduciary duty by approving a reorganization of the joint venture into a limited partnership because, although defendants demonstrated a legitimate business purpose for the reorganization, “the same legitimate objective could have been achieved through an alternative course of action less harmful to the minority's interest.” *Id.* at *28.

121. See *id.* at *27; see also Wilkes, 353 N.E.2d at 663 (holding that “when minority stockholders in a close corporation bring suit against the majority alleging a breach of the strict good faith duty owed to them by the majority[,] the court must ask ‘whether the controlling group can demonstrate a legitimate business purpose for its action”).

122. See *Id.* at *28.

123. See *Id.*
Alantec. In each case, the value of the plaintiffs’ stock holdings was diluted by an undisclosed stock issuance.\textsuperscript{124} In addition, both corporations were cash poor such that stock issuances were the only viable means of compensating valued management and research personnel.\textsuperscript{125} In this respect, the washout financing schemes served the legitimate business objective of “saving” the companies.\textsuperscript{126} Given the limited financial options available to start-up companies, business decisions to implement washout financing may in fact be one of the least harmful alternatives. In Alantec, the defendants, using washout techniques, first reduced the plaintiffs’ equity interest from eight percent to .007 percent, and then issued additional common stock to new management.\textsuperscript{127} “Such a strategy [of issuing additional stock to new management] is useful not only in giving [new] management an incentive to meet performance goals, but also to keep management tied to the [closely-held] company”—the ultimate objective being to “maximize shareholder value.”\textsuperscript{128} Investors require a greater equity share to compensate for taking greater risk; the alternative would be bankruptcy, which would make their investment worthless.\textsuperscript{129}

\section*{B. Delaware Law}

Similar to analyses under Massachusetts law, Delaware courts have taken a view which gives wide latitude to corporate policies implemented by the controlling group. In Delaware, the

\begin{footnotesize}
\begin{enumerate}
\item See Horton, 1997 WL 778662 at *22; supra Part V.C. (discussing the dilution of founders’ ownership interest in Alantec).
\item See Horton, 1997 WL 778662 at *14 (noting that additional stock was issued “to compensate [majority defendants] for services they provided . . . and to provide them with incentive to keep working to develop the new concept into a marketable product”); supra Part V.C. (discussing a comparable rationale for venture capitalists’ investment in Alantec).\textsuperscript{126}
\item See Horton, 1997 WL 778662, at *24 (noting that “[i]n assessing whether the majority has demonstrated a legitimate business purpose for its action, a court should consider ‘the fact that the controlling group in a close corporation must have some room to maneuver in establishing the business policy of the corporation’) (quotation omitted). The Horton court relies on the balancing test used in Wilkes which held that “courts must weigh the legitimate business purpose, if any, against the practicability of a less harmful alternative.” Id. at *23 (citing Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 663–64 (Mass. 1976)).
\item See King, supra note 51, at B9 (stating the plaintiffs’ claim that the defendants in Alantec issued themselves additional stock below the fair market value of the company in an effort to dilute the founders stock, and had “effectively given away common stock to new management”).\textsuperscript{127}
\item Smith, supra note 32, at 114–16 (explaining that the “control over executive compensation is often utilized to create compensation packages that include significant stock ownership and stock options to give managers an incentive to maximize shareholder value”).\textsuperscript{128}
\item See id. at 119.
\end{enumerate}
\end{footnotesize}
breach of fiduciary duty would be between the minority shareholder and the venture capitalist as a director of the corporation.\footnote{130}

In many washout situations, the venture capitalist will lie on both sides of the transaction, which could give a plaintiff a \textit{prima facie} case for an “entire fairness” analysis.\footnote{131} Because of the extreme dilution, a washout financing scheme, such as that employed in Alantec, would be viewed as a breach a director’s duty of loyalty to the founder. Nevertheless, Delaware courts have been reluctant to find a breach of fiduciary duty in the close corporation context.\footnote{132}

In \textit{Olsen v. Seifert},\footnote{133} a Massachusetts court applied Delaware law.\footnote{134} There, the court granted the defendants’ motion for summary judgment.\footnote{135} The plaintiff and defendants had been shareholders in a close corporation formed to develop and market multi-media communications technology. In order to secure venture capital, a new stock restriction agreement providing for

