<u>Draft – please do not circulate or cite without permission of the author</u>

BARGAINING INEQUALITY: EMPLOYEE GOLDEN HANDCUFFS AND ASYMMETRIC INFORMATION

*Anat Alon-Beck**
Assistant Professor
Case Western Reserve University School of Law

ABSTRACT

The problem of inaccurate unicorn firm valuation is very severe and well documented in the finance literature. Unicorn employees cannot value their equity grants, including stock, because they do not have access to fair market valuation or financial statements and, in many cases, are denied access to such reports, even if they ask for them. Startup founders, investors, and their lawyers have systematically abused equity award information asymmetry to their benefit. This Article sheds light on the latest practice that compels employees to waive their inspection rights as stockholders under Delaware General Corporation Law ("DGCL") Section 220 as a condition to receiving stock options from the company.

DGCL Section 220 provides protection to stockholders by allowing them to exercise their ownership rights and inspect the books and records of a Delaware corporation. In Delaware, this ownership right cannot be eliminated or limited by a provision in a corporation's certificate of incorporation or bylaws. But there is ambiguity in the case law with regards to the ability to eliminate this right via private ordering. Unicorn employees—who are not yet stockholders— are now regularly coerced to waive this inspection right by entering into a contract with the corporation, in the form of a stock option agreement. As a result, their employers, who are unicorn fiduciaries, get the benefit of operating without oversigh from minority common stockholders - their employees.

The Delaware Court of Chancery has yet to answer the question of whether a minority stockholder, such as an employee, can waive her rights to inspect books and records

under Section 220 by signing an option agreement that contains such a waiver. It should be noted that this practice is new and in many cases, the employees are putting forth the argument that they signed the waiver without any knowledge. There are even fraud allegations where employees had no idea that they were signing new language that is not "normal" or "customary" for the stock option type deals that tech companies in Silicon Valley used for decades. Many employees further complain that they were intentionally misled into signing or not provided copies of the agreements prior to signing.

This Article puts forward the competing arguments and policy considerations for and against such a waiver. It fills the gap in the case law and evaluates whether a contract between the company and its employees, which operates independently and outside the charter or bylaws, can modify or eliminate the mandatory inspection rights expressly set forth in the DGCL. Despite the fact that Delaware courts have yet to answer this question, it is clear that the resolution on this issue will have tremendous influence on corporate law, litigation, and practice.

The doctrinal analysis is complemented by descriptive analysis: I found that 97% of the unicorns in the United States are incorporated in Delaware. Additionally, relying on a hand collected data set consisting of SEC's public filings, for tech companies that filed for an IPO following the Domo case, I found that firms increasingly require that their employees sign a waiver provision entitled, "Waiver of Statutory Information Rights." Many law firms that represent privately-owned companies are updating the stock option restriction agreement templates they prepare for their clients to include this waiver.

TABLE OF CONTENTS

I. INTRODUCTION

> *Investors, founders and the law firms they work with systematically & ruthlessly exploit startup equity information asymmetry to their gain and employees' pain.*
>
> - Chris Zaharias[1]

> *Have you ever wondered about the value of the options and shares that startups issue to employees? If you ask the startup CEO, she tells you they are winning lottery tickets. If you ask your grandmother, she tells you they are worthless.*
>
> - Will Gornall & Ilya Strebulaev[2]

American startup and high-tech companies have a long history of sharing wealth in the form of equity (ownership rights) and profit with their employees.[3] High-tech founders typically "split the pie" and allocate equity to two groups: employees and external investor groups. Investors put money into the business and get shares of stock in order to earn a profit. Employees exchange their creativity and hard work for the sweat equity that is needed to create the game-changing innovations necessary for American competitiveness in the global marketplace.

For comments and suggestions, thanks are due to Jonathan Adler, Patrick Corrigan, Asaf Hamdani, Charlie Korsmo, Ann Lipton, Jay Ritter, Nizan Packin, Juliet Kostritzky, Marcel Kahan, Jens Dammann, Omari Scott Simmons, Will Moon, Verity Winship, Sergio Gramitto Ricci, Darren Rosenblum, Ed Rock, Jonathan Macey, Joan Heminway, Juscelino Colares, Cassandra Roberts, Sharona Hoffman, David Yermack, Yaakov Amihud, Miriam Schwartz, Asaf Hamdani, Stephen Choi, Peter Robau, Gerald Rosenfeld, Karen Brenner, Sara Samaha, Kathaleen McCormick, Brandon K. Wharton, Yifat Aran, and the participant at the NYU Law and Stern Corporate Governance Workshop. A special thank you to my amazing research assistants, John Livinstone and Colleen Campbell. All errors are my own.

*Assistant Professor, Case Western Reserve University School of Law.

[1] Nicholas Carlson, *Startup Employees Are Getting Screwed by VCs and CEOs, Says 22-Year Industry Insider*, BUSINESSINSIDER.COM (Mar. 6, 2014), https://www.businessinsider.com/this-22-year-veteran-of-startups-says-employees-are-getting-screwed-by-vcs-and-ceos-2014-3.

[2] Will Gornall & Ilya Strebulaev, VALUATION.VC, http://valuation.vc (last visited Mar. 5, 2021).

[3] *See* J. BLASI, D. KRUSE & A. BERNSTEIN, IN THE COMPANY OF OWNERS: THE TRUTH ABOUT STOCK OPTIONS AND WHY EVERY EMPLOYEE SHOULD HAVE THEM (2003).

Founders are willing to split the pie with their rank and file employees by giving them equity (shares of stock) or a promise of equity (stock options) due to the recognition that employee equity-sharing improves overall firm productivity, stockholder returns, and profit levels.[4] This is achieved through contractual innovation. The employee stock option agreement is an example of a very popular and prevalent practice among growth companies. Most high-tech startups, including Google, Intel, and Microsoft, used this type of contract to provide equity compensation to their employees, which in return helped build their companies.[5]

High-tech firms are repeat players in competitive technology markets, where most tech companies aggressively compete for talent—i.e., knowledgeable employees.[6] Talent is scarce and so founders agree to dilute their own ownership stakes in the high-tech firms that they founded by sharing property rights with employees, due to the incentive effects of using stock option agreements. Stock option agreements are a type of contract between the company and its employees. The contract is brilliantly designed to attract, engage, and retain talented

---

[4] *See* Saul Levmore, *Puzzling Stock Options and Compensation Norms*, 149 U. PA. L. REV. 1901, 1901 (2001) ("These options could take many forms but there is remarkable conformity in the practice of giving a class of employees a large percentage of compensation (in expected value terms) in the form of options . . . "). *See also* Thomas A. Smith, *The Zynga Clawback: Shoring Up the Central Pillar of Innovation*, 53 SANTA CLARA L. REV. 577, 580 (2013) (discussing at-will contracts and equity compensation).

[5] Joseph Blasi, Douglas Kruse & Richard Freeman, *Having a Stake: Evidence and Implications for Broad-Based Employee Stock Ownership and Profit Sharing*, THIRD WAY (Feb. 1, 2017), https://www.thirdway.org/report/having-a-stake-evidence-and-implications-for-broad-based-employee-stock-ownership-and-profit-sharing (on file with the *Columbia Business Law Review*).

[6] For insights on equity compensation, see generally MICHAEL B. DORF, INDISPENSABLE AND OTHER MYTHS (2014) (questioning the theoretical foundation for incentive pay and advocating for salary-based executive pay); ALAN HYDE, WORKING IN SILICON VALLEY: ECONOMIC AND LEGAL ANALYSIS OF A HIGH-VELOCITY LABOR MARKET (2003) (providing a comprehensive overview of the Silicon Valley labor market and compensation practices); Robert Anderson IV, *Employee Incentives and the Federal Securities Laws*, 57 U. MIAMI L. REV. 1195, 1217–52 (2003) (discussing the status of employee options as securities); Matthew T. Bodie, *Aligning Incentives with Equity: Employee Stock Options and Rule 10b-5*, 88 IOWA L. REV. 539 (2003) (focusing on the availability of Rule 10b-5 actions); Smith, *supra* note 4, at 589-606 (focusing on the law and economics of equity compensation as private ordering); Yifat Aran, Note, *Beyond Covenants Not to Compete: Equilibrium in High-Tech Startup Labor Markets*, 70 STAN. L. REV. 1235 (2018). Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay but How*, HARV. BUS. REV., May–June 1990, at 138, 141 (advocating for equity compensation as a form of incentive-based executive pay).

employees.[7] It provides an incentive for employees to share in the ownership of their firm and help grow the pie, while allowing the company to preserve its cash.[8] It allows the firm to delay leakage of its proprietary knowledge (including unpatended information) by providing incentives that reduce employee mobility.

To this day, the high-tech industry predominantly relies on the practice of awarding options (rather than outright stock awards) to rank and file employees.[9] After the employee exercises her options to buy the shares, she becomes a minority common stockholder.[10] As a stockholder, the employee can typically enjoy several rights that are associated with ownership, including: voting, distribution in the event of dissolution, dividends, inspection, and the right to sue.

The latest contractual innovation in this area of the law, however, is one that compels employee-stockholders to waive their inspection rights as a condition to receiving stock options from their company.[11] Unfortunately, there is a new controvertial practice in the U.S. that places limits on an employee's stockholder rights, particularly - inspection rights. Inspection rights originated from the common law.[12] Most states in the U.S., including Delaware, have codified the common law inspection rights, with variations from state to state. Stockholder inspection rights are generally considered one of the few "immutable" rules of corporate law. Immutable rules are mandatory rules—ones that

---

[7] *See* Erica Gorga & Michael Halberstam, *Knowledge and Inputs, Legal Institutions and Firm Structure: Towards a Knowledge-Based Theory of the Firm*, 101 NW U.L. REV. 1123, 1185 (2007) ("Stock options are a crucial tool for startups in the high-tech industry to retain knowledgeable employees.").

[8] However, there is no consensus as to which of the designs achieves these results. *See* CONSTANCE E. BAGLEY & DIANE W. SAVAGE, MANAGERS AND THE LEGAL ENVIRONMENT: STRATEGIES FOR THE 21ST CENTURY 519 (2010).

[9] *See* BLASI, KRUSE & BERNSTEIN, *supra* note 3, at 86. *See* Anat Alon-Beck, *Unicorn Stock Options—Golden Goose or Trojan Horse*, 2019 COLUM. BUS. L. REV. 107 (2019).

[10] *See infra* Part IV the ways in which employees can become stockholders.

[11] *See* Roy Shapira, *Corporate Law, Retooled: How Books and Records Revamped Judicial Oversight*, 42 CARDOZO L. REV. (forthcoming 2021), https://ssrn.com/abstract=3600935. *See* George S. Geis, *Information Litigation in Corporate Law*, 71 ALA. L. REV. 407, 410, 414 (2019) (purporting that "it is becoming increasingly clear that information litigation is starting to play a much greater gatekeeping role for corporate governance problems" and that "[i]nvoking the right magic words—such as 'I want to value my stock'—should not automatically open the doors to sensitive prospective corporate data").

[12] *See infra* Part III.

parties cannot contract around.[13] To illustrate their importance, note that inspection rights in Delaware cannot be waived by the corporation's bylaws or certificate of incorporation.[14] However, it is unclear whether inspection rights can be waived by contract.

Many tech firms, including unicorns, are taking advange of this arbitrage by adopting a new practice that contracts around stockholder inspection rights and compels employees to waive their rights as stockholders under Delaware General Corporation Law ("DGCL") Section 220.[15] This is done through private ordering, where the firm requires that the employees waive the right *ex-ante*, by entering into a separate conatrct with the employee enter – the stock option agreement.[16] The employee signs the stock option agreement, which contains a waiver clause entitled, "Waiver of Statutory Information Rights."[17] By signing this waiver, the employee relinquishes her

[13] *See* Jill Fisch, *Stealth Governance: Shareholder Agreements and Private Ordering*, 99 WASH. U.L. REV. (forthcoming 2022); Gabriel Rauterberg & Eric Talley, *Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, 117 COLUM. L. REV. 1075 (2017); Lucian Arye Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U.L. REV. 489, 496 n.16 (2002) (providing "the duty of loyalty of corporate directors" as an example of mandatory corporate governance regulation); Jill E. Fisch, *Picking a Winner*, 20 J. CORP. L. 451, 458 (1995); Bernard S. Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 551-53 (1990) (citing self-dealing rules as one example of mandatory law); Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1486 (1989) (arguing that self-dealing rules are "largely mandatory, at least for publicly held corporations"); Randall S. Thomas, *What Is Corporate Law's Place in Promoting Societal Welfare?: An Essay in Honor of Professor William Klein*, 2 BERKELEY BUS. L.J. 135, 139 (2005) (stating self-dealing rules are mandatory for public corporations); Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, 89 NW. U. L. REV. 565, 607 n.164 (1995) (claiming that the rules on self-dealing by managers are mandatory). DEL. CODE ANN. tit. 8, § 122(17).

[14] Cochran v. Penn-Beaver Oil Co., 34 Del. 81, 88 (1926) (holding that a charter provision that "permits the directors to deny any examination of the company's records by a stockholder is unauthorized and ineffective"); Rainbow Navigation, Inc. v. Pan Ocean Navigation, Inc., 535 A.2d 1357, 1359 (Del. 1987) (the shareholders' right of inspection "can only be taken away by statutory enactment"); BBC Acquisition Corp. v. Durr-Fillauer Med., Inc., 623 A.2d 85, 90 (a shareholder's inspection rights "cannot be abridged or abrogated by an act of the corporation").

[15] *See, e.g.,* DEL. CODE ANN. tit. 8, § 220 (2006); compare to MODEL BUS. CORP. ACT §§ 16.02- 16.03 (requires corporations to provide shareholders with annual financial statements).

[16] *See infra* Part III, G on private ordering.

[17] The employees waive their inspection rights of the following materials: company stock ledger, a list of its stockholders, other books and

stockholder rights to inspect the firm's books and records under section 220 of the DGCL.[18]

Stockholder inspection rights are one of the most powerful fundamental rights in corporate law because they allow stockholders to inspect nonpublic company information. Inspection rights address the problem of information asymmetry, which is inherent in all companies, and especially privately-held startup firms.[19] These rights were designed to allow a stocksholder to gain access to nonpublic information so that the stockholder can protect her economic interests, make informed decisions and hold the company fiduciaries accountable by subjecting them to oversight.[20]

Section 220 of the DGCL not only provides an important protection to a stockholder by allowing her to seek inspection of the books and records of a Delaware corporation to investigate potential wrongdoings, but is also used as an important tool in litigation for pre-filing investigations. In recent years, there has been a rise in the general use of Section 220 by the plaintiff's bar.[21] This rise is partly attributed to Delaware courts' decisions such as *Corwin*,[22] which raised the pleading standard for stockholder plaintiffs. Prior to filing a stockholder derivative or post-merger damages suit, stockholders are encouraged to seek books and records under Section 220 of the DGCL. Without the information gathered from a books and records request, a plaintiff's suit is likely to be thrown out as an insufficient pleading.

Inspection rights under Section 220 can be an important tool for hundreds of thousands of tech workers around the country who received equity awards from unicorns (or other tech firms) in return for their sweat labor and are now questioning the worth of their shares.[23] Unicorn firms raise money at a billion-dollar valuation but are not required to be audited by an independent auditor before issuing equity compensation to unaccredited or unsophisticated purchasers—their

---

records, and the books and records of subsidiaries of the company. The waiver is in effect until the first sale of common stock of the company to the public.

[18] *See* Shapira, *supra* note 11; Geis, *supra* note 11.

[19] *See infra* Part V.

[20] *See infra* Part III on stockholder inspection rights.

[21] *See* William Gornall & Ilya Strebulaev, *Squaring Venture Capital Valuations with Reality* 2 (Nat'l Bureau of Econ. Research, Working Paper No. 23895, 2017). *See also* Robert P. Bartlett, III, *A Founder's Guide to Unicorn Creation: How Liquidation Preferences in M&A Transactions Affect Start-up Valuation*, *in* RESEARCH HANDBOOK ON MERGERS & ACQUISITIONS 123 (Claire A. Hill & Steven D. Solomon eds., 2016).

[22] Corwin v. KKR Fin. Holdings, LLC, 125 A.3d 304 (Del. 2015).

[23] *See infra* Part IV,D on unicorn valuation.

employees.[24] The problem of inaccurate unicorn firm valuation is very severe and limits the ability of employees to understand the true value of their equity compensation.[25]

With the rise in the number of unicorn firms in the U.S., there is a need for more certainty in the exercise of this inspection right. The employees do not have access to financial reports, and in many cases, are denied access to such reports, even if they ask for them. Some startup founders, investors and their lawyers recently systematically abused equity award information asymmetry to their benefit. They were able to do so thanks to change in our securities laws, which limit the type of information that employees receive as stockholders. Unicorn employees are left with no choice but to turn to the courts for help to get access to such information.[26] As a result, there is a wave of litigation concerning books and records demands by unicorn employees.[27]

This Article tracks this new development and presents the following questions: Can stockholder rights be waived? Should Delaware Courts enforce these contractual limits on stockholder rights? This issues surrounding stock option awards are a hot topic in Silicon Valley, especially due to the rise in disputes between Venture Capital - backed unicorns and their employees.[28]

To illustrate this predicament, this Article will introduce the *Domo* and *JUUL* cases. This new development became popular following the *Domo* case and its extensive press coverage. Relying on a hand-collected data set consisting of SEC's public filings, which included tech companies that filed an Initial Public Offering ("IPO") prior to and following *Domo*, I found that many firms started requiring that their employees sign a waiver clause entitled, "Waiver of Statutory

[24] *See infra* Part IV.

[25] *See infra* Part III.

[26] See *infra* Part III, A, the JOBS Act and following legislation leave employees vulnerable (as investors in their companies) and subject them to the discretion of majority shareholders.

[27] This Article will also mention the differences between a state like Delaware, compared to New York or California. Corporate law is governed by state law, and changes from state to state in the United States. Generally, it is customary that Delaware courts are more management friendly, whereas New York and California courts protect shareholders.

[28] David Priebe, *Document Inspection Rights for Shareholders of Private Companies*, DLA PIPER, https://www.dlapiperaccelerate.com/knowledge/2017/document-inspection-rights-for-shareholders-of-private-companies.html (last visited Mar. 5, 2021).

Information Rights."[29] I also discovered that the National Venture Capital Association (the "NVCA") recently updated its model legal documents to incorporate this waiver clause.[30] Accordingly, many law firms have updated their clients' stock option restriction agreement templates to include this waiver provision.[31]

It also makes the following contributions to the literature. First, it proposes amending the DGCL to expand statutory inspection rights under Section 220 to include stock-option-holders. Second, it exposes a new practice of employers requiring their employee stock-option-holders/stockholders to waive inspection rights in an option exercise form. Finally, it weighs in on whether such waiver should be enforceable by a court. It puts forward the competing arguments and policy considerations for and against enforcing a stockholder inspection rights waiver. It fills the gap in the case law and evaluates whether a contract between the company and its employees, which operates independently and outside the charter or bylaws, can modify or eliminate the mandatory inspection rights expressly set forth in the DGCL. The Delaware Chancery court will have to answer this question in the future. The resolution of this issue will have tremendous influence on corporate law, litigation, and practice.

This Article proceeds as follows. Part II introduces the role of stockholder inspection rights in corporate law. It sheds light on a new practice requiring unicorn employees to sign a waiver clause entitled, "Waiver of Statutory Information Rights."

Part III presents empirical findings, which reveal that 97% of the unicorn firms in the United States choose to incorporate in Delaware. Part III Parts IV explains the design of a stock option agreement—its original design and new changes. Part V considers how the problem of inaccurate unicorn firm valuation affects unicorn employee bargaining power. Part VI calls for the Delaware courts and legislature to provide protection for minority stockholders and stock-option-holders from oppression and mismanagement by the majority. Part VII concludes by suggesting reforms that may improve governance in unicorn firms.