\begin{footnotes}
\item[130] See Ragazzo, \textit{supra} note 77, at 1128–33 (discussing Nixon v. Blackwell, 626 A.2d 1366, 1379 (Del. 1993), which held that there should not be any “special, judicially-created rules to protect minority stockholders of closely-held Delaware corporations” but noting that the Seventh Circuit has not formally recognized this broad decision in later precedents); Smith, \textit{supra} note 32, at 103–94 (explaining that “[a]lthough the relationship between management and shareholders in publicly held companies is often analogized to a contractual relationship, this feature of the venture capital relationship differs dramatically from the relationship of a shareholder in a publicly traded company to the management of that company”—the relationship in the venture capital context being much closer because “the dependence of one upon the other is so great”).
\item[131] See, \textit{e.g.}, Kahn v. Lynch Communication Sys., 638 A.2d 1110, 1111–13 (Del. 1994) (remanding to lower court because controlling shareholder did not meet burden of proving the entire fairness of the merger transaction in which the controlling shareholder was on both sides of the transaction); \textit{see also} Bartlett & Garlitz, \textit{supra} note 6, at 594 (noting that “investors in the dilutive round are ordinarily in de facto or de jure control of the issuer”).
\item[132] See, \textit{e.g.}, Nixon v. Blackwell, 626 A.2d 1366, 1380–81 (Del. 1993). The court held that the directors of a closely-held corporation, but not a statutory close corporation, did not breach a fiduciary duty to minority stockholders and noted that it “would be inappropriate judicial legislation for [the court] to fashion a special judicially-created rule for minority investors when the entity does not fall within those statutes, or when there are no negotiated special provisions in the certificate of incorporation, by-laws, or stockholder agreements.” \textit{Id.} The court concluded that the entire fairness test is “the proper judicial approach.” \textit{Id. But see} Lawrence E. Mitchell, \textit{The Death of Fiduciary Duty in Close Corporations}, 138 U. PA. L. REV. 1675, 1729 (1990) (noting that “the practical problems of accommodating controlling shareholders’ legitimate self-interest has led courts…to develop analytical approaches to fiduciary duty which depart from [the traditional fiduciary/loyalty analysis]”). Fiduciary duty can be used to supplement statutory remedies for close corporations. \textit{See id.}
\item[134] \textit{See id. at} *4 (noting that because the defendant was incorporated in Delaware “the law of the state of incorporation governs that corporation’s internal affairs”).
\item[135] \textit{See id. at} *7.
\end{footnotes}
periodic vesting was voluntarily executed by all parties. Subsequently, defendant terminated plaintiff's employment before his stock had fully vested. This development allowed the defendant to repurchase the unvested shares at a cost considerably below the merger price. A few months later Lucent Technologies, Inc. acquired the company. The plaintiff claimed that the defendants breached their duty of good faith and loyalty by terminating him on the “eve of a very profitable merger” and wrongfully diluted the value of his stock.\footnote{136}

The court found the plaintiff's argument “belied by the express terms of the stock restriction agreement,” noted that the terms of the repurchase plan were not limited to “voluntary departure,” and held the defendant’s actions to be a legitimate means of contract enforcement.\footnote{137} In applying the “entire fairness” test, the court noted that the employment contract was “at-will” and thus, disregarded the termination and timing aspects of the merger, focusing instead on the stock restriction agreement as the relevant transaction.\footnote{138} In reference to the allegation that the merger impaired the value of his stock, the court found no colorable claim because the plaintiff voted in favor of the merger and received the full merger price for all his vested stock. Additionally, the court found the merger offer to be fair—noting that the plaintiff received over $2 million on a $10,000 investment. The court emphasized that the “entire fairness” test cannot supplant the terms of plaintiff’s employment and stock restriction agreements,\footnote{139} and thus concluded that the defendants did not breach any fiduciary duty.\footnote{140} In effect, the fiduciary duty “approximate[s] the bargain the parties themselves would have reached had they been able to negotiate [without transaction

\footnote{136. Id. at *4.}
\footnote{137. Id. at *7 n.7, 4 (explaining that “the Delaware Supreme Court observed that minority shareholders could protect themselves with appropriate stockholder agreements and other contractual arrangements [and that this] was viewed as preferable to post hoc imposition of judicially created remedies”).}
\footnote{138. See id. at *5-*6 (noting that “[t]he ‘entire fairness' test does not supplant the terms of Olsen's [at-will employment with Agile] nor the terms of Olsen's stock restriction agreement” and finding that on the date of the company's incorporation, Seifert was no longer Olsen's ‘partner' [and thus the] duties owed to Olsen were the duties owed to a stockholder”).}
\footnote{139. See id. at *5 (citing Riblet Prod. Corp. v. Nagy, 683 A.2d 37, 40 (Del. 1996) which held that the express terms of an employment agreement will be enforced like any other contract and holding that these "contract rights [are neither] enhanced [nor] enlarged because of [the corporate officer's] status as a shareholder").}
\footnote{140. See id. at *5, n.5 (noting that the result would be the same under Massachusetts law because the Donahue/Wilkes analysis holds that “questions of good faith and loyalty with respect to rights on termination or stock purchase do not arise when all the stockholders in advance enter into agreements concerning termination of employment”).}
costs].”

The Delaware court in *Orban v. Field* failed to find a breach of director fiduciary duty. Orban was the founder of Office Mart and owned most of the common stock. He resigned as CEO of Office Mart and was replaced by Stephen Westerfield, who was approved unanimously by the Board. Office Mart, which was faring poorly, recapitalized to eliminate a debt burden. Soon after the recapitalization, merger negotiations took place with Staples, Inc. Orban objected to the merger deal, as common stockholders would receive nothing. The board of Office Mart became worried about Orban’s objections because his common stock holdings could allow him to block the merger deal. Thus, the board proceeded to dilute Orban’s common stock interest to assure that he would not be able to block the merger with Staples.

Orban claimed that the board breached its fiduciary duty of loyalty to common stockholders by facilitating this dilution. Despite the business judgment rule not being applicable, the court found that the board’s “conduct was taken in good faith pursuit of valid ends and was reasonable in the circumstances.” In finding in favor of defendants, the court stated that, as long as the conduct was in good faith and reasonable, “the greater good [justifies] the action.” According to the court, the board had a choice between supporting Orban’s effort to extract value from his voting privilege or accomplishing the negotiated merger transaction. Factually, Orban’s common stock interest was valueless, regardless of the dilution so Orban’s position was not “allocatively efficient.” Hence, the board’s “legally permissible action was measured and appropriate under the circumstances.”

From these opinions, it is apparent that Delaware law gives much deference to business decisions, especially those expressed in contract, even in determining fairness. In *Olsen*, the court deferred to the stock restriction agreement and refused to delve

141. Mitchell, *supra* note 132, at 1725 (citation omitted).
143. See id. at *28–*29. For purposes of summary judgment, the court did not apply the business judgment rule presumption.
144. *Id.* at *29.
145. *Id.*
146. *See id.* at *31. As long as Orban had over 10% common stock voting interest, then he could block the proposed merger transaction.
147. *Id.* at *32 n.26.
148. *Id.* at *33.
into the fairness of its terms. In *Orban*, the court deferred to the negotiated merger. The court looked beyond the concerns of the shareholders and emphasized the best interests of the corporation.

So in employing the Alantec scenario, the washout financing can definitely be seen as the best interests of the corporation. Otherwise, the company may end up in bankruptcy where its assets would be very difficult to value. This difficulty in valuation would add greater credence to making the financing more allocatively efficient, especially because the founders are usually seen as a cause of the company’s hard times. With this in mind, the dilution and termination of employment of Kalashian and Vij would follow the court’s previous analyses as actions which are reasonable and measured given the circumstances.

**C. The Alantec Dispute**

Delaware and Massachusetts have the leading case law opinions when it comes to corporate and close corporation law. However, the Alantec dispute occurred in California. Moreover, as the technology-based venture capital industry is centered in California, many start-up companies, which may be subject to a washout, will typically be incorporated there, too.

A look at California case law regarding fiduciary duties shows that California courts seem to be stricter than those in Massachusetts and Delaware. Looking at California case law and at the particulars of Alantec should provide some guidance on how to conduct a washout financing in California and shed light on why the venture capitalists settled the case during trial.

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151. Id. at *27 n.23.
152. *See, e.g.*, David Gray Carlson, *Secured Creditors and the Eoly Character of Bankruptcy Valuations*, 41 AM. U. L.R. 63, 64 (1991) (making it obvious that asset valuation in bankruptcy is a challenging and, at times, contradictory endeavor because courts have produced an “extremely diverse and contradictory set of valuation theories”).
153. *See Bartlett & Garlitz, supra* note 6, at 595; *see, e.g.*, Herhold, *supra* note 8, at 1C.
155. *See supra* Parts IV.
156. *See King, supra* note 51, at B9.
testimony.

As in Massachusetts, directors and majority shareholders in California owe a fiduciary duty to minority shareholders, as well as to the corporation. For directors, the duty is codified in the California Corporation Code. The fiduciary responsibilities of majority shareholders, however, are a creature of case law, as outlined by the California Supreme Court in Jones v. H.F. Ahmanson & Co.

In H.F. Ahmanson, the court extended fiduciary obligations to the controlling shareholders of a close corporation who excluded the minority shareholders from a marketing scheme which artificially created a market for their shares. The court iterated that any use of corporate power "must benefit all shareholders proportionately and must not conflict with the proper conduct of the corporation's business." The court held that "controlling shareholders may not use their power to control the corporation for the purpose of promoting a marketing scheme that benefits themselves alone to the detriment of the minority." In H.F. Ahmanson, the majority exchanged their small number of high-value shares for a large number of lower value shares of a holding company they created. They artificially created a market for these sales and offered them for public sale. The minority shareholders of the original company were not allowed to participate.

Though there is much emphasis on not doing anything detrimental to minority shareholders, the H.F. Ahmanson court plainly stated that the rule in California is one of "inherent fairness from the viewpoint of the corporation and those interested therein." This concession demonstrates a general California corporate law doctrine that a proper corporate purpose

158. See CAL. CORP. CODE § 309 (West 1990) (stating that a director will perform his or her duties "in the best interests of the corporation and its shareholders").
159. 460 P.2d 464, 471 (Cal. 1969); see also Stephenson v. Drever, 947 P.2d 1301, 1307 (Cal. 1997) ("The rule of corporation law and of equity invoked is well settled and has been often applied. The majority has the right to control; but when it does so, it occupies a fiduciary relation toward the minority, as much so as the corporation itself or its officers and directors.").
160. See H.F. Ahmanson, 460 P.2d at 474–75 (stating that "[t]he case before us . . . supports our conclusion that the comprehensive rule of good faith and inherent fairness to the minority in any transaction where control of the corporation is material properly governs controlling shareholders in this state").
161. See id. at 471, quoted in Stephenson, 947 P.2d at 1307.
162. Id. at 476.
163. Id. at 469, 476.
164. Id. at 472 (quoting Remillard Brick Co. v. Remillard-Dandini, 241 P.2d 66, 75 (Cal. Dist. Ct. App. 1952)).
will be considered in determining a breach of fiduciary duty.\textsuperscript{165} For example, the court did recognize that the majority has “the right to dissolve the corporation to protect their investment if no alternative means were available.”\textsuperscript{166}

This case law provides the legal backdrop for the Alantec settlement. In the Alantec dispute, the washout financing was detrimental to the minority shareholders (the founders) and would end up benefiting the venture capitalist investors at the expense of the founders.\textsuperscript{167} However, with Alantec on the verge of bankruptcy and in need of an immediate cash infusion, the venture capitalists had a strong argument that the washout financing was done for a proper corporate purpose.\textsuperscript{168}