---

[29] The employees waive their inspection rights of the following materials: company stock ledger, a list of its stockholders, other books and records, and the books and records of subsidiaries of the company. The waiver is in effect until the first sale of common stock of the company to the public.

[30] *See infra* Part III.

[31] *See infra* Part II.

II. The Role of Stockholder Inspection Rights in Corporate Law

Stockholder inspection rights are one of the most powerful fundamental rights in corporate law. They allow stockholders to inspect nonpublic company information to mitigate agency problems and asymmetry of information. Access to nonpublic information allows the stockholder to protect her economic interests, by making informed decisions, holding the company fiduciaries accountable and subjecting them to oversight.

The following is an explanation of the importance of information rights to deal with bargaining inequality.

A. Bargaining Inequality, Assymetric Information and Agency Costs

Employees who are stockholders or stock-option holders experience inequality in bargaining power, which is why the mandatory inspection rights rules of corporate law are so important and should not be waived easily. Their firm, employer, has more negotiation power and can bargain for more favourable terms.

Inspection rights are an important tool for stockholders in privately-held firms for the following reasons. Employees who invest in their firms and become stockholders, usually experience fundamental information inadequacies when compared to the founder (or management) of the firm. There is always uncertainty concerning the potential or success of the entrepreneur's product, impact or research.[32] Investment in private firms inherently involves information

[32] *See* PAUL A. GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 127 (1999) (entrepreneurs and budding companies, by their very nature, are associated with considerable levels of uncertainty. There is uncertainty concerning the success of the entrepreneur's product or research, which in turn affects the decisions of the firm's executives, the motivation of investors to advance capital and the intention of suppliers to extend credit.).

asymmetry[33] and uncertainty, as well agency problem,[34] which contribute to "adverse selection," where investors have difficulty with screening and selecting entrepreneurs.[35] The markets for allocating risk capital to private startups are inefficient.[36] Therefore, access to private nonpublic information is incredibly important to protect stockholders.

Note that we do not have a separate corporate law for private or public firms. However, there are fundamental differences between a

---

[33] Laura Lindsey, *Blurring Firm Boundaries: The Role of Venture Capital in Strategic Alliances*, 63 J. FIN. 1137 (2008); *See also* GOMPERS & LERNER, *supra* note 32, at 128 (discussing the asymmetric information problem, which arises because the entrepreneur, due to her daily involvement with the firm, knows more than the prospective partners, investors or suppliers, about her company's outlook).

[34] *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,* 3 J. FIN. ECON. 305, 309 (1976) ("[T]he problem of inducing an 'agent' to behave as if he were maximizing the 'principal's' welfare is quite general. It exists in all organizations and in all cooperative efforts . . . .").

[35] *See* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84(3) Q. J. ECON. 488, 493 (1970) (Akerlof discusses the "adverse selection" problem, as well as firms' offerings of equity that may be associated with the "lemons" problem); *see also* Manuel Utset, *Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital Financed Firms*, 2002(1) WIS. L. REV. 45, 56 (2002); *see also* GOMPERS & LERNER, *supra* note 32, at 129.

[36] *See* GEORGE S. FORD, THOMAS M. KOUTSKY & LAWRENCE J. SPIWAK, PHOENIX CTR., DISCUSSION PAPER, AN ECONOMIC INVESTIGATION OF THE VALLEY OF DEATH IN THE INNOVATION SEQUENCE (Aug. 2007) http://www.osec.doc.gov/Report-Valley%20of%20Death%20Funding%20Gap.pdf; *see* LEWIS BRANSCOMB & PHILLIP AUERSWALD, U.S. DEP'T OF COMMERCE, BETWEEN INVENTION AND INNOVATION: AN ANALYSIS OF FUNDING FOR EARLY- STAGE TECHNOLOGY DEVELOPMENT, ADVANCED TECHNOLOGY PROGRAM, NATIONAL INSTITUTE FOR STANDARDS AND TECHNOLOGY (NIST), NIST GCR 02841 (Nov. 2002), http://www.atp.nist.gov/eao/gcr02-841/gcr02-841.pdf; *see also* PHILLIP AUERSWALD, LEWIS BRANSCOMB, NICHOLAS DEMOS & BRIAN MIN, U.S. DEP'T OF COMMERCE, UNDERSTANDING PRIVATE-SECTOR DECISION MAKING FOR EARLY-STAGE TECHNOLOGY DEVELOPMENT, A "BETWEEN INVENTION AND INNOVATION PROJECT" REPORT, NATIONAL INSTITUTE FOR STANDARDS AND TECHNOLOGY (NIST*),* NIST GCR 02-841A (Sep. 2005), http://www.nist.gov/tpo/sbir/upload/gcr02-841a.pdf; *see also* Ederyn Williams, *Crossing the Valley of Death*, INGENGIA, Dec. 30, 2004, at 21, http://www2.warwick.ac.uk/services/ventures/valley.pdf (discussing valley of death in the U.K.); *see also* Philipp Marxgut*, Interview with Charles Wessner, Director of the Program on Technology, Innovation, and Entrepreneurship at the National Academy of Sciences*, BRIDGES, Oct. 16, 2008, at 19, http://ostaustria.org/bridges-magazine/volume-19-october-16-2008/item/3585-innovation-policy-in-the-us-an-interview-with-charles-wessner.

owning stock in a publicly-held versus a closely-held corporation. In the public corporation context, if a stockholder is dissatisfied with the ways in which the firm is managed or with the value of her stock, she can simply call her stock broker, or use an app, and sell her stock on the market. In the private (closely-held) corporation context, the stockholder is "locked -in" and will typically find it very hard, if not forbidden by contract, to sell her stock and get liquidity.[37] Capital lock-in refers to a situation where a stockholder is not able to withdraw or "redeem" the capital that she contributed to the firm freely.[38] She cannot force the firm to distribute assets or buy back her shares.[39]

An investment in a private firm is therefore inherently risky. Inpection rights are designed to mitigate some of these information assymentry and agency problems. In return for investment capital, the entrepreneur agrees to disclose credible information about her firm to the inevstor, and to continue to disclosure such information following the initial investment, so that the investor will be motivated to invest in the company. This reduces costs. Inspection rights provide the stockholder with a way to access valuable information about the private company's operations and financial performance. An investor may not have an economic incentive to invest in a private firm, if she did not have the ability to monitor the entrepreneur and value her interest in the company.

Employees do not have the same protections or bargaining powers, such as typical sophisticated investors in startup, i.e., venture capital (VC) investors. VCs can negotiate for and get voting-control provisions and other inspection rights. They are represented by lawyers that will probably flag such a waiver, and not allow their clients to sign such a provision, without negotiations. VCs are sophisticated investors, and as such will always negotiate for and receive several protections in their investment documents. Employees typically are not able to negotiate for the same protections. As explained in greater detail below, the stock option agreement that employees sign ties them with "golden hancuffs" to the firm.[40] The agreement is designed to attrack, engage and retain employees. Most employees would not be able to bargain

[37] *See* Alon-Beck, *supra* note 9.

[38] *See* Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1, 6 (2012). *See also* Margaret M. Blair, *Reforming Corporate Governance: What History Can Teach Us*, 1 BERKELEY BUS. L.J. 1, 26 (2004).

[39] *See* Ibrahim, *supra* note 38. *See also* Blair, *supra* note 38, at 14, 26 (citing early corporate charters and statutes that limited withdrawals to formal corporate dissolution).

[40] "Golden handcuffs" refer to benefits that an employer provides to employees to discourage the employee from taking employment elsewhere.

away from the predominant practice of equity incentive plans, because to do so might send a hostile signal to the market and to their employer, which they would like to avoid.[41]

Many employees probably do not understand the risks associated of owning their company stock (or more accurately, options), as compared to other types of diversified investment alternatives. The Zuber example bellow illustrates the risks associated with exercising stock options while the company is still private, and moreover the adverse tax effects of such an investment decision. It is risky to extrapolate past performance into the future, even when employees work for a large private company that has historically done well.

Moreover, and more importantly, the problem of inaccurate unicorn firm valuation is a well-known and documented problem in the finance literature. This information asymmetry problem is very severe because it prevents unicorn employees from accurately valuing their stock options and making informed investment decisions. A decision on whether to exercise the stock option in order to gain standing in a potential lawsuit or be able to file a demand with a company to access stockholder information rights is a financial investment decision. The unicorn employee does not know if her stock options are worth anything without access to information.

B. *Zuber* Example

To illustrate this predicament imagine you just received a job offer from a unicorn firm—Zuber. If you accept the offer, you will receive an annual salary of $200,000 and 100,000 stock options. You need to figure out exactly how much the Zuber stock options are worth because a stock option award is different from a straightforward stock award. Note that as a stock-option-holder, you are not a shareholder yet. A stock-option-holder merely has an option, which is a contractual right to purchase a set number of shares in the future. If you accept this offer, then later on you will need to make an investment decision—i.e., a decision to exercise the options and purchase the stock or not.

If Zuber was a publicly-traded company, this decision on whether to exercise Zuber options would be easy, all you would have to do is look at Zuber's stock trading price and decide. But, remember,

[41] *See* Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms and the Self Governing Corporation*, 149 U. PA. L. REV. 1619 (2001).

Zuber is not a publicly-traded firm, instead, it is a unicorn. A unicorn is a type of privately-held firm, which means that you will not find accurate public information about Zuber's share price.

There is always a risk associated with exercising stock options when the company is private because the stock can be "underwater." Underwater means that you paid more for the stock than it is worth (according to current market price). If the purchase price (the "exercise") for the stock option is higher than the market price for the stock after the company goes public or is acquired, then the you will lose on your investment in the company.

To illustrate this point, let's return to our hypothetical: if you received stock options with an exercise price of $6 per share, then you will pay the company (Zuber) $6 per share to purchase the shares. So you will pay $600,000 for 100,000 shares of Zuber. But what if Zuber decides to go public and, unfortunately for you, the Zuber stock only trades for $2 per share following the IPO. In this scenario, you paid more for the shares ($600,000) than they are worth because the market price is lower ($200,000) than you anticipated. Note that exercising options will not generate a tax loss (of $400,000). Therefore, as an employee, you cannot apply this loss against your income. In this scenario, you basically paid for the privilege of working for Zuber.

Unfortunately, this is not the only or main problem associated with exercising the options. There are also important and detrimental tax issues. If you work for Zuber and decide to exercise your options (or settle your RSUs), then you will have an immidiate tax liability. You will have to pay taxes on profit that might never materialize. It means that you have to pay out of pocket for both the strike price and the tax. Many unicorn employees may not be able to raise enough cash to pay for these expenses because of the high valuations of their firms (remember, unicorn firms are worth over $1 billion dollars).[42]

---

[42] Exercising incentive stock options can trigger the alternative minimum tax. *See Fundamentals of Equity Compensation*, PAYSA, https://www.paysa.com/resources/fundamentals-of-equity-compensation [https://perma.cc/DKW3-X9J8] (last visited Aug. 2, 2018). Although Congress did not repeal the alternative minimum tax, it significantly increased the income exemption and phase-out amounts, leaving fewer startup employees who receive stock options subject to the tax. *See Six Ways Tax Reform Affects Your Stock Compensation and Financial Planning*, MYSTOCKOPTIONS.COM, https://www.mystockoptions.com/articles/index.cfm/ObjectID/22615723-D31E-CCDF-68284D3C456C3E3A [https://perma.cc/HJ6Z-ANGT]. There is a new Internal Revenue Code § 83(i), which allows certain individuals, if certain conditions are met (such as the underlying stock is eligible stock and the corporation is an eligible corporation), to defer tax liability on the income

Unicorns are private firms and no one really knows what the future will bring. Their past performance, even if is a solid one, is not necessarily a good predictor of their future performance. Most rank and file employees are naïve and should not be considered as insiders for the purposes of making such an investment decision.[43] They do not have inside information on the firm's long-term prospects. At some point, as explain in further detail below, they will need to decide on whether to exercise or forfeit their options, without a guarantee that there will be an IPO in the future. Furthermore, unicorn employees do not have downside protection as common shareholders.

Unicorn employees become common shareholders when they exercise their options. There are different types of stock, including common and preferred. What it means to ows common shares is that the Zuber employee, as a common stockholder will be last in line to be paid in the event of a sale or other types of distribution.[44] If Zuber is sold to another in a fire sale in the future, then it is probable that Zuber employees will end up with nothing. The case of *Good Technology* ("Good") explain this problem of lack of downside protection.[45]

Good was a successful unicorn firm that ultimately sold in a fire sale for almost half this value after running into financial distress. News of the fire sale came as a shock to Good's employees. One day the employees, who were common shareholders, basically discovered that the value of their stock in the firm went down substaintially from $4.32 to 44 cents a share.[46] The investors, on the other hand, who held onto Good's preferred share, were able to recover their investment in the firm and get paid from the sale.[47]

---

earned from exercising options (or settlement of RSUs) for up to five years. This is intended to mitigate the problem described above concerning NSOs (and RSUs). For more on this, see Alon-Beck, *supra* note 9.

[43] For more on naïve employees, see Bubb, Corrigan and Warren, who are criticizing federal retirement plans policy. They postulate that employees are naïve and the current structure of the labor market gives employers strong incentives to offer matching contributions that exploit the employees. *See* Ryan Bubb, Patrick Corrigan & Patrick L. Warren,, *A Behavioral Contract Theory Perspective on Retirement Savings*, 47 CONN. L. REV. 1317, 1323 (2015).

[44] A sale of a startup is more likely to happen today than an IPO. See empirical research on this below.

[45] *See* Abraham J.B. Cable, *Fool's Gold? Equity Compensation & The Mature Startup*, 11 VA. L. & BUS. REV. 613, 614-16(2017).

[46] Matt Levine, *Good Technology Wasn't So Good for Employees*, BLOOMBERG OPINION (Dec. 23, 2015, 5:35 PM), https://www.bloomberg.com/opinion/articles/2015-12-23/good-technology-wasn-t-so-good-for-employees.

[47] *Id.*

Prior to the fire sale, several Good employees took on loans to pay for the taxes to exercise their stock options. These employees never profited from their investment in the firm because the loan amounts (to pay for the tax bills) were much larger than what their stock was worth after the sale. Good is a cautionary tale concerning employees as investors, who believed in the company and had no idea about its financial distress.[48]

To summarize, unicorn employees need access to information in order to make an informed decision, especially due to the fact that pre-IPO unicorn valuations are very high. Companies design stock option plans to allow the company to conserve cash while sharing ownership with employees and increasing the productivity of the employees. Additionally, in a recent Delaware case, *Riker v. Teucrum Trading, LLC*,[49] the Delaware Court of Chancery addressed a demand for books-and-records by an LLC member, and specifically recognized that valuation is a well-established statutory proper purpose. Rather, the focus in the case was on whether the documents requested were necessary in order to perform a valuation. However, there is still a lot of uncertaintly in this area.

In *JUUL*, the Delaware Court decided not to decide on whether a waiver of DGCL section 220 rights would be enforceable or not. There is a lot of ambiguity in the case about a potential resolution on this issue, as noted correctly by a prominant Delaware litigator nd commentator Francis G.X. Pileggi.[50] On the one hand, Although at footnote 14 the Court provides citations to many Delaware cases that sowed doubt about the viability of that position–but then the Court also cited cases at footnote 15 that more generally recognized the ability to waive even constitutional rights.

[48] Tania Babina, Paige Ouimet & Rebecca Zarutskie, *Going Entrepreneurial? IPOs and New Firm Creation* (FEDS, Working Paper No. 2017-022), https://ssrn.com/abstract=2940133. Babina et al.'s results suggest a new potential cost of the IPO that firms should factor into their IPO decision: losing entrepreneurial-minded employees.

[49] Riker v. Teucrum Trading, LLC, C.A. No. 2019-0314-AGB (Del.Ch. May 12, 2020).

[50] *See infra* Part IV.

This Article highlights the fact that there are importnat differences between stock-holders and stock-option-holders concerning information rights. Note that a stock-option-holder is not yet a shareholder and does not have the same protection under the law as a stock-holder. Only a stockholder in a private company has a statutory and common law right to access information about the company. If a stockholder demands information (i.e., accessing books and records) but is refused by the company, then it is considered a violation of the stockholder's information right, which can be the basis of a stockholder oppression lawsuit. The stockholder can thus turn to the courts and seek judicial remedies that were designed specifically to enforce a stockholder's information rights.

But, what about stock-option-holders? They do not have this right or any protection. Therefore, this Article is proposing below an amendment to the Delaware General Corporation Law, which would expand the statutory inspection rights under Section 220 to specifically include stock-option-holders.

The following explains the statutory design on stockholder inspection rights.

C. The Statutory Design of Stockholder Inspection Rights

Stockholder inspection right originated from the common law of England. The right was recognized in England as early as 1745.[51] The right under English rule was not absolute, but rather had several restrictions, such as that the shareholder had the right to inspect the books of the corporation at reasonable times, the inspection had to be in good faith and for a proper purpose.[52] The idea behind this right was to provide shareholders with disclosures, which can improve efficiency and reduce information asymmetries.

Many states in the U.S. followed the English courts and codified this rule in their own statutes and applied it in their case law.[53]

---

[51] *See* Dominus Rex v. The Fraternity of Hostmen in Newcastle-Upon-Tyne 2 Str. 1223, 93 Eng. Rep. 1144 (K.B. 1745). The early English case of Dominus Rex was one of the first cases to recognize the right of stockholders to inspect corporate books. *See* William T. Blackburn, *Shareholder Inspection Rights*, 12 SW. L.J. 61 (1958).

[52] *See* William T. Blackburn, *Shareholder Inspection Rights*, 12 SW. L.J. 61 (1958).

[53] *See* JONES DAY, THE TOOLS AT HAND: INSPECTION OF CORPORATE RECORDS, https://www.jonesday.com/files/Publication/70e4b38e-e3e9-

Twenty four (24) states adopted the Model Business Corporation Act ("MBCA"), which is a model act prepared by the Committee on Corporate Laws of the Section of Business Law of the American Bar Association. According to Section 16.02 of the MBCA, inspection rights are mandatory immutable rules of law, which means that they cannot be waived by the parties like default rules.[54]

The Model Business Corporation Act (MBCA) Section 16.02 includes the following language on shareholder inspection:[55]

> "The right of inspection granted by this section may not be abolished or limited by a corporation's articles of incorporation or bylaws."

Not surprisingly, Delaware did not adopt the MBCA, but rather codified it's own comparable version of inspection rights. Many courts today look to Delware case law when they are required to interpret inspection rights according to their own statutes.[56]

Section 220 of the Delaware General Corporation Law ("DGCL") also balances the rights of stockholders and management. On the one hand, it provides important protections to stockholders by allowing them to exercise their ownership rights and inspect the books and records of a Delaware corporation. On the other, it also protects the firm and management. DGCL Section 220 is not an absolute right. There are hurdles. A shareholder that wants access to information must have standing and proper purpose.

The DGCL Section 220 states, in part:

> (b) **Any stockholder**, in person or by attorney or other agent, shall, **upon written demand** under oath stating the purpose thereof, have the right during the usual hours for business **to inspect for any proper purpose**, and **to make copies and extracts from**:
> **(1) The corporation's stock ledger, a list of its stockholders, and its other books and records;** and

---

4718-b4c9-a04247277901/Presentation/PublicationAttachment/f4507208-1c42-4add-a976-1dd7735d526e/ToolsAtHand.pdf

[54] *See also* Geis, *supra* note 11, at 429 (questioning the ability of states that adopted the MBCA to allow parties to contact around this provision).

[55] MODEL BUS. CORP. ACT § 16.02(F) (AM. BAR ASS'N 2016).

[56] *See* JONES DAY, *supra* note 52. *See* Arctic Fin. Corp. v. OTR Express, Inc., 72 Kan. 1326, 1331, 38 P.3d 701, 703 (Kan. 2002); *see also* Danzinger v. Luse, 815 N.E.2d 658 (Ohio 2004).

> (2) A subsidiary's books and records…(emphasis added)

The inspection right is not absolute due to the understanding that there is a need to protect the firm from frivolous or meritorious lawsuits, and to protect the firm's proprietary information. To have standing in court, the employee, as a shareholder, must first overcome the following hurdles.

1. Standing - Shareholder of Record Requirement

There is a big difference between holding stock (equity ownership) and holding stock options (promise of equity). A stock option is not a grant of stock and therefore does not confer shareholder status. Stock-option-holders merely have a contractual right (but not an obligation) to acquire stock in the future. A stock-option-holder may exercise her option at a predefined price ("exercise price") if certain conditions are met.

To have stading in court, the employee has to be a shareholder of record. As noted, owning stock options does not qualify the employee as a shareholder. Rather, the employee must first exercise her options (after they vest), buy the shares and only then she becomes a shareholder (and thus become eligible to demand to inspect her employer's books and records). Founders and investors usually get outright stock in the company, whereas startup employees get stock options.

Stock-option-holders do not have standing under Section 220, unless they become shareholders. The decision to exercise the options and become a stockholder is problematic without access to information for the following reasons. There is always a great economic risk associated with exercising stock options when the company is private. This risk arises because of asymmetry of information and uncertainty.

Unicorn employees at many of the largest private (but secretive) startups across the country are uninformed about their rights, their firm's equity structure, or its overall finances.[57] Despite the fact that they work for the company, unicorn employees are naïve and should not be treated as traditional insiders.[58] In the economic literature,

---

[57] A unicorn is a large privately held venture-capital ("VC") backed company that is valued at over $1 billion (a "unicorn").

[58] For more on naïve employees, see Bubb, Patrick and Warren, *supra* note 42, who criticize federal retirement plans policy. They postulate that employees are naïve and the current structure of the labor market gives

employees who are insiders are compared to gamblers or lottery winners, who have access to information and are well-positioned to monitor their company's progress.[59] Under these theories, the insiders' economic incentives are aligned with those of the founders', which is not the case for unicorn employees, as illustrated below.

Employees that work for a small sized startup can very well be regarded as insiders who have information on the operations and status of the firm. Unicorn employees, on the hand, work for very large, even quasi-public companies with thousands of employees.[60] They are not necessarily privy to nonpublic information on the firm's performance. Addisionally, as investors in private firms, they are locked-in and do not have a way of disciplining the firm's managers by threatening to withdraw their capital from the firm, which further contributes to governance problems within the firm.[61]

2. Proper Purpose - The "Demonstration" Requirement

Proper purpose is another hurdle that is rooted in common law tradition. Even if the employee becomes a shareholder of record after exercising her stock options, the inspection right is not absolute but rather conditional. After exercising her options, the employee who became a new shareholder must "demonstrate a proper purpose for making such a demand." The DGCL statute defines a "proper purpose" as "a purpose reasonably related to such person's interest as a stockholder."

Until recently, it was not clear whether an employee-shareholder could establish a proper purpose when that purpose is to ascertain the value of her stock. However, Delaware Vice Chancellor Travis Laster in *Woods v. Sahara Enterprises, Inc.*, clarified that a

---

employers strong incentives to offer matching contributions that exploit the employees. *See id.*

[59] For a further discussion on employee incentives, see generally Anderson, *supra* note 6 (discussing the status of employee options as securities); Bodie, *supra* note 6 (focusing on the availability of Rule 10b-5 actions); Smith, *supra* note 4 (focusing on the law and economics of equity compensation as private ordering); and Jensen & Murphy, *supra* note 6 (advocating for equity compensation as a form of incentive-based executive pay).

[60] *See also* Cable, *supra* note 44, at 616-17.

[61] *See* Larry E. Ribstein, *Should History Lock in Lock-in?*, 41 TULSA L. REV. 523, 524–25 (2006); *see also* Darian M. Ibrahim, *supra* note 38, at 6-7.

stockholder demanding corporate records under Section 220 is not required to explain *why* the stockholder wants to value her interest in the company to satisfy the recognized proper purpose of valuation.[62]

The court also provided a list of "proper purposes" that can be shown to satisfy Section 220.[63] Proper purpose typically exists when a stockholder alleges or demostrates a credible basis to suspect that the company has engaged in wrongdoing, or the board of directors breached their fiduciary duty.

The Delaware Supreme Court in *Lebanon Cnty. Emps. Ret. Fund v. Amerisource Bergen Corp.*, clarified the circumstances in which stockholders are entitled to demand books and records to investigate allegations of mismanagement.[64] This decision further suggests an inclination by Delaware courts to permit plaintiffs (who are stockholders) to use Section 220 to get "pre-lawsuit" discovery, even if it seems that there is no credible basis to believe there are actionable claims.[65]

Additionally, there are new Delaware court decisions that have clarified the different types of documents that may be obtained under a Section 220 demand, which include, in limited circumstances, even communications such as personal emails or text messages.[66] No surprisingly, these is an increase in the number of Section 220 demands in recent years. The more stockholders use this investigation tool, the more potential for stockholders to file derivative lawsuits against directors and officers.

These developments perhaps encourage corporate attorneys to innovate, take advantage of bargaining inequality and put limits on information rights of certain stockholders - employees. Lawyers are paid to come up with new ways and practices to protect their clients,

---

[62] *See* Woods v. Sahara Enters., Inc., C.A. No. 2020-0153-JTL, slip op. at 11, 14-15 (Del. Ch. July 22, 2020). Additionally, according to the decision in *Amerisource*, stockholders may state broader purposes for investigations under section 220. Lebanon Cnty. Emps' Ret. Fund v. AmerisourceBergen Corp., C.A. No. 2019-0527, 2020 WL 132752 (Del. Ch. 2020).

[63] *See Woods*, slip op. at 8-9.

[64] If a stockholder seeks to investigate credible allegations of mismanagement, they have to meet a low bar.

[65] Roger A. Cooper, Mark E. McDonald, Pascale Bibi & Kal Blassberger, *Delaware Supreme Court Clarifies Section 220's "Proper Purpose" Test*, CLEARY GOTTLIEB (Dec. 16, 2020), https://www.clearymawatch.com/2020/12/delaware-supreme-court-clarifies-section-220s-proper-purpose-test/.

[66] *See* KT4 Partners LLC v. Palantir Techs. Inc., No. 281, 2018, C.A. No. 2017-0177-JRS (Del. Jan. 29, 2019).

which are the firm and its management team. Thanks to cases like *Domo* and *Woods*, corporate lawyers who represent unicorn firms, decided to innovate with a new practice—one that compels employees to waive their inspection rights under Section 220 as a condition to receiving stock options from the company.

D. Exploitation and Market Power

There are benefits and costs associated with disclosure, which affect the cost of capital when there is information assymetry.[67] If private firms choose to disclose information to their stockholders generally, it reduces the information assymetry between the stockholders (investors) and managers, which also reduces the cost of capital. It improves the liquidity of the stock and contributes to more demand from other investor groups.

Information is power and disclosure is very important to unicorn firms. Our intellectual property laws do not protect valuable tacit knowledge (as opposed to formal, codified or explicit knowledge). Tech companies cannot easily use patent or trade secret, for example, in a way to prevent or deter imitation of tacit knowledge. Additionally, the current market dynamics lead to concentration in the economy (in tech digital industry). There is a decline in competition in the technology sector. Both public and private larger tech firms, are taking advange of these market conditions to weaken competition and leverage their dominant position to strengthen their hold on the market.

Unicorns are spending a lot of reasources to keep information private. Leakage of proprietary information about the firm can be used by the firm's competitors and hurt the firms competitive advantage. Unicorn firms, which are leading large tech companies, spend a lot of resouces on innovation, new technology and secrecy to maintain their market dominance. Such firms are very protective of financial and other proprietary information about their business affairs. Unicorns generally do not disclose this sort of information to anyone except for major stockholders, who are able to protect their interests and specifically negotiate for contractual provisions such as for exit or voice.

---

[67] Douglas W. Diamond & Robert E. Verrecchia, *Disclosure, Liquidity, and the Cost of Capital,* 46(4) J. FIN. 1325 (1991) (showing that revealing public information to reduce information asymmetry can reduce a firm's cost of capital by attracting increased demand from large investors due to increased liquidity of its securities).

Tech firms have an incentive to protect their knowledge resources from imitation by others, because it helps the firm to generate rents from this valuable knowledge. One of the most common ways for leakage to competitors is through employee mobility across firms. (Almeida, 1996; Almeida and Kogut, 1999; Rosenkopf and Almeida, 2003). Tech employees are the human capital that contributes to the knowledge in the firm.

There are several ways to protect knowledge leakage when employees leave to go work for a cometing firm, such as non-disclosure agreements (NDAs) and non-compete agreements (NCAs).[68] However, in practice, the enforcements of these contractual arrangements depends on the geographic location and the court's willingness. It is also very hard to enforce and detect knowledge spillover using these contractual arrangements, especially in innovation clusters, such as Silicon Valley, where a court might not be willing to enforce these arrangement. Therefore, corporate lawyers had to innovate and come up with another mechanism. The stock option agreement is designed to retain the employee, so that the employee does not have an incentive to compete with the firm or leave for a competitor.

There is a difference between insider and outside investor groups. It is not clear if unicorn founders trust major stockholders (preferred stockholders) to protect information, maybe. It is more likely that founders are compelled to disclose some information in order to induce investment in the firm. It all depends on the bargaining power of the founders and investors. Sophisticated accredited investors, such as VCs or alternative VCs (hedge funds and institutional investors), have bargaining power, conduct due-diligence (investigation) prior to investment, and hense decide on whether to use "voice" (voting rights) or demand exit (aggressive redemption rights) when investing in unicorns. They are sophisticated players, which are also represented by lawyers, and can use their power to engage with the management to try to institute change.[69]

---

[68] ALAN HYDE, WORKING IN SILICON VALLEY: ECONOMIC AND LEGAL ANALYSIS OF A HIGH-VELOCITY LABOR MARKET (2003); KANNAN SRIKANTH, ANAND NANDKUMAR, PRASHANT KALE & DEEPA MANI, THE ROLE OF ORGANIZATIONAL MECHANISMS IN PREVENTING LEAKAGE OF UNPATENTED KNOWLEDGE (2015); M. Marx, *The Firm Strikes Back: Non-Compete Agreements and the Mobility of Technical Professionals*, 76(5) AM. SOCIO. REV. 695 (2011); M. Marx, D. Strumsky & L. Fleming, *Mobility, Skills, and the Michigan Non-Compete Experiment*, 55(6) MGMT. SCI. 875 (2009); *see* ANNALEE SAXENIAN, REGIONAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE 128 (1996).

[69] See Alon Brav, Wei Jiang & Hyunseob Kim, *Hedge Fund Activism: A Review* 2 (Working Paper, 2010),

Depending on the group of outside invetors in question, there are different contractual provisions associated with the investments in the unicorns. The parties' incentives can vary and are depended on timing of financing round, participating investors and performance of the startup.[70] VC invetors typically invest in earlier rounds than other alternative VC investors, and bargain for preferred stock, extensive control rights and control of the start-up's board of directors.[71] I find it hard to believe that such sophisticated invetors would be willing to sign a waiver of statutory inspection rights. I was not able to find any evidence of such practice.

Startup founders and their lawyers have found a new way to abuse equity award information asymmetry to their benefit when dealing with employees. Inspection rights are especially detrimental to minority common stockholders, such as employees, who are usually not represented, but still required to make an investment decision, such as exercise their stock, or leave and compete with the firm. Since employees are minority shareholders, there are not only serious agency problem, but also a conflict of interest between majority and minority common shareholders, which now plagues the corporate governance system in unicorn firms.

---

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1947049&download=yes, on institutional engagement ("early institutional shareholder activism has been plagued by many regulatory and structural barriers such as free-rider problems and conflict of interest (Black (1990)). As a result, the evidence on the effect of their activist efforts has largely been mixed (Gillan and Stark (2007)."). *See* Alex Edmans & Clifford Holderness, *Blockholders: A Survey of Theory and Evidence*, *in* HANDBOOK OF CORPORATE GOVERNANCE (Benjamin Hermalin & Mike Weisbach eds., 2017) ("Blockholders can exert governance through the threat of exit and voice, rather than only through actual exit and voice. The absence of these actions, therefore, does not imply the absence of blockholder…"); *see also* Joseph McCahery, Zacharias Sautner & Laura Starks, *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 J. FIN. 2905 (2016) ("These theories have recently been complemented by models showing that the threat of exit can also discipline management.").

[70] Anat Alon-Beck, *Alternative Venture Capital: The New Unicorn Investors*, 87 TENN. L. REV. 983 (2020).

[71] Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 970 n.9 (2006) ("preferred stock offers investors more senior rights than does common stock. Most importantly, preferred stockholders have a 'liquidation preference': a claim to the proceeds from the sale of the business that ranks ahead of claims by common shareholders. Preferred stock is said to be 'convertible' if the holder has the right to convert to a designated number of common shares. Most preferred stock issued to VCs is convertible.").

In the past, both startup founders and rank and file employees used to belong to the same class of common shareholders. Their incentives were aligned. These days, however, founders of unicorn firms are able to negotiate for other, more powerful, contractual arrangements thanks to market changes and investments from alternative and VC investors. For example, in *Unicorn Stock Options*, and *Alternative Venture Capital*, I shed light on these new practices. Founders are able to control the board of directors thanks to super voting rights and other types of contractual arrangements. These new arrangements enhance the power of founders within the firm at the expense of other employees. As a direct result of these developments, the interests of the employees and founders as common shareholders are not aligned anymore.

Unicorn founders choose to stay private for a reason. They want to have more control over the firm, protect their proprietary information, keep it secret, and prevent leakages to competitors. Founders also use the stock option agreement in order to constrain leakage from firm the to other competitors. Founders also have an incentive to avoid the high costs associated with employee turnover. Tech employees are skilled labor, and as such, they are in high demand. There is currently a shortage in talent in the global markets. This shortage in talented employees is expected to become more acute in coming years.[72]

Tech companies limit leakage of information, so that they can continue to maintain their market power, dominance and crush competition, which raises the barriers to entry for small firms. There are several geographic tech regions in the United States, but the most known ones are Silicon Valley around San Fransisco and Route 128 in Boston. These areas enjoy concentrated technology development and access to capital. This success can be attributed to several factors, including: robust investment in research and development efforts, availablility of government funding, strong linkages between academic institutions and industry, developed risk-capital networks, complementary infrastructure of suppliers (for example specialized law firms), and last but not least – a ruthless code of secrecy.[73] There are

[72] Pedro Nicolaci da Costa, *Tech Talent Scramble*, *Global Competition for a Limited Pool of Technology Workers Is Heating Up,* INT'L MONEY FUND (Mar. 2019), https://www.imf.org/external/pubs/ft/fandd/2019/03/global-competition-for-technology-workers-costa.htm.

[73] *See* BRANSCOMB & AUERSWALD, *supra* note 36.

many urban legends about retribution for employees who break the code of secrecy.[74]

It is not purprising that unicorn firms have come up with this new practice to limit stockholder inspection rights. The following is a description of the rise in use of this new contractual innovation, its wide adoption and practice.

III. THE RISE OF STOCKHOLDER INSPECTION WAIVERS

Tech founders may claim that keeping their financial information private—even from their own minority stockholders—prevents the information from falling into rival hands. They may also claim that the lack of public scrutiny also gives them freedom to invest for the long-term. However, with regards to employees, employees used to have a right to information under our securities laws. Today, unicorns rely on regulatory arbitrage, a new exemption under our securities laws, specifically Rule 701, to avoid providing their employees with disclosure of information.[75]

The following is an investigation of the factors that contributed the rise in the use of waivers.

A. SEC Continues to Ease Disclosure Obligations

Initially, our securities laws were design to protect all investors, including employees as investors. That meant that all the companies in the U.S. were required to disclose financial and other information about the offering firm, prior to offering securities to the public. Our law, specifically the Securities Act of 1933 (the "Securities Act"), required that a company that offers to sell its securities must first register the securities with the SEC. During the registration process, the issuing company disclosed certain facts, including certified financial statements, a description of it assets and business operations, management composition, etc… In the past, tech employees used to get

---

[74] Olivia Solon, *'They'll Squash You Like a Bug': How Silicon Valley Keeps a Lid on Leakers*, GUARDIAN (Mar. 16, 2018),

https://www.theguardian.com/technology/2018/mar/16/silicon-valley-internal-work-spying-surveillance-leakers.

[75] *See infra* Part V. Thanks to Rule 701, unicorns are not required to provide employees with enhanced information, especially concerning the risks associated with investing in illiquid securities of a high-risk venture that is often controlled by founders who lack management experience.

disclosures from their employers when receiving equity compensation because startups had to file a registration statement with the SEC.

Things changed. Startups today enjoy several exemptions from registration. Thanks to a series of reforms to the federal securities laws, which began in 1988.[76] In 1988, the SEC adopted Rule 701, which provides an exemption from registration to private firms, including startups, under certain circumstances. The thinking was to encourage broad based equity sharing, and the fear that SEC registration can entail significant burdonsome costs, especially for small and medium enterprises, such as startup firms.

However, a series of reforms to our securities laws, now allow startups – both very large (unicorns) and small - to enjoy the same types of exemptions from the old registration requirements.[77] The newer main legislative efforts that allow companies to use exemptions are the Jumpstart Our Business Startups Act of 2012 ("JOBS Act"), the Fixing America's Surface Transportation Act of 2015 (the "FAST Act") and the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 (the "Economic Growth Act").[78]

Clearly, large private startups continue to advocate for the SEC to ease their reporting and registration "burdens". These efforts are very successful. On November 24, 2020, the SEC proposed additional changes to Rule 701 and Form S-8 under the Securities Act of 1933, which relax additional disclosure delivery requirements under Rule

---

[76] *See* Renee M. Jones, Professor of Law and Associate Dean for Academic Affairs, Boston College Law School, Written Testimony Before the H. Fin. Servs. Comm., Subcomm. on Inv. Prot., Entrepreneurship, and Cap. Mkts. (Sept. 11, 2019), https://financialservices.house.gov/uploadedfiles/hhrg-116-ba16-wstate-jonesr-20190911.pdf (citing Alon-Beck, *supra* note 9).

[77] *Id*.

[78] For more on these Acts, see Alon-Beck, *supra* note 9. *See also* Press Release, U.S. Sec. & Exch. Comm'n, SEC Seeks Public Comment on Ways to Harmonize Private Securities Offering Exemptions (June 18, 2019), https://www.sec.gov/news/press-release/2019-97. The other legislations are: 1. The Financial CHOICE Act of 2017, which includes modernizing the Regulation D offering process and creates the "venture exchanges." 2. Crowdfunding regulations that were adopted by the SEC, which allow companies to use a crowdfunding platform (intermediary) for raising small amounts of equity capital (less than $1 million annually) from potentially large pools of investors over the internet. *See* Joan M. Heminway, *Securities Crowdfunding and Investor Protection* (Univ. of Tenn. Legal Studies Research Paper No. 292, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2810757. 3. Offerings under Regulation A+ of Title IV of the JOBS Act (Reg A+), which increased a private company's ability to make unregistered public offerings to a maximum of $50m to the public in any twelve-month period.