During trial testimony, however, allegations surfaced about the motivation of the venture capitalists.\textsuperscript{169} The plaintiffs claimed that the necessary approvals were all done surreptitiously.\textsuperscript{170} Approval from the founders’ class of common stock was required, so, according to the plaintiffs, the venture capitalist board majority secretly issued common stock to newly installed officers.\textsuperscript{171} The new officers were loyal to the venture capitalists, and the founders claimed that the new officers were given so much common stock that the founders’ vote no longer mattered.\textsuperscript{172} However, the venture capitalists thought that the founders did not deserve the stock that they did own.\textsuperscript{173} If, in

\begin{itemize}
\item \textsuperscript{165} See 2 H. Marsh, California Corporation Law & Practice § 11.46, at 958–60 (3d ed. 1995) (asserting that “[i]f the finding of fact is that the board made its decisions for a proper corporate purpose, and not from the alleged motivation of ‘squeezing out’ the minority shareholder, then there is no violation of their fiduciary duty; and the minority shareholder is generally remediless”).
\item \textsuperscript{166} H.F. Ahmanson, 460 P.2d at 471 (requiring also that “no advantage was secured over other shareholders”).
\item \textsuperscript{167} Herhold, supra note 8, at C1 (reporting on the dilutive reduction of the founders’ interest from 8% to 0.007%, reducing the founders’ value from $40 million to $600,000 at the time of the sale of the enterprise).
\item \textsuperscript{168} See King, supra note 51, at B9 (reciting venture-capitalist defendants’ claims that at the time of the washout financing, the company was on the verge of bankruptcy; that additional issuances of stock to new management were necessary to motivate those who would now be running the company; and that, given the company’s situation, the defendants could persuade no other investor group to participate in the washout financings).
\item \textsuperscript{169} See id. (reciting plaintiffs’ claims that the defendants conspired to issue themselves additional stock below fair market value of the company at the plaintiffs’ expense; that defendants intentionally attempted to dilute the plaintiffs because they believed plaintiffs had too much stock given their diminished role; and that defendants had effectively given away common stock to new management merely to permit them to vote those shares in favor of the new financings).
\item \textsuperscript{170} See id.
\item \textsuperscript{171} See id.
\item \textsuperscript{172} See id.
\item \textsuperscript{173} See id.; see also Herhold, supra note 8, at 1C (noting that notes of a young
fact, this were the case, the founders would not know about the washout financing until it was already done, and the venture capitalists would do another financing soon afterwards. And, even though the founders’ vote was no longer an issue, even more common stock was issued until their total share of Alantec fell from 8% before the first washout to 0.007% after the second washout.174

All of these allegations came out during the trial testimony.175 Especially given California’s expansive view of corporate fiduciary duties, the Alantec washout would not be justifiable without a defense of proper business purpose. When the venture capitalists were shown to have acted in bad faith, it took away their best defense: that the washout was done for a proper business purpose.

In the end, the lesson from Alantec is a simple one. It can be found in any corporation statute. It is the lesson that board directors must serve in good faith.176 With this in mind, venture capitalists should be able to easily distinguish themselves from the Alantec scenario while carrying on a washout.177

VI. ACADEMIC JUSTIFICATION

Academic opinions on the subject of minority oppression have articulated several reasons to support the courts’ interpretations of the current legal standards in a closed corporation dilution context.178 In general, there is unanimity in the fact that an entrepreneurial firm faces many inherent

174. See King, supra note 51, at B9 (noting that the plaintiffs’ share of Alantec was in common stock, and the total share of the company included the classes of preferred stock, most of which were in the hands of the venture capitalist investors).

175. See id. (recounting trial testimony); see also Herhold, supra note 8, at C1 (suggesting that even the use of the word “washout” by the venture capitalists was used as evidence of bad faith).

176. See, e.g., CAL. CORP. CODE § 309 (West 1990); FLA. STAT. ANN. § 607.0830 (West Supp. 2001); N.Y. BUS. CORP. LAW § 717 (McKinney Supp. 2001); WASH. REV. CODE ANN. § 23B.08.300 (West 1994); Steven M.H. Wallman, The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties, 21 STETSON L. REV. 163, 164 (1995) (citing as an example of corporate constituency statutes § 1712(a) of the Pennsylvania Consolidated Statutes [1990]: “A director of a business corporation shall stand in a fiduciary relationship to the corporation and shall perform his duties as a director...in good faith.”).

177. See infra note 231 (providing examples of preventive action).

178. See Moll, Investment Model Solution, supra note 92, at 528-29 (observing the reasons why courts have adopted the reasonable expectations test to determine if oppressive conduct has occurred, and characterizing minority shareholder oppression as “burdensome, harsh, . . . wrongful conduct . . . [and] breach of an enhanced fiduciary duty”).
risks. The leaders of such firms confront much competition and obstacles. In order to survive and flourish, the management of an entrepreneurial firm needs leeway to make decisions without concern for judicial intervention. Several commentators would agree with these assertions. These commentators have articulated justifications for the relaxed legal treatment of those in control of an entrepreneurial firm.

A. "Best Interests" Model

Brian Cohen argues that corporate governance for a close corporation should incorporate the stakeholder model with the shareholder model. These models describe doctrines of corporate law as to whom directors and officers of a corporation owe a duty. Cohen agrees with Steven M.H. Wallman’s thesis that “the directors’ duty is owed solely to the corporation, not to


180. See Moll, Question of Perspective, supra note 95, at 803–04 (noting that “many close corporations are small start-up businesses that face a high risk of failure”); see also Terry A. O’Neill, Self-Interest and Concern for Others in the Owner-Managed Firm: A Suggested Approach to Dissolution and Fiduciary Obligation in Close Corporations, 22 SETON HALL L. REV. 646, 668 (1992) (commenting on how entrepreneurs face “overwhelming odds”).

181. See Cohen, supra note 179, at 147–48 (commenting on how entrepreneurs are “motivated by freedom” and how they “need to be free to take an idea and implement it according to their own business plan”).

182. See id. at 147 n.121 (citing WILSON HARRELL, FOR ENTREPRENEURS ONLY 150 (1994) (“It is the quest for freedom that fuels the entrepreneurial spirit. Free to be your own person; free to get your head above the crowd; free to have an idea, and turn that idea into a company, and that company into an empire, if you can”); see also Thomas W. Maddi, Note, Nodak Bancorporation v. Clarke and Lewis v. Clark: Squeezing Out “Squeeze Out” Mergers Under the National Bank Act, 51 WASH. & LEE L. REV. 763, 773–75 (1994) (describing the modern legislative trend to liberalize the treatment of squeeze-out mergers by entrepreneurs).