701, simplify the content and reduce frequency of Rule 701 disclosure, relax the deadline for Rule 701 disclosure for new hires, and more.[79]

The result of these actions and the vast exemptions to tech firms allow these firms to keep material information private longer, as they are not required to disclose information.[80] These changes directly affected employees, which used to be protected as an investor group by our securities laws.[81]

Unicorn firms rely on the exemption under Rule 701 to avoid providing employees with enhanced disclosure, such as certified financial reports. There are several approached to the types of disclosure materials according to Yifat Aran, including a maximalist, minimalist and intermediate.[82] However, there is comcensus that there

---

[79] For more info, see *SEC Proposes Changes to Rule 701 and Form S-8*, COOLEY ALERT (Dec. 1, 2020) https://www.cooley.com/news/insight/2020/2020-12-01-sec-proposes-changes-rule-701-form-s8; Press Release, U.S. Sec. & Exch. Comm'n, SEC Proposes Amendments to Modernize Framework for Securities Offerings and Sales to Workers (Nov. 24, 2020), https://www.sec.gov/news/press-release/2020-294.

[80] *See* Michael D. Gutentag, *Patching a Hole in the JOBS Act: How and Why to Rewrite the Rules that Require Firms to Make Periodic Disclosures*, 88 IND. L.J. 151, 152 (2000).

[81] STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: ESSENTIALS 23 (2008). The purpose of the Securities Act of 1933 is "[t]o provide full and fair disclosure of the character of securities sold." *See* Jennifer S. Fan, *Regulating Unicorns: Disclosure and the New Private Economy*, 57 B.C. L. REV. 583 (2016) (Fan recommends that unicorn companies be subject to a scaled disclosure regime); *see also* Elizabeth Pollman, *Startup Governance*, 168 U. PA. L. REV. 155 (2019) (Pollman explores the development of secondary markets for startup company stock and suggests scaled disclosure requirements); Jeff Schwartz, *The Law and Economics of Scaled Equity Market Regulation*, 39 IOWA J. CORP. L. 347 (2014) (Schwartz outlines the costs and benefits of scaled regulation of large private companies); Jeff Schwartz, *The Twilight of Equity Liquidity*, 34 CARDOZO L. REV. 531 (2012) (Schwartz argues for a "lifecycle model" of securities regulation that would adapt to firm age); Robert B. Thompson & Thomas C. Langevoort, *Rewarding the Public-Private Boundaries in Entrepreneurial Capital Raising*, 98 CORNELL L. REV. 1573, 1625-27 (2013); (Langevoort calls for legislative reforms to reduce regulation for large private companies and advocates for enhanced regulation of broker-dealers as an alternative approach). *See* Cable, *supra* note 44, at 616.

[82] It should be noted that there are several views in academia and practice on the type of information that should be provided to employees. According to Aran, I represent the maximalist approach (for more see Unicorn Stock Options), practitioners represent a minimalist one, and Aran proposes an intermediate approach to the regulation of disclosures to start-up employees.

is a need for more disclosure. These changes fail to consider the new reality, which is that large tech private companies stay private longer and take advantage of information assymetry.[83] The kind of information that any investor in a similar situation would require is enhanced information with regards to the risks associated with investing in illiquid securities of a high-risk venture that is often controlled by founders who lack management experience. Accordingly, many scholars criticized these changes.[84]

According to Aran, we need a better disclosure regime, "not only to promote fairness and transparency, but also to prevent the market for equity-based compensation from becoming a market for lemons."[85] Aran further warns that with changes to current disclosure mechanisms, employees will lose trust in equity compensation arrangements. This is already happening, as evidents from employees complaining on public platforms such as Glassdoors and PaySa.[86] Now, employees moved their fights to the courtroom.

B. Workers Go to Court

Employees are not only complaining about this predicament on public platforms, but also turning to the courts to gain access to information on the company. Why courts? One of the most well-known ways in corporate law to gain access to information, is to invoke one's

---

See Yifat Aran, *Making Disclosure Work For Start-Up Employees*, 2019 COLUM. BUS. L. REV. 867 (2019).

[83] *See* Alon-Beck, *supra* note 69.

[84] Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of Public Companies*, 68 HASTINGS L.J. 445, 449 (2017). R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937); Paul Rose & Steven Davidoff Solomon, *Where Have All the IPOs Gone? The Hard Life of the Small IPO*, 6 HARV. BUS. L. REV. 83, 84 (2016); Gutentag, *supra* note 79. *See* Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 FORDHAM L. REV. 3389 (2013); Cable, *supra* note 44.

[85] *See* Aran, *supra* note 81.

[86] These sites rank the "Best Companies to Work For" and employees pay "careful attention . . . to Employee Engagement Scores that link corporate reputation, employee motivation, and productivity." Judith Samuelson, *Why Do We Still Call It Capitalism?*, QUARTZ: QUARTZ AT WORK (Apr. 9, 2018), https://work.qz.com/1247835/spotifys-ipo-should-make-us-consider-why-we-still-use-the-term-capitalism/. Unicorn employee complaints are not private anymore, as the "conversation has moved to employee hangouts, both virtual and real, to interview rooms on college campuses, and to public conversations about Board diversity, the glass ceiling, and in the talent pool." *Id.*

statutory shareholder inspection rights.[87] Lawyers are familiar with a little secret—if the firm is incorporated in Delaware, shareholders can make a demand on the company to inspect the books and records under Section 220 of the Delaware Code.

Some employees consulted with lawyers and decided to take this fight to the courts. Today, Silicon Valley is not the only place in the U.S. dealing with this controversy, Delaware (and California) courts are also confronting it. As noted above, under current Delaware case law, stockholder inspection rights are fundamental to the governance of a corporation.

DGCL Section 220 provides protection to stockholders by allowing them to exercise their ownership rights and inspect the books and records of a Delaware corporation. In *Cedarview Opportunities Master Fund v. Spanish Broad. Sys., Inc.*, Delaware court held that this ownership right "cannot be eliminated or limited by a provision in a corporation's certificate of incorporation." But, as noted, there is ambiguity in the case law about private ordering and waiving these rights by contract.

Can employees (who are not yet stockholders) waive this right by entering into a contract with the corporation such as a stock option agreement? And, in the event of litigation, would a Delaware court side with management or employees? The Delaware Chancery court has yet to answer these questions.

One of the first cases before the Delaware Chancery was *Biederman vs. Domo* ("Domo"). Domo is a business intelligence and data visualization startup at the time. Following the *Domo* lawsuit, the company went public and now trades on the Nasdaq. Domo decided to take advantage of the lacuna in case law and adopted a new practice that contracts around the ostensibly mandatory rules. It compelled its employees to waive their inspection rights as stockholders under DGCL Section 220.[88]

---

[87] *See* James D. Cox, Kenneth J. Martin & Randall S. Thomas, *The Paradox of Delaware's 'Tools at Hand' Doctrine: An Empirical Investigation* (Duke Law School Public Law & Legal Theory Series No. 2019-20 (2019); Vanderbilt Law Research Paper No. 19-10 (2019); European Corporate Governance Institute – Law Working Paper No 498/2020 (2019)), https://ssrn.com/abstract=3355662.

[88] As explained below, *infra*, Part III, the inspection right is not absolute but conditional. After exercising their options, the employee-stockholder must "demonstrate a proper purpose for making such a demand." The statute defines a "proper purpose" as "a purpose reasonably related to such person's interest as a stockholder." It is not clear whether an employee-stockholder

The financial press decided to follow this case. On January 26, 2017, the *Wall Street Journal* reported that Jay Biederman—a former employee and minority shareholder of the unicorn startup—finally compelled the company to open up its books.[89] According to the financial press, Biederman used an "obscure" Delaware law to inspect Domo's books and records. The obscure law that the press referred to was Section 220.[90]

Biederman was refused, laid off, and had to litigate with Domo for over a year. Like many other startup employees, Biederman received stock options under his company's employee stock incentive plan. He exercised those options, and became a shareholder, by purchasing over 64,000 shares after his options vested. Therefore Biederman was both a shareholder and stock-option-holder. He wanted to review Domo's financial statements to value his position in the company. Domo was a private company at the time and was not required to disclose its financial information to the public. Despite the fact that it raised over $1 billion dollars and joined the unicorn club, it is not clear whether its valuation was aggressive or justified.[91]

Like Domo, many of the largest unicorns in our market can stay private for long periods of time while avoiding public disclosures that would reveal their financial conditions and fair market value, including to their own employees. Another reality is this: Unicorns are notorious

---

can simply establish a proper purpose by requesting to ascertain the value of her stock.

[89] *See* BLASI, KRUSE & BERNSTEIN, *supra* note 3. *See* Sean Kelly, *Start-Up Hauled to Court over Secret Stock Value*, COURTHOUSE NEWS SERV. (Aug. 18 2016), https://www.courthousenews.com/start-up-hauled-to-court-over-secret-stock-value/

("According to a complaint filed August 15 in Delaware state court, Biederman owns over 64,000 shares of Domo Inc. after his stock options vested and he purchased the options under an employee incentive plan for 32 cents per share. But Biederman says just days after he requested information about the stock's worth, he was fired. And then the stonewalling began, the complaint says.").

[90] Rolfe Winkler, *Former Employee Wins Legal Feud to Open Up Startup's Books,* WALL ST. J. (Jan. 26, 2017), https://www.wsj.com/articles/former-employee-wins-legal-feud-to-open-up-startups-books-1485435602.

[91] David Trainer, *Domo Richly Priced at Post-IPO Market Value*, FORBES (July 3, 2018), https://www.forbes.com/sites/greatspeculations/2018/07/03/domo-richly-priced-at-current-market-value-after-ipo/#36a9a78f4da8.

for their "exaggerated valuations." [92] That is why it is critical that the stock-option-holder-employees have access to real data, not just exaggerated valuations put out by company leadership.[93]

During the *Domo* litigation, Vice Chancellor Sam Glasscock III of the Delaware Court of Chancery ruled against the company and ordered Domo to provide Biederman with audited financial reports. The decision came after many months of media scrutiny in which *The Wall Street Journal* repeatedly reported on Domo's refusal to provide Biederman with financial records. The Domo case was celebrated by the press as a win to minority shareholders—employees.

C. Contractual Innovation

Despite its initial promise, *Domo* had an unintended consequence for employee stock-option-holders and employee stockholders, in order to avoid disclosing information, unicorns adopted a waiver of statutory stockholder inspection rights.

Many tech companies are now requiring their employees to sign a waiver provision entitled, "Waiver of Statutory Information Rights," which states:

> **Waiver of Statutory Information Rights**. Purchaser acknowledges and understands that, but for the waiver made herein, Purchaser would be entitled, upon written demand under oath stating the purpose thereof, to inspect for any proper

---

[92] There are new research studies that examine the fair market value of startups worth over $1 billion. Gornall & Strebulaev find huge discrepancies in their purported worth. *See* Gornall & Strebulaev, *supra* note 21. On the skepticism about unicorn reported valuations, see also Robert P. Bartlett, III, *A Founder's Guide to Unicorn Creation: How Liquidation Preferences in M&A Transactions Affect Start-up Valuation*, *in* RESEARCH HANDBOOK ON MERGERS & ACQUISITIONS 123 (Claire A. Hill & Steven D. Solomon eds., 2016) ("achieving unicorn status provides a firm with added visibility to prospective employees and customers, giving it a potential competitive advantage over rival firms."); *see also* Sarah Frier & Eric Newcomer, *The Fuzzy, Insane Math That's Creating So Many Billion-Dollar Tech Companies*, BLOOMBERG TECH. (Mar. 17, 2015), 9:00 AM), https://www.bloomberg.com/news/articles/2015-03-17/the-fuzzy-insane-math-that-s-creating-so-many-billion-dollar-tech-companies ("investors agree to grant higher valuations, which help the companies with recruitment and building credibility"); Fan, *supra* note 80; Cable, *supra* note 44.

[93] *See* William Gornall & Ilya Strebulaev, *Squaring Venture Capital Valuations with Reality* 2 (Nat'l Bureau of Econ. Research, Working Paper No. 23895, 2017).

> purpose, and to make copies and extracts from, the Company's stock ledger, a list of its stockholders, and its other books and records, and the books and records of subsidiaries of the Company, if any, under the circumstances and in the manner provided in Section 220 of the Delaware General Corporation Law (any and all such rights, and any and all such other rights of Purchaser as may be provided for in Section 220, the "Inspection Rights"). In light of the foregoing, until the first sale of Common Stock of the Company to the general public pursuant to a registration statement filed with and declared effective by the Securities and Exchange Commission under the Securities Act of 1933, as amended, Purchaser hereby unconditionally and irrevocably waives the Inspection Rights, whether such Inspection Rights would be exercised or pursued directly or indirectly pursuant to Section 220 or otherwise, and covenants and agrees never to directly or indirectly commence, voluntarily aid in any way, prosecute, assign, transfer, or cause to be commenced any claim, action, cause of action, or other proceeding to pursue or exercise the Inspection Rights. The foregoing waiver applies to the Inspection Rights of Purchaser in Purchaser's capacity as a stockholder and shall not affect any rights of a director, in his or her capacity as such, under Section 220. The foregoing waiver shall not apply to any contractual inspection rights of Purchaser under any written agreement with the Company.

This waiver illustrates that unicorn employees who sign this waiver are oppressed because they do not have access to information about the risk of exercising their stock options or the valuation of their company, even if they later exercise their options and become stockholders. This is true until and unless the company decides to go public.

Most employees are unable to bargain away from this practice. If they wanted to do so, most employees would have to refuse equity incentive plans altogether, and to do so might send a hostile signal to the market and to their employer that they would probably like to avoid.[94]

This practice is gaining momentum. Relying on a data set of the SEC's public filings for companies that filed an IPO prior to and following *Domo*, I found many examples of companies that are using this new practice. That is why the results of Table 2 below are unsurprising.

---

[94] *See* Rock & Wachter, *supra* note 40.

I found that companies started using the "Waiver of Statutory Information Rights," immediately after the enactment of the JOBS Act in 2012. The following findings make note of the timing following the 2012 JOBS Act and *Domo*.

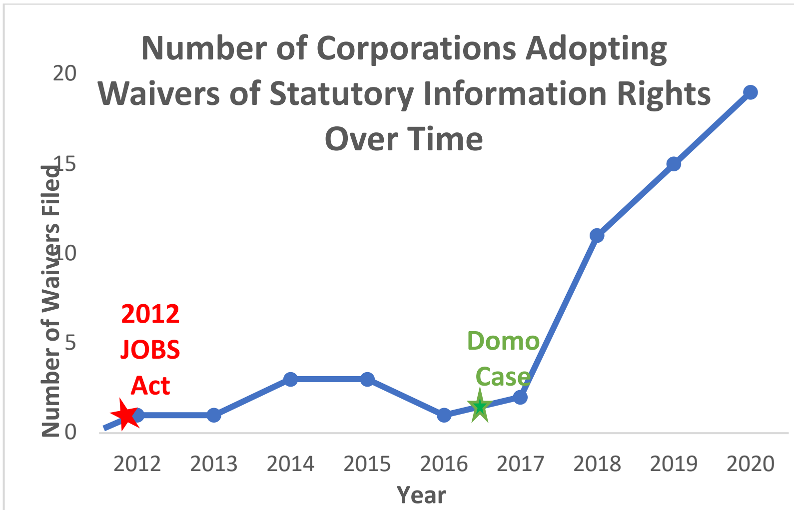


Table 2. The Number of Corporations Adopting Waivers of Statutory Information Rights Over Time.

The line graph shows the yearly number of filings that included a waiver between 2012 (when the waiver first appeared) and 2020. The line graph also notes the timing between the 2012 JOBS Act and the *Domo* case to show the change over time. I found that the waiver became popular following the *Domo* case, possibly due to all the financial press coverage, and the publication of client alerts by large law firms.

Delaware has to make a decision on this issue soon. In a recent case, *JUUL Labs, Inc. v. Grove* ("JUUL"), the Delaware court noted that it was not deciding whether waivers of a stockholder's statutory inspection rights under Section 220 in JUUL Labs' form agreements would be enforceable. That being said, the court almost deliberately left this question open for further deliberation.

There is perhaps a plausible reason for this "uncertainty." On the one hand, we have, in my opinion, a very clear situation of a mandatory law that should not be contracted around.[95] On the other

[95] JUUL Labs, Inc. v. Grove, No. 2020-005-JTL (Del. Ch. Aug. 13, 2020). The Delaware Court in footnote 14 of the JUUL case cited the following cases that state that the parties cannot waive inspection rights:

hand, in recent years, Delaware courts and the legislature have been recognizing the ability to waive statutory and even constitutional rights.[96] Delaware courts allow parties to use private ordering to

"*See State v. Penn-Beaver Oil Co.*, 143 A. 257, 260 (Del. 1926) ("[T]he provision in defendant's charter which permits the directors to deny any examination of the company's records by a stockholder is unauthorized and ineffective."); *Marmon v. Arbinet-Thexchange, Inc*., 2004 WL 936512, at *5 (Del. Ch. Apr. 28, 2004) ("Nor could they rely upon a certificate provision prohibiting disclosure to avoid a shareholder's inspection right conferred by statute."); *BBC Acq. Corp. v. Durr-Fillauer Med., Inc.,* 623 A.2d 85, 90 (Del. Ch. 1992) (holding that a contract with a third party could not be used to limit inspection rights, which "cannot be abridged or abrogated by an act of the corporation"); *Loew's Theaters, Inc. v. Commercial Credit Co.*, 243 A.2d 78, 81 (Del. Ch. 1968) (holding that charter provision which limited inspection rights to holder of 25% of shares was void as conflicting with statute); *State ex rel. Healy v. Superior Oil Corp.*, 13 A.2d 453, 454 (Del. Super. Ct. 1940) ("In Delaware it has been considered that the right of a stockholder to examine the books of the company is a common law right and can only be taken away by statutory enactment."); *State v. Loft, Inc*., 156 A. 170, 173 (Del. Ch. 1931) (following *Penn-Beaver*)." *Id.* at 24 n.14.

[96] In footnote 15 of the *JUUL* case, the Delaware court cited to the following cases that recognized the ability to waive not only inspection rights but even constitutional rights. "*See Baio v. Commercial Union Ins. Co*., 410 A.2d 502, 508 (Del. 1979) ("Clearly, our legal system permits one to waive even a constitutional right . . . and, a fortiori, one may waive a statutory right.") (citations omitted); *see, e.g., Graham v. State Farm Mut. Auto. Ins. Co*., 565 A.2d 908, 913 (Del. 1989) (holding that an arbitration clause in a contract effectuated a valid waiver of the constitutional right to a jury trial); *Manti Hldg., LLC v. Authentix Acq. Co*., 2019 WL 3814453, at *4 (Del. Ch. Aug. 14, 2019) (concluding "that waiver of appraisal rights is permitted under Delaware law, as long as the relevant contractual provisions are clear and unambiguous"); *Tang Capital P'rs, LP v. Norton*, 2012 WL 3072347, at *7 (Del. Ch. July 27, 2012) (holding that the plaintiff contractually waived its rights to seek a receivership under Section 291 of the DGCL); *Libeau v. Fox*, 880 A.2d 1049, 1056 (Del. Ch. 2005) (holding that the plaintiff waived her right to statutory partition by contract, noting that "[b]ecause it is a statutory default provision, it is unsurprising that the absolute right to partition might be relinquished by contract, just as the right to invoke § 273 to end a joint venture or to seek liquidation may be waived in the corporate context"); *Red Clay Educ. Ass'n v. Bd. of Educ. of Red Clay Consol. Sch. Dist*., 1992 WL 14965, at *6 (Del. Ch. Jan. 16, 1992) (holding that a provision in a collective bargaining agreement constituted an effective waiver of negotiation right under unfair labor practices statute). The *Kortum* decision, cited above, held that a bilateral agreement had not waived statutory inspection rights where the waiver was not "clearly and affirmatively" expressed. *See Kortum*, 769 A.2d at 125; *accord Schoon v. Troy Corp*., 2006 WL 1851481, at *2 (Del. Ch. June 27, 2006). Perhaps even a clear and express waiver would be contrary to public policy under *Penn-Beaver* and its progeny, but the standard set forth in *Kortum*, at minimum, implies that a stockholders' agreement could waive statutory inspection rights if the waiver was sufficiently clear." J*UUL*, at 24-25 n.15.

contract around other types of mandatory laws.[97] Is Section 220 next? If the court feels that there is a vague legal standards here, perhaps it is waiting for the Delaware legislature to change the law so that parties can account ex ante to this complexity? As we know, creating bright-line rules is very important for lowering costs and having certainty for all the parties involved. This issue needs to be resolved sooner than later.

If Delaware courts decide to validate this practice in a future litigation— due to principles of respecting private ordering—then the employees will not have access to financial data or reports to value their options. As noted, in many cases, these employees are systematically denied access to such reports, even if they explicitly ask for them. The fight might move to other states, outside of Delaware, due to concern by plaintiff bar that Delaware courts will side with management. So, what about the internal affairs doctrine?

In *JUUL*, the court decided to focus on the internal affairs doctrine. The employee tried to avoid the jurisdiction of Delaware,

---

[97] In footnote 15 of the *JUUL* case, the Delaware court cited to the following cases that recognized the ability to waive not only inspection rights but even constitutional rights. "*See Baio v. Commercial Union Ins. Co*., 410 A.2d 502, 508 (Del. 1979) ("Clearly, our legal system permits one to waive even a constitutional right . . . and, a fortiori, one may waive a statutory right.") (citations omitted); *see, e.g., Graham v. State Farm Mut. Auto. Ins. Co*., 565 A.2d 908, 913 (Del. 1989) (holding that an arbitration clause in a contract effectuated a valid waiver of the constitutional right to a jury trial); *Manti Hldg., LLC v. Authentix Acq. Co*., 2019 WL 3814453, at *4 (Del. Ch. Aug. 14, 2019) (concluding "that waiver of appraisal rights is permitted under Delaware law, as long as the relevant contractual provisions are clear and unambiguous"); *Tang Capital P'rs, LP v. Norto*n, 2012 WL 3072347, at *7 (Del. Ch. July 27, 2012) (holding that the plaintiff contractually waived its rights to seek a receivership under Section 291 of the DGCL); *Libeau v. Fox*, 880 A.2d 1049, 1056 (Del. Ch. 2005) (holding that the plaintiff waived her right to statutory partition by contract, noting that "[b]ecause it is a statutory default provision, it is unsurprising that the absolute right to partition might be relinquished by contract, just as the right to invoke § 273 to end a joint venture or to seek liquidation may be waived in the corporate context"); *Red Clay Educ. Ass'n v. Bd. of Educ. of Red Clay Consol. Sch. Dist*., 1992 WL 14965, at *6 (Del. Ch. Jan. 16, 1992) (holding that a provision in a collective bargaining agreement constituted an effective waiver of negotiation right under unfair labor practices statute). The *Kortum* decision, cited above, held that a bilateral agreement had not waived statutory inspection rights where the waiver was not "clearly and affirmatively" expressed. *See Kortum*, 769 A.2d at 125; *accord Schoon v. Troy Corp*., 2006 WL 1851481, at *2 (Del. Ch. June 27, 2006). Perhaps even a clear and express waiver would be contrary to public policy under *Penn-Beaver* and its progeny, but the standard set forth in *Kortum*, at minimum, implies that a stockholders' agreement could waive statutory inspection rights if the waiver was sufficiently clear." *JUUL*, at 24-25 n.15.

which is known to be "management friendly," so he brought a suit in California, invoking California's Section 1601.[98] Until now, it was my understading that in a case like this, a California courts is entitled to apply California law, because the plaintif is a California resident, and is seeking to inspect the books and records of a Delaware corporation that is headquarted in California

I am building on Stephen Bainbridge's work, and use his textbook to teach my students Business Associations. Bainbridge postulates that he "long understood (and taught) that shareholder inspection rights are a rare exception to the internal affairs doctrine."[99]

Unfortunately for the employee, the Delaware court in *JUUL* held that under United States Supreme Court and Delaware Supreme Court precedent, stockholder inspection rights are a matter of internal affairs. Is it? Delaware law is my bible, however, there is a need to examine this opinion further. The following is a short explanation of this analysis, and more importantly the ramifications of this view on the future of practice and litigation.

D. Internal Affairs

Every state in the U.S. has its own unique set of state corporate laws. These provide a standard set of rules for investors, shareholders, managers, creditors, directors and, other stakeholders. These rules are not uniform, and they change from state to state.

These differences are possible thanks to a choice of law rule called the "internal affairs doctrine." Under the internal affairs doctrine, the laws that govern the corporation and any future disputes between the parties, such as shareholders and directors, are determined by the state of incorporation. That is why the state of incorporation governs

---

98 California adopted section 1601 inspection of books and records from the MBCA.

[99] Stephen Bainbridge, *Are Shareholder Inspection Rights Subject to the Internal Affairs Doctrine?*, PROFESSORBAINDRIDGE.COM BLOG (Oct. 5, 2020),

https://www.professorbainbridge.com/professorbainbridgecom/2020/10/are-shareholder-inspection-rights-subject-to-the-internal-affairs-doctrine.html Building on Bainbridge's work, I also teach the case *Crane Co. v. Anaconda Co.*, 346 N.E.2d 507 (N.Y. 1976), in which the court applied New York law to determine whether a shareholder (that was incorporated in Illinois) was eligible to examine the stockholder list of a company incorporated in Montana. (Access to stockholder lists, in fact, is a well-established exception to the internal affairs doctrine as a matter of both corporate law and conflicts of law.)

the disputes between parties, even when the firm is predominantly doing business in other state and is located outside the state of incorporation. For example, if our hypothetical Zuber is incorporated in Delaware, a dispute between a Zuber shareholder and Zuber director will be determined by Delaware law—even if Zuber's corporate campus is located in California.

A direct result of the internal affairs doctrine is that different states compete with each other over the incorporation business, seeking to lure corporations to incorporate in their state rather than another. Delaware has been very successful in maintaining its title as the winning state for choice of incorporation. It is home to about 80% of the publicly traded firms and over two-thirds of the Fortune 500 companies. It should be noted that the business of incorporation is a business like any other; states generate revenue from the incorporation of businesses.

Delaware, for example, collects both license fees and corporate income tax from its entities.[100] According to the National Association of State Budget Officers ("NASBO") and the Urban Institute, Delaware:

> has the fifth-highest per capita corporate income tax revenue ($257 compared with the national average of $162) and far and away the highest per capita revenue from corporate license fees (Delaware collected $1,363 in 2017 while the next-highest state was $130 and national average was $18.) Corporate license fees accounted for 12.8 percent of Delaware's state and local general revenue in 2017; the national average was 0.2 percent.

There are different theories to why firms choose to incorporate in Delaware, ranging from tax reasons and the existence of professional equity courts (without a jury) to "race to the bottom" or "race to the top" theories, which claim that the legislature adopts business-friendly corporate laws to lure managers and directors to incorporate in the state. Delaware itself typically credits its success to two features: (1) the "customer service" that it provides and (2) its "flexibility in [corporate] formation".

Two things are clear though. First, that most states will have trouble competing with the Delaware court system because its comprised of professional, predictable judges who are some of the

[100] Marcel Kahan, *Delaware's Peril*, 80 MD. L. REV. 59, 61 (2021).

finest business experts. Second, that Delaware has a clear incentive to continue to compete over this business with other states, and the legislature has an incentive to continue to amend its laws to draw the affection of businesses and get them to incorporate in the state. As noted, a large part of Delaware's revenue comes from the fees for incorporation, the annual taxes, franchise fees, and other revenue-generating operations.[101]

However, Delaware cannot afford to ignore the current push in the U.S. for change and social justice. If it ignores this movement, it might risk other U.S. states, nation-states, or even the federal government emerging as a competitor and threatening Delaware's dominance.

In light of the recent developments, and especially the Business Roundtable's recent new "Statement on the Purpose of a Corporation," there is no doubt that the judges in Delaware's Chancery Court, who are some of the finest business experts in our nation, are also facing public scrutiny over the outcomes of their decisions. Are they going to continue with the old shareholder primacy model? Or are they going to start taking stakeholder interests into account, such as employees, creditors, the environment, society and the like?

In the *JUUL* case, the Delaware court had to decide on "what law should be applied to the case at hand?" A claim was brought in California to inspect the books and records of a New York firm. *JUUL* is a foreign corporation that is doing business within the borders of California. A foreign corporation simply means that it is a corporation that is formed and incorporated outside of California. In this case, Delaware. In order to be able do business in California (like in many other states), the corporation had to register as a foreign corporation in California, appoint a California registered agent and file the correct forms.

At issue is which state law governs? This is a conflicts of law situation. It should be noted that these types of cases can and probably will continue to come up in this context, as is illustrated by the empirical investigation below.

---

[101] Alana Semuels, *The Tiny State Whose Laws Affect Workers Everywhere*, ATLANTIC (Oct. 3, 2016), https://www.theatlantic.com/business/archive/2016/10/corporate-governance/502487/.

The Restatement (Second) of Conflict of Laws, provides:[102]

> The right of a shareholder to inspect the books of a corporation poses special problems. This is an issue which can practicably be determined dif- ferently in different states. This is also an issue which, if decided differently in different states, will not seriously undermine the policy favoring uniform treatment for all shareholders of a corporation. For these reasons, a court will apply to a foreign corporation doing substantial business in the state a local statute providing for the inspection of books by a share- holder if in the court's opinion the statute embodies an important policy.

According to the restatement, states can exercise authority to require disclosure of stockholder lists of foreign corporations doing business within their borders. However, this is an evolving and intriguing area of the law, which has been and still is evolving rapidly. As noted by Francis Pillegi, Section 220 is not for the faint-hearted.

It is well established that a foreign corporation authorized to do business in a state is going to be subject to that domestic state's statutory provisions. Unless the language in the domestic state's statute has some sort of limitations, such as explicit language that it only applies to domestic corporations, most states respect requests for access to corporate books and records.[103]

---

[102] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 304, cmt. d (1971).

[103] In *JUUL*, in footnote 7, the court states that there is a substantial volume of authority that posits that the internal affairs doctrine should not limit the ability of a non-chartering jurisdiction to grant rights to inspect the books and records of a foreign corporation. The court cited the following sources: "*See, e.g.,* 36 Am. Jur. 2d *Foreign Corporations* § 58, Westlaw (database updated Aug. 2020) ("Despite a foreign corporation's incorporation in another state, the right of shareholders or other interested parties to inspect the corporation's books and records is governed by the laws of the state in which the corporation does business, not the law of the state of its incorporation."); *id.* § 377 ("When a foreign corporation is licensed to do business in the forum state, and has its office and records in the forum state, the law of the forum state regarding the inspection of records rather than the law of the state of incorporation applies. Under other authority, a local court will follow the law of the foreign corporation's domicil[e] regarding the right of a shareholder to inspect the corporation's records unless a local statute defines the rights of inspection of stockholders of all corporations doing business in the state. In any event, a foreign corporation authorized to do business in a state may be subject to that state's statutory provisions respecting access to corporate books and records at least when nothing in the language of a statute or underlying policy considerations

The *JUUL* case also raises interesting constitutional questions, inquiries about the concept of the corporation and state powers. State sovereignty suggests that the state can exercise its power and authority within its borders (jurisdiction).[104] Each state has powers to subject persons, including domestic and foreign corporations, and goods to the process of its courts based on its adjudicative jurisdiction.[105] The crucial question that arises from the JUUL case is whether Delaware's jurisdiction extends outside its borders? Is a California court going to say to the parties – you need to take this lawsuit to Delaware?

The important take away from the *JUUL* case is with regards to the choice of law concept. The court finds that according to Delaware's internal affairs doctrine, inspection rights for a stockholder of a Delaware corporation are governed by Delaware law. It means that Delaware laws apply here and not the laws of other jurisdictions,

---

indicate an intention to limit the statute's effect to domestic corporations. Consequently, shareholders are entitled to inspection of the records of a foreign corporation under a statute that provides that foreign corporations enjoy the same privileges as domestic corporations and requires that each corporation keep a record of shareholders at a registered office or the office of its transfer agent for inspection.") (footnotes omitted); Deborah A. DeMott, *Shareholder Derivative Actions: Law and Practice* § 2:13(1) (2019–20) (collecting "inspection cases" involving the "application of forum-state law" to a foreign corporation); K. M. Potraker, Annotation, *Stockholder's Right to Inspect Books and Records of Foreign Corporation*, 19 A.L.R.3d 869 (1968) (collecting cases); *see also* Elvin R. Latty, *Pseudo-Foreign Corporations*, 65 Yale L.J. 137, 138–39 (1955) ("Legislation relating to corporations not infrequently contains protective provisions that the parties to be protected cannot 'waive' by contract in drafting the charter. For example, a court would surely not uphold a charter clause to the effect that no shareholders can inspect those books and records that the law otherwise entitles them to inspect. It is not logical that local law be automatically excluded simply because parties have, by selecting the place of incorporation, exercised freedom of contract on a matter that local law does not leave completely to freedom of contract." (footnote omitted))". JUUL Labs, Inc. v. Grove, No. 2020-005-JTL, at 12-13 n.7 (Del. Ch. Aug. 13, 2020).

[104] According to the *JUUL* court, "That concept of the corporation (and of state-chartered entities more generally) can have implications for the valid exercise of one state's power in relation to other states, whether through action by the state itself or as a result of private parties exercising state power by proxy by inserting terms in the entity's governing documents." *Id.* at 14 n.7.

[105] According to the *JUUL* court, "the DGCL rests on a concept of the corporation that is grounded in a sovereign exercise of state authority: the chartering of a "body corporate" that comes into existence on the date on which a certificate of incorporation becomes effective." *Id.* at 14 n.7. *See* 8 DEL. C. § 106. Id.

regardless of where a company's principal place of business is located.[106]

It is not surprising, therefore, that the Delaware court in *JUUL* declared that the employee's rights as a stockholder are governed by Delaware law, and that he thus could not seek an inspection under California's Section 1601.[107] The court is urging shareholders to file a demand in Delaware, the state in which the corporation is incorporated, rather than where it does business.

But, the question remains - what about the other states? are they going to follow Delaware or resist? California is not the only state that has to balance competing interests between stockholders and management. Moreover, California's take on an issue like waiving statutory law via private ordering, is probably going to be very different. As noted above, in the U.S., domestic states usually grant rights to access the books and records to stockholders of a foreign corporation.

Delaware is the state of choice for incorporation for many firms in the U.S. and around the world, whether they are large or small entities. Last year, 2020, was no exception, and Delaware continued its

---

[106] "Under principles articulated by the Supreme Court of the United States and applied by the Delaware Supreme Court, Delaware law governs its internal affairs. The scope of Grove's inspection rights is a matter of internal affairs, so Delaware law applies." *Id.* at 2.

[107] "Because Grove's inspection rights implicate the Company's internal affairs, Grove must pursue any remedy in this court under the exclusive forum-selection provision in the Company's certificate of incorporation." *Id.* at 2. The court is citing the following sources: "George S. Geis, *Information Litigation in Corporate Law*, 71 Ala. L. Rev. 407, 448 (2019) ("Inspection rights clearly relate to the internal affairs of the corporation . . . ."); P. John Kozyris, *Corporate Wars and Choice of Law*, 1985 Duke L.J. 1, 63 (stating that "[c]ertain internal affairs matters are even less amenable to differential treatment than others" and that "[t]he hard core areas where 'indivisible unity' is paramount should include first and foremost the rights that attach to corporate shares" like "obtaining information" and "inspecting corporate records"); Deborah A. DeMott, *Perspectives on Choice of Law for Corporate Internal Affairs*, 48 L. & Contemp. Probs. 161, 168 (1985) [hereinafter DeMott, *Perspectives on Choice of Law*] (describing "shareholders' inspection rights" as one of the "quintessentially internal matters"); *see Restatement (Second) of Conflict of Laws* § 304 (concluding that the law of the state of incorporation generally should "determine the right of a shareholder to participate in the administration of the affairs of the corporation"); 17 William Meade Fletcher et al., *Fletcher Cyclopedia of the Law of Private Corporation*s § 8434 (Sept. 2019 update) ("It has been held that shareholder meetings and maintenance of books and records were 'internal affairs' of the corporation not subject to regulation in another state.")." *Id.* at 16 n.8.

reign as the domicile of choice for members of the Fortune 500. It also dominated the market for companies that decided to file an IPO and become public entities for the first time. To illustrate, note that approximately 89% of all U.S. companies that filed an IPO last year chose to incorporate in Delaware.[108] In a separate study, relying on hand collected data consisting of various filings, I find that 97% of the unicorn firms in the United States choose to incorporate in Delaware. Thus, any Delaware court decision on this issue will determine the rights of hundreds of thousands of unicorn employees across the U.S.

There is still uncertainty with regards to choice of law clauses because the question of whether forum selection clauses, for example, are even enforceable is usually highly contested in the U.S.. Can contracting parties exercise their autonomy and select via contract the *forum* in which these types of books and records disputes will be resolved? The answer to this question requires further research on constitutional law, and is therefore outside the scope of this Article. I will be very surprised if these types of matters will not end up before the Supreme Court.

One thing is clear, other states can and in practice do define the terms by which stockholders of a foreign corporation can inspect books and records in their jurisdiction. Unfortunately for practitioners, this means uncertainty. What are corporate lawyers going to say to a client? In the future, a Delaware corporation is going to be subjected to different legal and policy standards, depending on the specific jurisdiction and the ways in which that jurisdiction follows Delaware law.

I can also imagine a new practice where sophisticated parties that want books and record claims to be governed exclusively by Delaware law, will try to state as clearly as possible that they want their clause to (a) be exclusive or non-exclusive, (b) apply or not apply to this specific type of claim – inspection of books and records, (c) apply or not apply to non-signatories, or (d) select specific state courts that have authority to adjudicate these matters.

Due to the importance of these legal implications, the following is an empirical investigation.

---

[108] DEL. OFF. OF BUDGET & MGMT., FINANCIAL SUMMARY: BUDGET DOLLAR GOVERNOR'S RECOMMENDED BUDGET (2019), https://corpfiles.delaware.gov/Annual-Reports/Division-of-Corporations-2019-Annual-Report.pdf.

E. Empirical Invetigation

I examined whether firms that adopted the waiver have the same preferences as U.S. unicorn firms. Specifically, is Delaware the domicile of choice for firms that adopted the waiver?

Relying on a hand collected data set consisting of SEC public filings, I found many firms that require that their employees sign a waiver provision entitled, "Waiver of Statutory Information Rights." I then looked at where they have chosen to incorporate and establish their headquarters. I found that 89% of the firms that adopted the waiver are incorporated in Delaware.

The following table shows where different types of firms (private and public, unicorn and non-unicorn, U.S and outside-U.S.) have chosen to incorporate and establish their headquarters.

State Headquarters and Incorporation for Corporations with Waiver			
State of Incorporation		**Headquarters**	
Delaware	89%	California	56%
Massacusetts	2%	Connecticut	2%
Nevada	2%	Maryland	2%
Pennsylvania	2%	Massachusetts	15%
Oregon	2%	New Hampshire	2%
California	2%	New York	6%
Outside of US	3%	North Carolina	2%
		Outside of US	3%
		Pennsylvania	5%
		Tennessee	2%
		Texas	5%
		Utah	2%
		Washington, DC	2%

<u>Table 3</u>. Information on State Headquarters and Incorporation Choice for all Firms that adopted the Waiver of Statutory Inspection Rights.