183. See Cohen, supra note 179, at 126. Stakeholders include not only shareholders, but also other groups who are affected by corporate decisions. See id. Examples of stakeholders are “suppliers, customers, employees, stockholders, and local community, as well as management.” Id. (citing Eric W. Orts, Beyond Shareholders: Interpreting Corporate Constituency Statutes, 61 GEO. WASH. L. REV. 14, 21 (1992)).

184. See MODEL BUS. CORP. ACT § 1.40 (Supp. 1990) (defining a shareholder as “the person in whose name shares are registered in the records of a corporation or the beneficial owner of shares to the extent of the rights granted by a nominee certificate on file with a corporation”).

185. See Steven M. H. Wallman, The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties, 21 STETSON L. REV. 163, 167-68 (1991) (indicating that proponents of the stakeholder model argue that directors and officers owe a duty to all stakeholders while proponents of the long-standing shareholder model believe that directors of a corporation are responsible for maximizing the wealth of the company’s owners, its shareholders).
shareholders or any other group." As Cohen puts it, "directors should not afford primacy to any particular stakeholder, but rather to the corporation as a whole."

This "best interests of the corporation" model of corporate governance is best suited for start-up entrepreneurial firms. "To start a business and work toward creating an empire" requires a large measure of freedom and flexibility in decision-making. Many legal causes of action, however, may limit this freedom. For example, a number of jurisdictions have adopted the "reasonable expectations" test, "which requires that the controlling shareholders of a close corporation act so as not to defeat objectively reasonable expectations of the noncontrolling shareholders."

186. See id. at 165 (proposing the "best interests" model as the most beneficial to the corporation as a whole, which positively affects all stakeholders, including shareholders).
188. See id. at 129-30.
189. Id. at 147-48.
190. A cause of action for oppression can be found three ways: 1) if the majority's conduct is found to be "burdensome, harsh and wrongful... [and amounts to] a visible departure from the standards of fair dealing and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely," 2) if a majority shareholder breaches the "enhanced fiduciary duty" he/she owes to the minority shareholder in a closed corporation, and 3) if the majority shareholder's conduct "defeats the 'reasonable expectations' held by minority shareholders in committing their capital to a particular enterprise." Moll, Question of Perspective, supra note 95, at 762 (citation omitted). Furthermore:

[The fair dealing standard differs from the reasonable expectations standard because it refers to conduct on the part of majority shareholders that is "harsh, dishonest, or wrongful." However, the frustration of a shareholder's reasonable expectations does not necessarily imply that there has been a lack of fair dealing by the majority shareholders... . . . The fair dealing standard has therefore been recognized as a fault-based standard, while the reasonable expectations standard has been advocated to promote no-fault dissolutions.

191. The "reasonable expectations" standard has been codified in Minnesota and North Dakota. See id. at 514 n.80. The standard has also been "adopted by the highest court of six states, including Alaska, Montana, New York, North Carolina, North Dakota, and West Virginia," and has been "used by lower courts in New Jersey and New Mexico." Robert B. Thompson, Corporate Dissolution and Shareholders' Reasonable Expectations, 66 WASH. U. L.Q. 193, 213 (1988). Courts permit expectations to be established outside of formal written agreements, but the minority shareholder retains the burden of proving the existence of the expectations. Id at 217-18. "The relevant expectations are those that exist at the inception of the enterprise, and as they develop thereafter through the course of dealing concurred in by all shareholders. Expectations of participants may change during the evolution of an enterprise and courts should examine the whole history of the participants' relationship." Id.
192. See Cohen, supra note 179, at 128 (citing Franklin A. Gevurtz, Squeeze-Outs and Freeze-Outs in Limited Liability Companies, 73 WASH. U. L.Q. 497, 500-01 (1995);
The concern about imposing such standards is that a good faith decision made by the controllers of a close corporation may not meet the standards even while furthering the corporation. This is especially pertinent to start-up entrepreneurial firms where there is a focus on growth.\textsuperscript{193} This focus requires quick decisions, which are necessary in the long-term, but which could be easily second-guessed.\textsuperscript{194} Cohen thinks that standards based on the shareholder model, i.e., the reasonable expectations test, place too many limits on the decision-making ability of entrepreneurial firms in the “early, close corporation stage”.\textsuperscript{195} A good faith decision in the corporation’s best interests could result in corporate dissolution if the decision was found to be wrong.\textsuperscript{196} “In order to effectively build and invigorate a long term competitive position in the marketplace,”\textsuperscript{197} entrepreneurs need freedom.

The contours of this freedom allowed by the “best interests” model are touched upon in Cohen’s piece. For example, Cohen maintains that controlling shareholders must be able to “retain an unbridled prerogative to put short-term earnings on the backburner for the sake of the corporation and its future.”\textsuperscript{198} Moreover, “[i]f minority shareholders create pressure for short-term profitability at the expense of long-term prosperity of the enterprise, prudent management dictates the elimination of the minority.”\textsuperscript{199}

Not only do these examples evince the differences between the “best interests” model and the shareholder model, but they also demonstrate how washout financings may be a part of Cohen’s entrepreneurial discretion. When the alternative is bankruptcy, the “best interests of the corporation” may be a major dilution of minority shareholders.\textsuperscript{200} In a washout, the

Melvin Aron Eisenberg, The Structure of Corporation Law, 89 COLUM. L. REV. 1461, 1467–68 (1989)).