From these findings, it is clear that 89% of the firms that adopted the waiver are incorporated in Delaware and that 56% of those Delaware-incorporated firms are headquartered in California. Therefore the Delaware court decision on the *JUUL* case is incredibly important to different types of firms, including unicorn firms. The following figures illustarate the findings in Table 3.

Figure 1: This figure breaks down the percentages of each corporation that has adopted a waiver by examining its choice of domicile

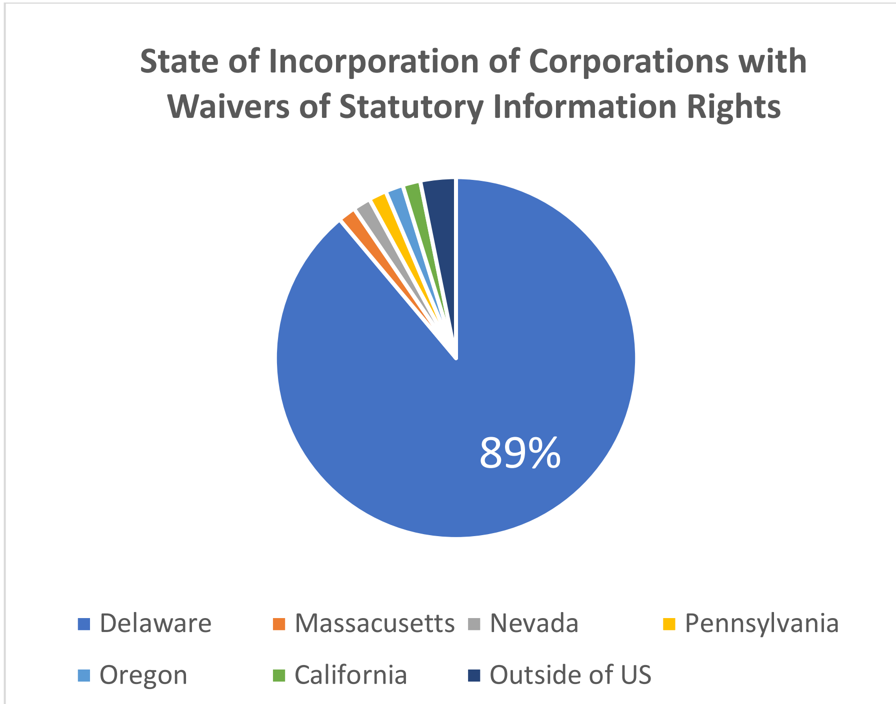


Figure 2: This figure breaks down the percentages of each corporation that has adopted a waiver by examining the state in which their headquarters is located

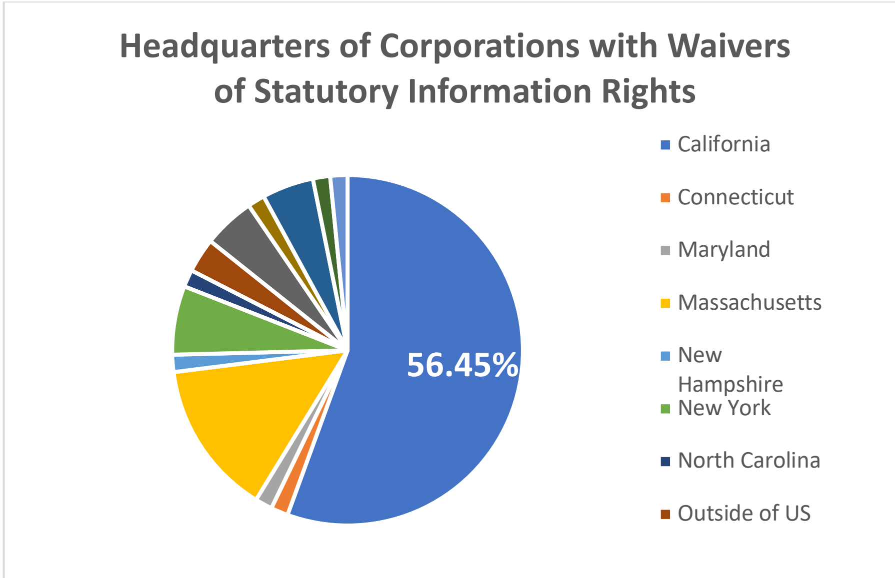
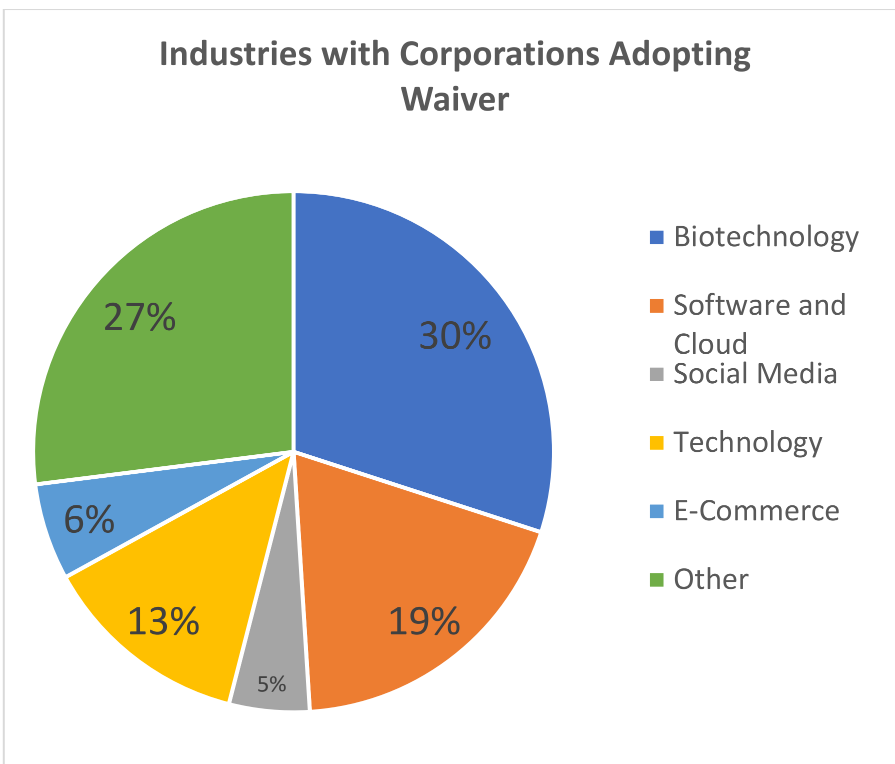


Figure 3: This figure is a pie chart that shows the proportion of each industry relative to the total number of firms with statutory waivers of information. The "Other" category includes firms in the retail, media, freelance, food and beverage, fitness, engineering, consumer lending, automotive, finance, and acquisition industries.



It is clear from these findings that this new waiver practice is very popular among tech companies, and most popular among biotechnology firms.

F. NVCA Moves to Standarize Statutory Stockholder Inspection Waivers

Another very important development in this field is an effort by interest groups that represent tech firms to standardize statutory stockholder inspection waivers. Recently, between July 28, 2020 and September 1, 2020, the National Venture Capital Association (the "NVCA") released updates to its model legal documents for use in venture capital financing transactions that incorporated the waiver language in the Investors' Right Agreement ("IRA").

The NVCA is an organization that is based in the U.S. Its members consist of individuals in the venture capital industry and other investment professionals. The NVCA has created model legal documents for venture financing transactions to promote coherent, transparent investment terms and efficient transaction processes. These model documents are widely used in the U.S.[109] The model documents are the work product of a national coalition of attorneys who specialize in venture capital financings, who are working under the auspices of the NVCA.[110]

The NVCA added language in its form IRA, which gives an option to companies to waive statutory inspection rights under Section 220 of the DGCL. This option allows companies to adopt the Waiver of Inspection of Statutory Rights, and modify the traditional information and inspection rights that were granted to *certain* shareholders. These "certain" shareholders are not called by their names – employees. The purpose of this change is to reduce the potential claims from shareholders involving demands for access to books and records under Section 220 of the DGCL. It is well known that "other" shareholders, who are sophisticated and probably represented will not easily agree to such language, without negotiation

---

[109] *Venture Capital Investing: New NVCA Models, and New Challenges for Foreign Investors in Early-Stage U.S. Companies*, CLEARY GOTLLIEB (Oct. 7, 2020), https://www.clearygottlieb.com/-/media/files/alert-memos-2020/20201007-venture-capital-investing-new-nvca-models-and-challenges-for--pdf.pdf.

[110] The National Venture Capital Association (NVCA), Model Legal Documents, https://nvca.org/model-legal-documents/ (last accessed June 5, 2021).

and push back. It should be further noted that employees are not regularly represented when receiving stock options.

On some cites, the law firms tell their clients that a Delaware court may still hold the waiver provision enforceable, given the trend to enforce private agreements between sophisticated investors.[111] Do they consider employees that are not represented and not accredited to be sophistuicated? I guess so.

Tech employees are probably in a stronger position to negotiate than employees in other industries, but that does not mean that do not need protection from these practices. The digital transformation contributed to the rise of the new knowledge economy.[112] The knowledge economy is an econonmy where companies depend on their talent—employees—to provide the human capital that helps the firm grow and compete in a dynamic, complex, and everchanging world.[113] There are constant changes in our market structures, securities regulations, and corporate governance practices, and this transformation creates inflection points in and across many industries.

Unicorn firms are increasingly important for economic activity and contribute to the fact that equity ownership is changing in the U.S. While there has been a decrease in the number of publicly listed firms and a decline in the volume of IPOs, there has also been a rise in the number of new unicorn firms. In 2020 alone, despite the COVID-19 pandemic, 160 new firms raised capital that allowed them to join the notorious unicorn club. But now unicorn employees are starting to file stockholder inspection right lawsuits, which bring attention to these inflection points.

Are tech employees going to revolt and demand that their firms change their state of incorporation? I am unsure; time will tell. But, in

---

[111] Cameron R. Kates, James B. Jumper, Daniel R. Sieck & Geoffrey S. Garrett, *Modeling the Market: The National Venture Capital Association Revises its Model Documents*, TROUTMAN PEPPER (Sept. 16, 2020), https://www.troutman.com/insights/modeling-the-market-the-national-venture-capital-association-revises-its-model-documents.html.

[112] Powell and Snellman define the knowledge economy as "production and services based on knowledge-intensive activities that contribute to an accelerated pace of technical and scientific advance, as well as rapid obsolescence. The key component of a knowledge economy is a greater reliance on intellectual capabilities than on physical inputs or natural resources." Walter W. Powell & Kaisa Snellman, *The Knowledge Economy*, 30 ANN. REV. SOCIO. 199 (2004).

[113] *See* Anat Alon-Beck, *Times They Are A-Changin'; When Tech Employees Revolt!*, 80 MD. L. REV. 120 (2020).

any event, there is a battle between employees and unicorns on inspection rights, which is gaining coverage by the financial press and is now litigated in several courts, including the Delaware courts.

To understand why some employees, like the employee in *JUUL*, are trying to avoid the Delaware courts, it is important to understand the way Delaware courts typically treat private ordering arrangements between parties. The following is an explanation of how Delaware judges view private ordering agreements, default and immutable rules, and the overall market for corporate law.

G. Private Ordering

Despite the fact that different states have different corporate laws, all these laws have something in common—each has a set of default and immutable rules, respectively. States adopted these corporate law rules to make the incorporation process easier, cheaper, and more efficient. The "default" or "gap-filling" rules adopted by states give parties a choice. They can choose to use any of the default rules when setting up a company.

The rules are standardized and meant to save the parties on transaction costs that are associated with setting up a company. Default rules are not mandatory, which means that the parties can alter these rules or contract around them by using other specific language in the agreements that they enter into with each other.

Immutable rules, on the other hand, are mandatory rules—ones the parties cannot contract around. Section 220 of the DGCL, for example, is a mandatory rule. Distinguishing between default and immutable rules is attributed to the contrarian view of corporate law,[114] which is part of the law and economics view that regards corporate entities as a nexus of contracts.

The prominent supporters (and perhaps intellectual founders) of this view are Judge Frank Easterbrook and Professor Daniel Fischel, as well as Professors Michael Jensen and William Meckling.[115] According

---

[114] *See* Stephen M. Bainbridge, *Contractarianism in the Business Associations Classroom*, 34 GEO. L. REV. 631 (2000).

[115] *See generally* Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs,* 38 STAN. L. REV. 271 (1986); Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395 (1983); Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982); Michael C. Jensen & William. H.

to their view, the firm is not simply regarded as a single entity but rather a nexus of contracts.[116] Firms are made of a set of different contracts between the firm's various constituencies, such as management and labor. Additionally, according to the transactional cost theory of the firm,[117] incomplete contracts are the reason for the creation of the firm.

As stated eloquently by Professor Cox:[118]

> To nexus-of-contracts adherents, corporate rules are not mandatory but default rules; the parties are free to tailor the relationship to their own particular needs. Thus, within the nexus-of-contracts metaphor, forum selection, fee shifting, and mandated arbitration are just some areas, among many others, where parties can best tailor their needs through their negotiations and agreement. Broadly stated, to the nexus-of-contracts crowd, corporate law as provided by the state is merely facilitative of private bargaining.

According to this view, corporate law is is private and not law. It is not a secret that the Delaware courts have a laissez-faire attitude toward corporate governance contracting.[119] Professor Jill Fisch coined the term "new governance" to illustrate the ways in which private ordering is used to structure governance rights in organizational documents.[120] That might explain why employees are trying to turn to other jurisdictions on the issue of inspection rights.

Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

[116] *See* Bainbridge, *supra* note 113. *See, e.g.,* JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 22 (2008) ("It has long been recognized . . . that the corporation . . . should be viewed as a 'nexus of contracts' or set of implicit and explicit contracts."). For an analysis that separates between the early scholars, see William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407 (1989). *See* James D. Cox, *Corporate Law and the Limits of Private Ordering*, 93 WASH. U. L. REV. 257 (2015).

[117] *See* R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

[118] *See* Cox, *supra* note 115.

[119] Megan Wischmeier Shaner, *Interpreting Organizational "Contracts" and the Private Ordering of Public Company Governance*, 60 WM. & MARY L. REV. 985 (2019).

[120] Jill E. Fisch, *The New Governance and the Challenge of Litigation Bylaws*, 81 BROOK. L. REV. 1637, 1638-39 (2016).

Shaner, *supra* note 118. *See also* D. Gordon Smith et al., *Private Ordering with Shareholder Bylaws*, 80 FORDHAM L. REV. 125, 127 n.12 (2011).

As pointed out by Professor Jill Fisch, there is uncertainty on whether Delaware courts will uphold waivers of stockholder inspection rights. Dicta in several cases might suggest that the court may be willing to uphold such waivers.[121] On the other hand, in other cases, the court did not allow parties to limit stockholder rights. In *Kortum v. Webasto Sunroofs Inc.*, the court observed that a shareholders agreement does not waive the statutory inspection right and that such a waiver must be "clearly and affirmatively expressed."[122] In *Schoon v. Troy Corp.*, the court rejected the argument that the stock purchase agreement limits, in any way, the information that must be provided under Section 220.[123] As noted, there is uncertainty with regards to this.

The next step in the analysis perhaps, should be, in the event that the Delaware court decides to enforce the agreement between the parties. What constitutes consent? Traditional contract theory (and Coase), rely on bargaining that can then result in the consent to enter into an agreement. basis for the efficiency that lies at its end. Consent (or the lack of) is linked to another fundamental theory of private ordering: the hypothesis that the resulting contract will account for the terms and these terms are fully priced into the value of the firm's securites.

Regardless of whether one agrees with this theory, the elements of consent and meeting of the minds are necessary for the contractual paradigm to work.[124] With regards to employees, in several cases, the employees stated that they did not consent to the contract arrangement and had no knowledge that they are waiving their stockholder inspection rights. Would that make a difference? The employees are in a hold up situation.

The problem with employees is very sever, because they entered into a contract with a company when they are under the impression that the startup is going to have an exit. However, if they

---

[121] *See* Fisch, *supra* note 119.

[122] *See, e.g.,* Kortum v. Webasto Sunroofs Inc., 769 A.2d 113, 125 (Del. Ch. 2000) (observing that the shareholders agreement "does not expressly provide for a waiver of statutory inspection rights [and] there can be no waiver of a statutory right unless that waiver is clearly and affirmatively expressed . . . .").

[123] Schoon v. Troy Corp., 2006 Del. Ch. LEXIS 123, *7 (rejecting argument that shareholder's section 220 rights were defined by the stock purchase agreement where "[t]he agreement did not in any way, explicitly or implicitly, contractually limit the information that must be provided to Steel in the exercise of its statutorily protected inspection rights under Section 220.").

[124] *See* Cox, *supra* note 115.

end up working for firms that become unicorns (stay private for long periods of time) then the employees are in a hold up situation because they cannot exit, have to make an investment decision without information, and might need to renegotiate the contract with the company ex-post.

The following is an explanation of how stock option contractual arrangements work.

IV. BARGAINING UNDER ASSYMETRIC INFORMATION

The problem of inaccurate unicorn firm valuation is so severe that recently two finance professors, Will Gornall and Ilya Strebulaev, decided to develop an online calculator tool—VALUATION.VC—to help startup employees value their stock options and mitigate some of this asymmetric information. Prior to discussing valuation, it is important to understand the design and changes to an employee stock option agreement.

The following is a review of the history of stock option agreements, its design, and why it doesn't work for unicorn startups anymore.

A. Employee Stock Option Agreement

Stock option agreements are prevalent in unicorn companies. A stock option agreement is a type of contract that gives a party to the agreement the right to purchase the company's stock in the future upon the occurrence of certain terms specified in the agreement. This contractual mechanism contributed greatly to firm production and profitability. But the current model doesn't work anymore for unicorn firms. Employee stock options have lost their allure to unicorn firm employees because of the following reasons, including the fact that they have to renegotiate their contracts ex-post.

The concept of "splitting the pie" with labor by using a contractual mechanism, such as a stock option agreement, was revolutionary in the 1950s. Capital investors were willing to split the pie with startup founders and employees to grow the overall pie. Stock option grants made it possible for both founders and employees to participate in the growth of the business. They are designed as a form of equity compensation that is supposed to lead to greater worker efforts, as well as align incentives for both founders and employees. The idea was rather brilliant—the startup business did not have to put significant amounts of capital at risk,[125] or pay income tax that would ordinarily be due on additional cash compensation.[126]

Stock options are granted to employees through equity compensation agreements. These agreements are contracts are between the company and its employees (or its directors and advisors).[127] From the employer's perspective, equity compensation preserves cash, which is a precious commodity for most early startup firms.[128] In the early stages, a startup's internal cash flow is often insufficient to support[129] the firm's fast-growing technology, research, and development needs.[130] Companies are able to spend less money on employee salaries when they extend stock options (rather than a bigger salary).

---

[125] In order to attract labor to Silicon Valley, startups used stock option plans. *See* William Lazonick, *The Financialization of the U.S. Corporation: What Has Been Lost, and How it Can Be Regained*, 36 SEATTLE U.L. REV. 857, 865 (2013) [hereinafter Lazonick, *Financialization*]; *see also* WILLIAM LAZONICK, SUSTAINABLE PROSPERITY IN THE NEW ECONOMY? BUSINESS ORGANIZATIONS AND HIGH-TECH EMPLOYMENT IN THE UNITED STATES 51–56 (2009) (discussing Cisco as an example of a company that attracted employees with stock options).

[126] *See* Lazonick, *Financialization*, *supra* note 124, at 874–75.