\textsuperscript{193} See id. at 148–49.
\textsuperscript{194} Id. at 148.
\textsuperscript{195} See id. at 129–30.
\textsuperscript{196} See id. at 129.
\textsuperscript{197} Id. at 130.
\textsuperscript{198} Id. at 148.
\textsuperscript{199} Id. at 148 n.127 (quoting Thomas W. Maddi, Note, Nodak Bancorporation v. Clarke and Lewis v. Clark: Squeezing out “Squeeze-Out” Mergers Under the National Bank Act, 51 WASH. & LEE L. REV. 763, 774–75 (1994)).
\textsuperscript{200} See, e.g., Morning Briefcase, DALLAS MORNING NEWS, Apr. 12, 2000, at 2D:

Rite Aid Corp. said it received a $ 1 billion credit line from lenders, staving off the specter of bankruptcy and giving the drugstore chain two years to restore its financial health. The deal came at a cost of higher interest rates on some of its borrowings and substantial dilution for its
minority may not be creating pressure for short-term profits, but they may be hampering the company's ability to receive needed investment money. The minority's inability to raise investment dollars would make dilution of their shares in the "best interests of the corporation" as a whole.

B. Contractarian Position

In the context of close corporations, entrepreneurs, and washout financings, the contractarian position is more a collection of ideas, than a distinct doctrine. Many commentators touch upon this idea, as it is a basic and simple principle. Nonetheless, the contractarian position is important as an explanation for why the courts should not apply stringent regulations on close corporations. Essentially, the contractarian position revolves around the idea that contracts between shareholders and an entrepreneurial corporation represent the arrangement of a relationship which the judiciary should not disrupt, unless there is good reason to risk the coherence of a relationship.

 stockholders. Shares of Rite Aid rose $1.63, to $7.31. See also supra Part V.C. (describing the Alantec case and its closeness to bankruptcy).


202. See David Millon, Communitarians, Contractarians, and the Crisis in Corporate Law, 50 WASH. & LEE L. REV. 1373, 1378 (1993) ("The contractarian view thus rests on a descriptive assessment of current possibilities, as well as a normative vision of the limited role that law should play in relation to individual economic activity.").

203. As David Millon notes:

Today's advocates of the shareholder primacy position—including the current focus on institutional investor activism—rely on a “contractarian,” antiregulatory, individualistic stance. Proponents argue against corporate law rules that mandate or inhibit particular governance relationships. They would instead leave it up to the various participants in corporate activity to specify their respective rights and obligations through contract. According to this view, state corporate law provides the terms of the contract by which shareholders purchase management's undivided loyalty to their welfare. The key term is management's fiduciary duty to direct the corporation so as to maximize shareholder wealth. This mandate must necessarily be general and open ended, because detailed ex ante specification of how management should act in running the business is simply not realistically possible. In contrast, to the extent that management's pursuit of shareholder welfare threatens nonshareholder interests, workers, creditors, and other affected nonshareholders are free to bargain with shareholders (through their agents) for whatever protections they are willing to pay for.
When a founder and venture capitalist get together, their interests are intertwined.²⁰⁴ As their enterprise moves forward, their interests may converge or diverge.²⁰⁵ The agreements put in place at the start of their relationship may no longer evince the current status of their association. The static nature of a written agreement is an inherent limitation of contracts.²⁰⁶ Still, what the contracts do represent is the basis from which their relationship develops.²⁰⁷

The interactions between the venture capitalist and the founder become shaped by their contracts. To go outside of their contracts for a judicial remedy in a washout would simply create more uncertainty in an area where risk and uncertainty are already high. For this reason, contracts and their enforcement become all the more important.²⁰⁸ The agreements may be quantifiable, but the relationship that drives them may not be, especially because relationships evolve as the enterprise goes forward. Therefore, the contractarian position argues that judicial involvement to cure conflicts not covered contractually would interfere in such a relationship.²⁰⁹

Contractarians start from the presumption that people ought to be free to make their own choices about how to live their lives .... Legal rules that redistribute wealth, mandate particular forms of behavior, or prevent people from making bargains they would otherwise choose to make are presumptively objectionable because they interfere with people's ability to live their own lives according to their own preferences, structuring their relationships with others and defining their duties towards them by means of consent.

*Id.* at 1377–78, 1382.

²⁰⁴ See, e.g., Richard A. Shaffer, *These Days, Who Isn't a Venture Capitalist?*, FORTUNE, Apr. 17, 2000, at 532 (stating that “venture capitalists are supposed to be intimately involved with the companies they finance; that's why they're paid annual management fees of about 2% and keep to get 25% or more of all capital gains”).

²⁰⁵ See, e.g., Andrew J. Sherman, *How Venture Funds Can Work For You*, MGMT. REV., May 1990, at 44, LEXIS, News Library, Magazine Stories, Combined (noting that founders are interested in dilution of ownership and loss of control whereas venture capitalists are concerned about “return on investment, mitigating the risk of business failure, and protecting its interests as a minority shareholder”).

²⁰⁶ See, e.g., *RESTATEMENT (SECOND) OF CONTRACTS: INTEGRATED AGREEMENTS § 209(1) (1998)* (stating that an integrated agreement is a writing constituting a final agreement of one or more terms of an agreement).

²⁰⁷ See Sherman, supra note 205, at 44 (noting that the contracts “contain the legal rights and obligations of the parties, balancing between the needs and concerns of the company as well as the investment objectives and necessary controls of the venture capitalist,” and “serves as a road map for the entire transaction”).