[127] *See* Levmore, *supra* note 4, at 1901 ("there is remarkable conformity in the practice of giving a class of employees a large percentage of compensation (in expected value terms) in the form of options with strike price set at or slightly above the underlying stock's market value at the time the options are granted.") *See also* Smith, *supra* note 4, at 580 ("Companies may fire at-will employees for any reason, and being overcompensated is as good as any other reason or no reason.").

[128] BAGLEY & SAVAGE, *supra* note 8, at 519.

[129] *See* Ola Bengtsson, *Repeated Relationships Between Venture Capitalists and Entrepreneurs* 3 (Working Paper No. 1, 2007) (examining data on 1,500 serial entrepreneurs and finding that a failed entrepreneur is twice as likely to repeat VC relationships). Various studies show that approximately eighty to ninety percent of entrepreneurial firms which are unable to get venture capital backing fail within five to seven years of formation. *See* Paul Gompers & Josh Lerner, *The Money of Invention: How Venture Capital Creates New Wealth,* UBIQUITY (Jan. 2002), http://ubiquity.acm.org/article.cfm?id=763904 [perma.cc/CX5Z-4A4V] ("For newly launched enterprises without venture capital backing, failure is almost assured: nearly 90 percent fail within three years."); U.S. GEN. ACCT. OFF., GAO/GGD-00-190, SMALL BUSINESS: EFFORTS TO FACILITATE EQUITY CAPITAL FORMATION 19 (2000) [hereinafter GAO REPORT] (approximately 80% of new businesses fail or no longer exist within five to seven years of formation).

[130] If a startup cannot raise capital to support its growth, it will probably have to go through a bankruptcy process. Bankruptcy is often the result of a financing and information gap, which is termed in Silicon Valley the "Valley of Death." *See* Gompers & Lerner, *supra* note 128; *see also* George S. Ford et al., *An Economic Investigation of the Valley of Death in the Innovation Sequence* 3–6 (Phoenix Ctr. for Advanced Legal & Econ. Pub. Policy Studies, Discussion Paper, Aug. 2007), http://www.osec.doc.gov/Report-

Traditionally—in the formation stages of a startup—the founders "split the pie" with employees in order to recruit talent. Employees take on high-risk in the hopes of high returns. They accept a modest cash salary with significant stock option grants, and dream of cashing out for a large sum of money[131] after an IPO of the startup's stock.[132] This practice is popular due to the recognition that employee equity-sharing improves overall firm productivity, shareholder returns, and profit levels.[133]

The first founders to receive stock options were a famous group of Silicon Valley engineers who worked for the first startup in the area: Fairchild Semiconductor.[134] Robert Noyce and Gordon Moore were among these founders. Noyce and Moore became millionaires thanks to their stock options. They used the proceeds from the sale of their stock to found Intel.[135] To incentivize their new startup's hires, they decided to use this successful model and continue to split the pie with their employees. They decided to designate stock option grants as a key part of the Intel employee compensation package.

Valley%20of%20Death%20Funding%20Gap.pdf [perma.cc/K4BB-4LFU]; BRANSCOMB & AUERSWALD, *supra* note 36, at 35-38; AUERSWALD ET AL., *supra* note 36, at 35-38. *See* CONSTANCE E. BAGLEY & CRAIG E. DAUCHY. THE ENTREPRENEUR'S GUIDE TO LAW AND STRATEGY (5th ed. 2018). This is the traditional common way that startups functions, to show that unicorn capital raising is the exception.

[131] *See* Ryan Decker, John Haltiwanger, Ron Jarmin & Javier Miranda, *The Role of Entrepreneurship in US Job Creation and Economic Dynamism*, 28 J. ECON. PERSP. 3, 4 (2014) ("[A] small fraction of young firms exhibit very high growth and contribute substantially to job creation.").

[132] Joseph Blasi, Douglas Kruse & Richard Freeman, *Having a Stake: Evidence and Implications for Broad-Based Employee Stock Ownership and Profit Sharing*, THIRD WAY (Feb. 1, 2017), https://www.thirdway.org/report/having-a-stake-evidence-and-implications-for-broad-based-employee-stock-ownership-and-profit-sharing (on file with the *Columbia Business Law Review*) ("It is hard to find high-tech firms and start-ups that do not have some form of equity sharing and profit sharing with employees.").

[133] *See* Levmore, *supra* note 4 ("These options could take many forms but there is remarkable conformity in the practice of giving a class of employees a large percentage of compensation (in expected value terms) in the form of options . . . "). *See also* Smith, *supra* note 4 (discussing at-will contracts and equity compensation).

[134] *See* Yifat Aran, Note, *Beyond Covenants Not to Compete: Equilibrium in High-Tech Startup Labor Markets*, 70 STAN. L. REV. 1235, 1239–40 (2018).

[135] Michael Kanellos, *Intel Replaces Some Stock Options with Grants*, ZDNET.COM (Dec. 16, 2005), https://www.zdnet.com/article/intel-replaces-some-stock-options-with-grants/.

The mechanism of granting options to rank-and-file employees became so popular that by the mid-1970s, startups decided to give options to *all* of their employees.[136] Startup firms were able to attract, engage, and retain highly skilled employees by offering them large equity compensation packages. Employees agreed to this risky mechanism because they dreamed of cashing out for a large sum of money after an IPO of the startup's stock.[137]

Investors liked the stock option mechanism, too, because it used to align the interests of the founders with the rank-and-file employees. The practice guaranteed that the founder would have an incentive to file for an IPO because the founders would only make a lot of money after the "exit event"—i.e., the IPO—just like everyone else (the employees and investors). It should be noted, however, that while employees received stock options, founders traditionally received a combination of outright stock and stock options.

The stock option contract is designed as a long-term contract with a perpetual pipeline of unvested options to prevent employees from leaving the company.[138] The contract ties the employee to the firm with "golden handcuffs" in the following ways.[139]

It gives the employee—who is called an optionee (i.e., the stock-option-holder)—the right to buy a certain number of shares at a certain exercise price. The exercise price is a fixed price—most plans require it to be set at the fair market value of the options at the time the option is granted—that lasts for the exercise period, which is a fixed number of years (typically ten years).[140] As long as the employee continues to work for the company, she will typically have up to ten years to exercise the options from the grant date.[141] If, however, the

---

[136] Steven Blank, *How to Make Startup Stock Options a Better Deal for Employees*, HARV. BUS. REV. (Apr. 3, 2019), https://hbr.org/2019/04/how-to-make-startup-stock-options-a-better-deal-for-employees.

[137] *See supra* Part II.

[138] According to the Black-Scholes option pricing model, an option is more valuable the longer the period until expiration. *See* Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637, 638 (1973).

[139] *See* Lazonick, *Financialization*, *supra* note 124, at 865 ("So that stock options would perform a retention function as well as an attraction function, the practice evolved in New Economy firms of making option grants annually, with the vesting period for any annual block of option grants being 25% of the grants at the end of each of the first four years after the grant date.").

[140] *See* BAGLEY & SAVAGE, *supra* note 8.

[141] *See* Lazonick, *Financialization*, *supra* note 124, at 865. This practice derives from Section 422(b) of the Internal Revenue Code, which provides

employee leaves the firm, the option agreement typically only gives her only ninety days to exercise her vested options. That is why the practice is called "golden handcuffs."[142]

The following new developments changed the incentive value of the equity awards to the employees. As a result, early unicorn employees are left holding a large amount of illiquid investment in the firm that they cannot easily sell, diversify, or otherwise monetize.

B. Changes to Employee Stock Option Agreement

Recent changes to traditional founder stock treatment, combined with a longer timeframe from founding to IPO, is disrupting the 1950s-era model. In modern times, startup employees find that their rights, incentives, and bargaining powers have changed dramatically. Chief among them, traditional employee equity contracts were not designed to prevent the unforeseen contingency that startups will remain private for eleven years or longer rather than four years.

Stock option contracts were originally designed based on the principle that it will take the startup approximately four years or so to go public. But this is no longer the reality. According to empirical research by Jay Ritter, unicorn firms are now staying private longer than eleven years. This delay in IPO causes "lock-in" and illiquidity for unicorn shares. The stock option contract is designed as a long-term contract with a perpetual pipeline of unvested options to prevent employee from leaving the company.[143] The contract ties the employee to the firm with "golden handcuffs".[144] As long as the employee continues to work for the company, according to our tax code, she would typically have up to ten years to exercise the options from the grant date.[145] If, however, the employee decides to leave the company,

---

that an "incentive stock option" must not be "exercisable after the expiration of 10 years" from the grant date. 26 U.S.C. § 422 (2017).

[142] *See e.g.*, Connie Loizos, *Handcuffed to Uber*, TECHCRUNCH (Apr. 29, 2016), https://techcrunch.com/2016/04/29/handcuffed-to-uber/ [perma.cc/WRW7-X48L].

[143] According to the Black-Scholes option pricing model, an option is more valuable the longer the period until expiration. *See* Black & Scholes, *supra* note 138, at 638.

[144] *See* Lazonick, *Financialization*, *supra* note 124, at 865 ("So that stock options would perform a retention function as well as an attraction function, the practice evolved in New Economy firms of making option grants annually, with the vesting period for any annual block of option grants being 25% of the grants at the end of each of the first four years after the grant date.").

[145] *See* Lazonick, *Financialization*, *supra* note 124, at 865. This practice derives from Section 422(b) of the Internal Revenue Code, which provides

she will usually have only 90 days to decide whether to exercise her options.

Or, worse yet, what if the company never completes the IPO process and instead is sold in a "fire sale"?

Unicorn employees take on this high level of risk without having the proper information to make investment decisions.[146] The unicorn employer firms are private companies that usually do not disclose financial statements, shareholder lists, or other information pertaining to the valuation of the company. This leaves minority shareholders—like employees—at the mercy of majority shareholders. In the past, prior to the JOBS Act, employees were protected as an investor group by our securities laws. Startups had to count employees as investors and disclose material information accordingly. The JOBS Act changed that—leaving employees vulnerable in their position as investors and minority common shareholders in their companies. Employees are left subject to the discretion of majority shareholders, founders, and their company's legal counsel.

Valuation of unicorn stock will probably fluctuate after the firm grants options to employees. These scenarios can lead to employees with out-of-the-money options.[147] It is now illegal to backdate employee options, so unicorns cannot backdate option. It is also hard to re-issue options to employees in order to keep them motivated. Therefore, unicorn firms are experimenting with revisions to traditional practices to recreate the incentives and alignment of interests that were present before the new equilibrium.

On the one hand, Congress has encouraged employees to share in the ownership of very large firms,[148] such as unicorns; but on the other, Congress does not require the firms to provide enhanced disclosures to employee-investors. A direct consequence of these deregulation efforts is that in the last few years, privately held unicorns no longer provide their employees with useful disclosure and

---

that an "incentive stock option" must not be "exercisable after the expiration of 10 years" from the grant date. 26 U.S.C. § 422 (2017).

[146] *See* Aran, *supra* note 81.

[147] "Out of the money" describes an option contract that only contains extrinsic value. These types of options are not worth exercising.

[148] DAVID W. PERKINS ET AL., CONG. RESEARCH SERV., R45073, ECONOMIC GROWTH, REGULATORY RELIEF, AND CONSUMER PROTECTION ACT (P.L. 115-174) AND SELECTED POLICY ISSUES (2018), https://fas.org/sgp/crs/misc/R45073.pdf [https://perma.cc/AL32-8DLM].

information.[149] It is not surprising then that technology employees at major unicorn firms in Silicon Valley and across the United States are revolting. They are publicly protesting against their founders' decisions to stay private longer.

C. Airbnb Example

Airbnb, Inc. is an online marketplace for lodging and was considered a unicorn firm thanks to its then-estimated $35 billion valuation. Airbnb was founded in San Francisco in 2008 and has been searching for ways to remain a private company ever since. Unfortunately for Airbnb's founders, the roads to remaining private closed last year because a large portion of their employees' stock options were set to expire in 2020. Last year, Airbnb celebrated twelve years as a private tech startup, which affected both the corporation and its employees. The *New York Times*, *Bloomberg Law* and *Forbes*, reported that Airbnb employees were pushing management to go public.

IPOs allow employees to start a new firm (or join a new startup) and relax the employees' financial constraints. Because pre-IPO unicorn valuations are very high, many employees find that their options are prohibitively expensive due to liquidity constraints and tax concerns. There is a heated debate in Silicon Valley about whether the use of so-called "golden handcuffs," the 90-day stock option exercise period applicable to departing employees, is fair or efficient due to these new market conditions. At a minimum, golden handcuffs "lock in" employees who may prefer to work for a younger startup with more cutting-edge technology, which can stifle innovation. As long as the company continues to remain private, the employees continue to be locked-in. Even if they exercise and own outright stock, the company is private, which means that they cannot sell or transfer their stock.

After dealing with pressure from employees and negative publicity, Airbnb decided to become a public company in 2020. Airbnb employees wanted to finally be able to benefit from their stock options when the company went public. After a company's stock is traded on a public exchange, the employees can sell the stock they acquired upon exercising their options—and thereby realize the upside value they helped create. The Airbnb IPO took place on Dec. 9, 2020, and its shares began trading the following day.

---

[149] According to Cable, "Private placement regulation, like other areas of law, traditionally viewed employees as vulnerable . . . In recent decades, however, the SEC and Congress have essentially deregulated equity compensation by providing increasingly generous registration exemptions for equity grants to service providers. What is the basis for this policy change?" Cable, *supra* note 44, at 616.

Airbnb is not the only unicorn firm that dealt with employee uprising. Unicorn employees have been turning to the web to share their frustration, seek advice, and even to attempt unionization.[150] Employees are using websites, such as Glassdoor and PaySa, to complain about their dissatisfaction with stock illiquidity, which causes extreme capital lock-in.[151] The newest alert posted by employees about their employers concerns the new waiver practice. There are some online posts detailing the fact that employees do not even get a copy of the stock option agreement and are not aware that they waived their stockholder inspection rights.

D. The Black Box of Unicorn Valuation

Unicorns are private startup firms, which means that they usually focus on fast scale and large growth, and are unprofitable in their early years. The problem of inflated post-money valuations of unicorn firms is well documented in the finance literature.[152] Unsophisticated investors or the press might simply apply the latest series' share price to all these investors stock in order to figure out the valuation of the firm, but this practice is simply not accurate.

According to Gornall and Strabulaev, unicorns often report values that are on average about 51% to over 200% above their fair market value. To help tech employees figure out the black box of their unicorn employer's valuation, Gornall and Strabulaev also created a new online tool so that unicorn employees are able to value their stock.

---

[150] *See* Vladimir Atanasov, Vladimir Ivanov & Kate Litvak, *The Impact of Litigation on Venture Capitalist Reputation* 2–3 (Nat'l Bureau of Econ. Research Working Paper No. 13641, Nov. 2007), https://www.nber.org/papers/w13641 (on file with the *Columbia Business Law Review*). For more on agency costs and reputation, see Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 291–92 (1980).

[151] These sites rank the "Best Companies to Work For" and employees pay "careful attention . . . to Employee Engagement Scores that link corporate reputation, employee motivation, and productivity." Samuelson, *supra* note 154.

[152] Post-money valuation means a company's estimated worth after outside financing is added to its balance sheet. It is the market value given to a start-upfirm after a round of financing. See Gornall & Strabualev. Their research indicates that over 90 percent of mutual funds used inflated post-money valuations. For example, funds can hold different classes of stock in one company, which should have different prices, but would instead show the same figure.

It should be noted, however, that Gornall and Strabulaev's tool is not able to cover all the unicorn firms; it only covers the firms that they were able to get information on from different sources. This is a great initiative but, again, it does not fully solve the problem of lack of information on these companies.

Startups, including unicorns, typically sell shares to private investors to raise money. They often raise capital in multiple rounds. Each financing round can be very different. Unicorns are different from traditional startups because they able to stay private longer by raising large amounts of money from non-traditional investors (i.e., alternative venture capital).[153] Therefore unicorns have a complex capital structure. They sell shares to venture capitalists, institutional investors, hedge funds, mutual funds, corporate venture capitalists, sovereign wealth funds, Softbank, and other investors. Each of these investors usually negotiates different terms at each round of financing. Unicorns may have up to eight classes of stock, or maybe even more.

Investors typically look at the latest round of financing in order to try and figure out the exact market value (valuation) of the unicorn. They usually take the latest stock purchase price and apply that number to all of the outstanding shares. As an example, we can consider the unicorn, Square. At the last round of financing, Square was able to raise $15.46 a share for its Series E shares. After the financing round, Square was valued at $6 billion using the following formula:

> *"$15.46 Series E shares x ALL outstanding shares and unissued options = $6 billion"*[154]

There are several problems with valuing a company this way, as illustrated correctly by Gornall and Strabulaev. This sort of valuation does not factor in the different contractual terms, such as liquidation preferences that the various investors negotiated for, which were associated with the Series E stock. Additionally, the investors can negotiate for different economic rights, such as full ratchet or weighted average protections. Full ratchet and weighted average are examples of anti-dilution protections that sophisticated investors negotiate for in the event of liquidation or failure. These protect early investors by compensating them in the event of a future dilution in their ownership. Common and preferred stock do not typically get the same protections, which means that common stock holders are likely to get less for their shares.

---

[153] *See* Alon-Beck, *supra* note 69.

[154] *See* Gornall & Strabulaev, *supra* note 21.

If we were to use Gornall and Strebulaev's valuation model, which considers the different rights and protections of the various investors' groups, then a unicorn like Square will not be valued at $6 billion but rather only $2.2 billion. Note that when Square did eventually go public, its pre-IPO valuation was set at $2.66 billion.[155] So, Gornall and Strabulaev were spot on with their calculations of Square's valuation.

The following explains why information on the accurate valuation of the firm is important to employees.

E. Asymmetric Information

The issue of valuation and the ability to make informed investment decisions is extremely important for unicorn firm employees as minority shareholders. A central issue for unicorn employees, who are also stock-option-holders, is that they are uninformed about their rights, the *true* or *accurate* valuation of company stock, and the overall financial stability of the company. They might have access to public information to *some* valuation, but that valuation is wildly inflated. To make an informed investment decision on whether to exercise or forfeit their options, they need disclosure and access to appropriate information.[156]

An investment in a unicorn firm is investment in private equity markets, which are categorized by greater information asymmetries[157] when compared to public markets. Therefore, the variation in investment strategy among the various investors affects the stock price, which is difficult to ascertain if the investor-employees do not have information such as the list of shareholders and the various terms of the financing rounds.

This Article rejects the view that employees are simply insiders who already have financial information about the firm and its viability.

---

[155] *See* Gornall & Strabulaev, *supra* note 21.

[156] The U.S. Supreme Court made it clear in Ralston Purina that employee status, taken alone, does not guarantee access to material information. SEC v. Ralston Purina Co., 346 U.S. 119, 126 (1953).)

[157] *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,* 3 J. FIN. ECON. 305, 309 (1976). For further discussion on agency problems and strategies to reduce them, see also Henry Hansmann & Reinier Kraakman, *Agency Problems and Legal Strategies*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH (Reinier H. Kraakman et al. eds., Oxford Univ. Press 2d ed. 2009).

Some scholars[158] consider employees of startups as insiders (sometimes they go so far aso to consider these employees succesful gamblers or lottery winners) who are well-positioned to monitor their company's progress. They presume that the employees' economic incentives are aligned with the those of the founders. Moreover, they assume that the employees are protected by the bargaining ability of other sophisticated investors, such as VC investors, who can sanction the founders for bad behavior. Even if this is true in limited circumstances (perhaps this theory can work for employees of small or medium-sized startups), it certainly is not for unicorn employees.[159]

The founders of unicorn firms are usually diluted (i.e., they had to give up voting control and economic rights). The new investors—for example, VC firms—negotiate for control over the board of directors and for the power to fire the founders. Fried and Broughman show that Mark Zuckerberg's example (of a founder maintaining control over their firm after an IPO) is an exception and not the rule.[160] Fried and Broughman challenge Black and Gilson's traditional "call option on control" finance theory, which links VC and stock markets, and they further prove that the likelihood of founders reacquiring control via IPO is extremely low.[161]

Unicorns are different from small or medium size startups because they are raising large amounts of capital in private mega deals of $100 million or more from a mixed group of investors, including non-traditional investors. The mega deals allow unicorn founders to prolong the timeline to IPO or trade sale. These offerings are not

---

158 For a further discussion on employee incentives, see generally Robert Anderson, IV, *Employee Incentives and the Federal Securities Laws*, 57 U. MIAMI L. REV. 1195 (2003) (discussing the status of employee options as securities); Matthew T. Bodie, *Aligning Incentives with Equity: Employee Stock Options and Rule 10b-5,* 88 IOWA L. REV. 539 (2003) (focusing on the availability of Rule 10b-5 actions); Smith, *supra* note 4 (focusing on the law and economics of equity compensation as private ordering); Michael C. Jensen & Kevin Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, HARV. BUS. REV., May–June 1990, at 138 (advocating for equity compensation as a form of incentive-based executive pay).

159 *See also* Cable, *supra* note 44, at 616-17.

160 *See* Jesse M. Fried & Brian J. Broughman, *Do Founders Control Start-Up Firms that Go Public?*, 10 HARV. BUS. REV. 50, 51 (2020).

161 *See* Bernard S. Black & Ronald J. Gilson, Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets, 47 J. FIN. ECON. 243, 243 (1998). Black & Gilson argued that an IPO-welcoming stock market stimulates venture deals by enabling VCs to give founders a valuable "call option on control." It means that the founders could get control after the IPO. Fried & Broughman, *supra* note 159. The authors focus on control that is both strong—meaning founders have enough voting power to ensure they remain in the saddle—and durable—meaning control lasts at least three years. *Id.*

registered with the Securities and Exchange Commission ("SEC"). And VC investors are not the only players. Rather, in unicorns, alternative venture capital investors play a major role in contributing to the transition in equity ownership and capital formation in the U.S. towards models of private ownership.[162] The changes in the incentives and the composition of the investor groups give unicorn founders greater power vis-à-vis preferred shareholders and minority common shareholders to oppose a sale and keep the company private longer.[163] This also means that employees are no longer protected by traditional investors (i.e., VCs) who used to sanction the founders for bad behavior.[164]

Moreover, employees need access to information on the company because there is no exit event.[165] Unicorns are staying private longer than eleven years, which requires the employees to make an investment decision on whether to exercise or forfeit their options in the company.[166] There are several scenarios where employees are required to make such a decision: first, according to our tax code, stock option grants expire after ten years; second, if the employee wants to leave the firm, she may lose her unvested ownership. Her vested ownership may also lose value because she will have to exercise options, which create tax and cash-flow issues;[167] or third, she may be forced to sell her stock or options to the company without knowing their true value.

With no access to accurate information about the company, the mere reported but unconfirmed firm valuation can lead the employee to take on more risk than anticipated, and lead them to pay large amounts of taxes (for example, on profits that may never materialize). Moreover, in some cases, employees may be systematically misled by founders to think that the employees are rich but in reality might only be rich on paper. This could result in the employee-investor making the wrong investment decisions, such as exercising their options

---

[162] "Capital formation in the United States is currently in the midst of a significant transition . . . ." IRA M. MILLSTEIN CENTER, COLUMBIA LAW SCHOOL, PRIVATE OWNERSHIP AT A PUBLIC CROSSROADS: STUDYING THE RAPIDLY EVOLVING WORLD OF CORPORATE OWNERSHIP (2019).

[163] See Anat Alon-Beck, Alternative Venture Capitel. There are many different types of investors with different incentives, contractual rights and characteristics, including pooled investment vehicles, who owe fiduciary duties to their own investors.

[164] *See also* Cable, *supra* note 44, at 616-17.

[165] Exit is the point where investors in the startup may be able to liquidate their investment and get money.

[166] The U.S. Supreme Court made it clear in Ralston Purina that employee status, taken alone, does not guarantee access to material information. SEC v. Ralston Purina Co., 346 U.S. 119, 126 (1953).)

[167] See Anat Alon-Beck, Unicorn Stock Options.

prematurely. There is also always a chance that the value of the unicorn's common stock will drop below the strike price, which renders the employee's options practically worthless. The employees may end up paying to work for their company when their profits do not materialize.[168]

Employees only benefit from their vested options if their company goes public. If the company goes public, then they are able to sell the stock and realize the upside value that they helped create.[169] But, as noted, today many unicorn companies remain private, while their employees must pay large sums of money out-of-pocket for the exercise price and taxes[170] on profit that might never materialize.[171] The value of equity options to employees is diminished—helping to explain why unicorn firms are experiencing difficulties with attracting, engaging and retaining talent.[172] The longer the unicorn stays private the longer the employees are locked-in.

F. Lock-in

---

[168] *See infra* Part V.

[169] *See* BAGLEY & SAVAGE, *supra* note 8.

[170] Federal and state taxes are imposed on exercise of equity options, even when there is no active market to sell them and such a market might never materialize. *See* Lieberman, *supra* note 148; *see also* DAVIS POLK & WARDWELL LLP, *supra* note 148 ("This potential disconnect has grown more prevalent in recent years as many tech companies have deferred their initial public offerings, frustrating the ability of employees to receive the benefit of equity awards without paying taxes out of pocket."); Kathleen Pender, *Bills Would Ease Tax Burden of Private-Company Stock Options*, S.F. CHRON. (Aug. 17, 2016, 5:11 PM), https://www.sfchronicle.com/business/networth/article/Bills-would-ease-tax-burden-of-private-company-9157182.php [perma.cc/7GDT-JMTY]; *Tax "Reform" And Its Impact On Stock Compensation*, MY STOCK OPTIONS BLOG (Dec. 20, 2017), http://mystockoptions.typepad.com/blog/2017/12/tax-reform-and-its-impact-on-stock-compensation.html [perma.cc/2RSG-FFZ4].

[171] This can also lead to a cash-flow issue for the unicorn firm. The firm is required to withhold and remit income and employment taxes at the time of the exercise (NSOs) or vesting (RSUs), but it is not transferring any cash to the grantee from which it can withhold those amounts. *See* Scott Belsky, *Don't Get Trampled: The Puzzle For "Unicorn" Employees*, MEDIUM (Jan. 2, 2017), https://medium.com/positiveslope/dont-get-trampled-the-puzzle-for-unicorn-employees-8f00f33c784fhttps://medium.com/positiveslope/dont-get-trampled-the-puzzle-for-unicorn-employees-8f00f33c784f [perma.cc/76C3-E9CE].

[172] *See* Andrew Ross Sorkin, *How Valuable Is a Unicorn? Maybe Not as Much as It Claims to Be*, N.Y. TIMES (Oct. 17, 2017), https://nyti.ms/2yvpuyk [perma.cc/4Y7C-3KAA].

Unicorn shares are non-liquid financial assets. An investor is "locked in" when he or she is unwilling or unable to trade a security because regulations, taxes, or penalties prevent them from doing so. Stocks, options, and warrants offered under employee incentive programs, which usually come with a mandatory vesting period, can all become locked in.

In general, unicorn employees hope that the company will go public and that the shares will be traded at a price higher than the exercise price. In the event of a sale of the company, employees can exercise the vested options before the sale. After doing so, they will either be able to sell their shares or their options will be canceled in exchange for a payment equal to the spread between the exercise price and the sale price.[173]

Historically, the traditional exit mechanism for investors in private firms was limited to an IPO or a trade sale.[174] Private company investors deal with extreme "lock-in" of their capital due to the illiquidity of their stock.[175] Due to the prolonged timeline to IPO or trade sale, which is now longer than eleven years,[176] new liquidity practices have been developed to allow unicorn shareholders—such as employees and early investors—to liquidate their investments as an alternative to the traditional exit mechanisms.[177]

---

[173] Ilona Babenko et al., *Will I Get Paid? Employee Stock Options and Mergers and Acquisitions* 1 (European Corp. Governance Inst., Working Paper No. 486/2016, 2017) ("In 79.9% of all completed M&A deals, some of the target's outstanding employee stock options are terminated by the acquirer. . . . Further, employees are often forced to accept the intrinsic value of their vested in-the-money stock options in lieu of the Black-Scholes value...").

[174] *See* Fried & Broughman, *supra* note 163.

[175] The private startup company legal form is set to "lock-in parties while developing vulnerable match-specific assets." *See* Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 J. CORP. L. 913, 919 (1999). This article builds on the work of Rock and Wachter and postulates that capital lock-in is important for startup companies, including large unicorns, because the cost of investing in innovation-driven products or services is very high and risky.

[176] The timeline to IPO used to be 4 years and is now longer than 11 years. *See* Jay Ritter, Initial Public Offerings: Updated Statistics, https://site.warrington.ufl.edu/ritter/files/2016/03/Initial-Public-Offerings-Updated-Statistics-2016-03-08.pdf.

[177] *See* Katie Roof, *SoftBank's Big Investment in Uber Comes to a Close*, TECHCRUNCH (Dec. 28, 2017), https://techcrunch.com/2017/12/28/softbanks-big-investment-in-uber-comes-to-a-close/ [https://perma.cc/V3EC-74ZN]; *see also* Greg Bensinger & Liz Hoffman, *SoftBank Succeeds in Tender Offer for Large Stake in Uber: Group Led by Japanese firm Is Set to Acquire About 18% of Startup at a*

These new practices include secondary sales, structured liquidity programs (private tender offers), and other liquidity alternatives.[178] They are often used by existing shareholders (investors and employees) as a third exit option.[179] They involve specific contractual arrangements between the various participants, including investors with divergent rights and privileges.

Unfortunately for unicorn employees, the delays in IPO causes them both severe "lock-in" and illiquidity for their unicorn shares. Unicorn employees are faced with a dilemma: If their options are expiring (or if they want to leave the firm), they must choose between forfeiting their options, and thereby reducing their chances of getting rich, or exercising their options and paying taxes on profit they may never realize.[180] If the employee decides to exercise her options, she runs the risk that the unicorn firm will continue to stay private for a long time. During that time, there is always a chance that the value of the company's common stock will drop below the strike price and then her options will become practically worthless.

V. SUGGESTIONS

There is a continuing trend in the case law that demonstrates a growing tension between Delaware courts and other state courts, with regards to important and far-reaching choice of law issues.

Delaware courts need to provide more clarity in this area of the law where choice of law issues are relatively likely to come up on a regular basis in the future — stockholder inspection rights. Specifically, with regards to unicorn firms, since 97% of them are incorporated in Delaware, Delaware courts will continue to have significant relationship with these types of lawsuits when the dispute involves a Delaware entity and its stockholders inspection rights.

This Article, therefore, calls for Delaware courts and legislators to provides protection to minority stockholders and stock-option-

Steep Discount, WALL ST. J. (Dec. 28, 2017), https://www.wsj.com/articles/softbank-succeeds-in-tender-offer-for-large-stake-in-uber-1514483283 [https://perma.cc/4AEY-P2HA].

[178] *See* Dawn Belt (Fenwick & West LLP), Lexis Nexis Practice, Pre-IPO Liquidity for Late Stage Start-Ups (May 31, 2018), https://www.fenwick.com/FenwickDocuments/Pre-IPO-Liquidity-for-Late-Stage-Start-Up.pdf.

[179] *See* Darian M. Ibrahim, *Financing the Next Silicon Valley*, 87 WASH. U. L. REV. 717 (2010).

[180] *See supra* Part IV, explanation on equity compensation.

holder from oppression and mismanagement by the majority stockholders, founders, and managers of unicorn firms.

A. Delaware Courts

Delaware law must provide companies with clarity so as to avoid litigation with employees through better planning and clear contractual arrangements. Section 220 provides protection to stockholders by allowing them to exercise their ownership rights and inspect the books and records of a Delaware corporation. In Delaware, this ownership right cannot be eliminated or limited by a provision in a corporation's certificate of incorporation or bylaws. But there is ambiguity in the case law about contractual arrangements and private ordering.

Delaware courts should not depart from the established common law tradition that enforces mandatory immutable rules on this issue. Delaware courts should make it clear that from this moment forward Delaware corporations, their managers, and their attorneys are not free to exploit minority stockholders and stock-option-holders—especially employees of unicorn firms.

Delaware courts must make it clear that it is not permittable under current Delaware case law to contract out of mandatory stockholder inspection rights. More importantly, Delaware courts should declare that they will allow minority employee stockholders—even those who waived their stockholder inspection right via contract—to access the books and records of their companies under Section 220 in order to evaluate their stake in the company.

This does not represent a radical shift in the law but rather a restoration of the understanding of it that existed long before *Domo* was litigated. Even with its management friendly attitude, Delaware courts have consistently taken steps to protect minority shareholders. Despite attempts under federal law to strip away employees' status as shareholders, Delaware should step up and consider the broader role these shareholders play in governance and corporate purpose.

B. Delaware Legislature

The Delaware legislature should not amend its statutes to enable corporations to waive the important stockholder inspection right via private ordering. Perhaps the legislature should specifically enact a provision in the law prohibiting private shareholder contracts from including such a waiver provision or making this issue clear otherwise.

This Article has brought to light a lacuna in what is surely one of the most important provisions of the Delaware law, Section 220, which affords protection to minority stockholders from the oppressive behavior of the majority by allowing minority stockholders and to gain access to their company's books and records.

Unfortunately, DGCL Section 220 does not offer such protections to stock-option-holders. Therefore, this Article further calls on the Delaware legislature to amend its statutes in order to enable stock-option-holders to access their companies' books and records under DGCL Section 220.

C. Practitions – Provide More Information to Employees

Practitioners, the employer's attorneys (acting to enforce compliance by the employer) who are advising tech companies should innovate by helping their clients to find ways to provide information to their employees while protecting the firm's intellectual property. A departure from the traditional stock option model will not benefit the firm.

Practitioners are innovating because they want to protect the firm from a rise in potential lawsuits from employees, which is understandable. But they need to fix the problem. The problem is that there is a lack of information. The new contractual innovation – waiver of stockholder statutory inspection rights – will not only not solve the problem, but is making it much worse. When employees complain about their company in public (on online platforms) and initiate lawsuits against the company, it raises the costs for the firm to monitor its labor, especially where there is a short supply of labor and fierce competition in technology markets.

Again, the problem is about asymmetry of information. To mitigate some of the risks that are associated with the employees' investment decision, the employer's attorneys would require that the firm disclose the following information to shareholder-employees.

First, in addition to the Stock Option Purchase Agreement and the Plan, the attorney would request a schedule with the amount of capital that was raised by the company until that point. The schedule would include a list of investors that received liquidation preferences and founders who were granted super voting common stock.

Second, the attorneys would require the firm to disclose how much debt has accumulated (including debt evidenced by convertible or SAFE notes). Third, if companies allow employees to trade on secondary platforms, the companies would also provide appropriate disclosure, including any restrictions on resale, to make sure that employees understand and comply with the applicable securities regulations. If the companies do not allow employees to trade on secondary platforms, attorneys would inquire about facilitating private secondary market sales, or stock buybacks.[181]

Fourth, disclosure would include information on the compensation of the management team, information concerning current and future stock and debt issuances, a list of investors holding more than a specified percentage (perhaps 1%) of the outstanding stock (including their liquidation preferences and conversion rights), and a quarterly estimated fair market value of the stock. Finally, attorneys might request that unicorns be audited by an independent auditing firm. The employees should have access to and be entitled to rely on these reports.[182]

These disclosures can produce increasingly equitable and sustainable to employee participation in unicorn companies. Although these disclosures are equitable for employees—and can show that investing in the company is sustainable—disclosures are a nightmare for unicorn management teams. There is a need for innovation with regards to disclosure practices.

Time will tell whether, Section 220 is going to make it easier for unicorn employees to push for an exit event for liquidity, but it can help alleviate the problem of golden handcuffs and the ensuing constraint on employee mobility.[183]

---

[181] *See* Ric Marshall et al., *Taking Stock: Share Buybacks and Shareholder Value*, Harv. Law School F. Corp. Governance. & Fin. Reg. (Aug. 19, 2018), https://corpgov.law.harvard.edu/2018/08/19/taking-stock-share-buybacks-and-shareholder-value/ [https://perma.cc/SL43-FMXR] (finding no compelling evidence of a negative impact from share buybacks on long-term value creation for investors overall).

[182] For alternative suggestions on disclosure, *see* Yifat Aran.

[183] *See supra* Part IV.

VI. CONCLUSION

Unicorns stay private longer for various reasons, but in large part in order to avoid public disclosures that can reveal their true financial conditions and fair market value, including to their own employees. Unicorns are notorious for their exaggerated valuations. Employees are not privy to confidential information, including financial statements, shareholder lists and other material non-public documents. Unicorns are likely to refuse an employee that asks for access to such information.

Unicorn firms' founders, investors, and their lawyers have systematically abused equity award information asymmetry to their benefit. Unicorn firms do not provide their minority stockholders and stock-option-holders—specifically, their employees—with information on their stake in the company, which can improve efficiency and reduce information asymmetries. Unicorn employees do not have access to financial reports and, in many cases, are denied access to such reports.

This Article demonstrates that following a recent Delaware case, *Biederman vs. Domo*, unicorn firms adopted a new pervasive practice that compels their employees to waive inspection rights as stockholders under DGCL Section 220. The result is that employees cannot turn to the courts for assistance. Relying on a hand collected data set consisting of SEC's public filings, I found that many unicorn firms now require that their employees waive their inspection rights under DGCL Section 220 as a condition to receiving stock options from the company. Employees sign a waiver clause entitled, "Waiver of Statutory Information Rights," in which they waive their inspection rights of the following materials: company stock ledger, a list of its stockholders, other books and records, and the books and records of subsidiaries of the company. The waiver is in effect until the first sale of common stock of the company to the public.

Unicorn employees are now turning to the courts to compel their companies to open up their books and records and disclose financial information. Employees who are stock-option-holders, but not stockholders yet, do not have a right to access such information under Delaware law. In order to have standing in court, the employee must first exercise her options and become a stockholder of record. This Article advocates for reform. Both minority stockholders and stock-option-holders should be entitled to information so that they can make informed investment decisions, such as deciding whether to exercise their options or let them expire overnight.

The Article also presents evidence that U.S. unicorn firms prefer to incorporate in Delaware. Relying on hand collected data, I found that 97% of the unicorns in the United States are incorporated in Delaware. Therefore, the Article calls on the Delaware courts and legislature to not allow unicorns to modify or eliminate the mandatory inspection rights expressly set forth in the DGCL. Delaware law is and should continue to serve as a valuable tool for minority stockholders and stock-option-holders (employees) who are questioning the value of their shares. Delaware courts and legislators' actions and resolution on this important issue will have tremendous influence on corporate law, litigation, and practice.

VII. APPENDIX

Table 1: Unicorn Firms Incorporated in Delaware with Public Record of Statutory Waiver of Information

Corporation	Date of Incorporation	Date of Waiver	Valuation of Firm (Billions)
JUUL Labs	3/12/2007		$50.0
DoorDash	5/21/2013	11/13/2020	12.6
SoFi	4/26/2011		4.5
OpenDoor Labs	12/30/2013		3.8
GoodRx	9/12/2011	8/28/2020	2.8
Pax Labs	4/21/2017		1.7
Asana, Inc.	12/16/2008	8/24/2020	1.5
Segment	5/2/2011		1.5
One Medical Group	7/5/2002	1/3/2020	1
Casper	10/24/2013	1/10/2020	1.1
Hims	12/30/2013	1/26/2021	1.1
Sumo Logic	3/29/2010	8/24/2020	1