²⁰⁹ See, e.g., Rachel Weber, *Why Local Economic Development Incentives Don’t
Now, a contractarian position does not mean that judicial enforcement is never desirable. For one, judicial enforcement of contractual agreements is emphasized. Furthermore, circumstances do exist where a contract should not be enforced. When a contract is clearly oppressive or unconscionable, justice will dictate judicial involvement. When a contract does not represent the intentions of the parties, it should not be enforced, and judicial involvement may be necessary. Contract law covers various situations when the judiciary should step in. The gist of the contractarian view is just that contract law should be vigorously applied. Contract law recognizes the value of a contractual relationship. So, applying legal and equitable principles from other areas of the law will tend to interfere with the principles developed by contract law. The following two authors help to illustrate the contractarian position.

In his paper, Optimal Investment, Monitoring, and the Staging of Venture Capital, Paul A. Gompers notes and examines the factors involved in venture capital agreements. Gompers
focuses on agency theory and how venture capitalists attempt to monitor governance issues. He focuses on how staged capital infusions by venture capitalists are used in order to monitor and control their portfolio companies. When the venture capital investor agrees to invest in a company, his agreement with the entrepreneur may structure the investment to occur periodically, in rounds, where certain progress must be made in order to receive another round of financing. This is a potent control mechanism for a venture capitalist. It allows the investor to gather information and monitor progress of the firm and preserves the option to abandon the project. The duration and size of investment are also factors of weighing the risks and benefits of the project. In short, "[m]echanisms in financial contracts between venture capitalists and entrepreneurs directly account for potential agency costs and private information associated with high-risk, high-return projects."

If entrepreneurs can sue outside of the terms of their contracts, when their high-risk gamble does not take-off, they are being allowed to circumvent the private mechanisms that were put into place by both parties to weigh the risks of the agreement before they committed to its terms. The possibility of a washout financing was already factored in when the parties were fashioning the investment. To therefore later hold a venture capitalist liable for a washout would only serve to increase the already high transaction and agency costs of venture capital.

217. See id. at 1462 (stating that "[t]his paper develops predictions from agency theory that shed light on factors affecting the duration and size of venture capital investments").

218. See id. at 1461 (stating that "[t]he evidence indicates that the staging of capital infusions allows venture capitalists to gather information and monitor the progress of firms, maintaining the option to periodically abandon projects").

219. See id. at 1474–75, stating in part that:

[Data indicate[s] that venture capitalists stage capital infusions to gather information and monitor the progress of firms they finance. New information is useful in determining whether or not the venture capitalist should continue financing the project. Promising firms receive new financing while others either are liquidated or find a corporate acquirer to manage the assets of the firm.

220. See id. at 1461; see also William A. Sahlman, The Structure and Governance of Venture-Capital Organizations, 27 J. FIN. ECON. 473, 506 (1990) ("The most important mechanism for controlling the venture is staging the infusion of capital.").

221. See id. at 1475–84 (explaining the factors and effects on the size and timing of funding).

222. Id. at 1485.

223. See, e.g., Chapman, supra note 201 (stating that the costs of business will be increased because of a settlement in a recent lawsuit where founders of the networking company, Alantec, settled with venture capitalists for $15 million, claiming that the
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Transaction costs are also an issue in an article by Douglas G. Smith.224 He addresses how the contracting done by venture capitalists rebuts Professor Roe’s political theory of American corporate finance.225 Smith notes that venture capitalists are willing to absorb the high transaction costs that come with trying to “contract around” whatever legal rules and regulations have been established.226 This goes against Roe’s political theory.227 Smith hypothesizes that economic forces may then dictate corporate structures rather than the legal framework.228 He emphasizes that venture capital companies find holes in the regulatory framework and enter into “creative agreements” with entrepreneurs in order to maintain control.229

Again, the importance is in how the contractual relationship is planned. If not expressed in Smith’s hypothesis, it is at least implicit that judicial interference could only harm this relationship. A venture capitalist would have to absorb even greater transaction costs, but the investor would try to find a way to “contract around” any legal rule, as long as it was economically justified, according to Smith.230 So, if the Alantec settlement is an example of what is to come and washouts became illegal, then one could expect to find venture capitalists and entrepreneurs to come up with even more “creative agreements.”

venture capitalists seized control of their company through a series of “washout” financings and cheated them out of their share of profits).

224. See Smith, supra note 32, at 137 n.251, 150, 151 nn.339–40, 154 (discussing the high transaction costs associated with venture capital).

225. See id. at 90, 102 (stating that “[i]n his recent book . . . Professor Roe argues that the structure of American corporate governance has been dictated by political and historical forces, such as American populism and interest group politics, that have resulted in greater fragmentation of ownership in American companies than is found abroad” and concluding that “the venture capital company potentially represents a significant counterexample to Professor Roe’s political theory of American corporate finance”); see also MARK ROE, STRONG MANAGERS, WEAK OWNERS, at xv (1994) (asserting that American political and historical forces have developed the legal rules which shape corporate structure in the U.S.).

226. See Smith, supra note 32, at 102.

227. See id. (stating that “the venture capital company potentially represents a significant counterexample to Professor Roe’s political theory of American corporate finance”).

228. See id. at 89 (stating that “[c]orporations might evade legal restrictions in order to pursue whatever corporate structure is dictated by economic forces”).

229. See id. at 154.

230. See id. at 89.

231. See King, supra note 51, at B9 (recommending that attorneys (1) “should be attentive to conflicts of interest in any financing transaction;” (2) “build checks into the decision-making process that will support a record of director good faith;” (3) “[b]ring in a disinterested third party as the lead investor for a new round of financing to set the price is critically important;” and (4) “establish a special committee of the board of directors”).
C. Self-enforcement Position—“Omelet” Argument

Rock and Wachter present an analysis which stresses the attributes of the close corporation and self-enforcement. This self-enforcement aspect of the analysis makes their thesis similar in many respects to the contractarian position. Briefly, their thesis is that the close corporation form has attributes which make self-enforcement much preferable to judicial intervention.

The two attributes deemed to be the most crucial to the close corporation are the limitations on exit and the rule of no non pro rata distributions. These attributes are crucial as “self-enforcing mechanisms to protect the participants from misbehavior by fellow participants.” The crux of their argument lies in the fact that close corporations often require “match-investments” creating “match-assets.” Rock and Wachter compare the problem of match-investments to making an omelet: “between the time the eggs are broken and the omelet sets, the cook knows his grand plan for the omelet, but to outsiders, the half-cooked omelet is unappetizing.” As such, their value, in the beginning, is much higher to those involved in the company than to outsiders. This fact makes it difficult for accurate judicial intervention. This fact also makes the close corporation the form of choice. The limitations on exit prevent substantial losses which would result from a forced sale of match assets. The rule of no non pro rata distributions is the core protection against oppression because it ensures that wealth maximization would benefit all shareholders, minority and

233. See id. at 948 (“First, our analysis implies that the parties themselves, rather than the courts, are best able to resolve the nasty employment issues that animate many bitter close corporation cases.”).
234. See id. at 947.
235. Id.
236. Id. at 918 (noting that investments in match are more valuable to the contracting parties than to outside third parties).
237. Id. at 919.
238. See id. (concluding, as a consequence to the disproportionate valuation by insiders and outsiders, “the company will be capital constrained with no easy access to outside financing at an appropriate valuation of assets”).
239. See id. at 927 (concluding that “the parties are best served by self-enforcing rather than third-party” enforcement because of the “match investments” and “asymmetry of information”).
240. See id. (asserting that the close corporation form is “largely incentive-compatible”).
241. See id. at 919.
majority alike. The overlap between shareholders and managers also lowers agency costs. These attributes serve to limit opportunistic behavior among shareholders.

Rock and Wachter also argue against judicial intervention. Because the valuation of assets in a start-up company is difficult, judicial inquiry should limit itself to vigorously enforcing the rule against non pro rata distributions. If this is done, the “remaining problems that arise between shareholders can be handled by analogy to employment at will, where courts should not intervene in the absence of an explicit contract.” The shareholders in a close corporation would be forced to solve problems themselves. The attributes of a close corporation provide incentives to succeed, as there are substantial match-investments. With limited judicial intervention, the controlling shareholder can set corporate policy more freely. The protections of a minority shareholder would be non-legal, but still substantial. Basically, self-enforcement would be based on the relationship between the shareholders. For a venture capitalist, there is a strong reputational incentive to deal fairly with an entrepreneur. In short, by keeping the enforcement out of the courts, Rock and Wachter’s thesis advocates a position where economics should drive the relations.

VII. CONCLUSION

In its essence, what serves to justify washout financing is freedom. This freedom is of particular importance for entrepreneurial firms. In a highly competitive marketplace, entrepreneurs need to be flexible. In order to succeed, a long-term view often needs to be taken, and this might not maximize the wealth in the short term. The contemporary example of

242. See id. at 923.
243. See id. at 919.
244. See id. at 948.
245. See Rock & Wachter, supra note 232, at 937–38 (noting that the rule of no non pro rata distribution means that minority shareholders are able to cash out at the pro rata valuation).
246. Id. at 938.
247. See id.
248. See id. at 947.
249. See id. at 930.
250. See id. at 929.
251. See id.; see also Gompers, Venture Capital Industry, supra note 9, at 3 (noting that “without a reputation as a good venture capitalist, it is nearly impossible to raise money”).
252. Well, strictly speaking, the legal underpinning is the business judgment rule, but this rule is based on the freedom of directors to decide what is best for the business.
253. See Gompers, Venture Capital Industry, supra note 12, at 13 (“If capital
Internet start-up companies vividly illustrates this. Many of these companies have yet to show any profit, but shareholders continue to invest in the hopes of future reward.\textsuperscript{254} Competition is high, as many of these “dot-com” enterprises contend to fill the same online niche.\textsuperscript{255} In such an environment, directors and officers do not have time to worry about what is and is not a shareholder interest. It is the viability of the company that is at stake. For this reason, controllers of an enterprise should have the freedom to make decisions in the best interests of the corporation as a whole.

Moreover, this freedom extends to entering into contracts in order to further their interests. A venture capitalist’s interests may be simply to earn financial returns, or perhaps they may be to finance “noble” ideas.\textsuperscript{256} Whatever these interests may be, the ability to contract into a suitable relationship to further a high-risk project should not be spoiled by a court.

The judiciary has noted these justifications. In Delaware, the “entire fairness” test has been implemented in order to give freedom.\textsuperscript{257} In Orban, the court went so far as to say that a board may deploy corporate power against its own shareholders with “the greater good justifying the action.”\textsuperscript{258} In Massachusetts, the court in Wilkes conceded that the majority shareholder has rights of “selfish ownership” and “must have a large measure of discretion.”\textsuperscript{259} And even in California, the showing of a proper corporate purpose will leave the minority shareholder without a
remedy. These dicta show that the courts are aware of the importance of entrepreneurial freedom.

There is concern for the founder who puts in the “sweat equity” to start a firm who then is at the mercy of the capitalist interested only in profits. Alantec is certainly an example of founders who tapped into this sympathy. However, the close corporation by itself and the norms of the relationship will protect an entrepreneur from any real oppression. Judicial intervention would only serve to disrupt the balance in a high-risk venture capital relationship.

260. See supra Part IV.B.