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Venture Capital's ESG Problem

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COMMENT

VENTURE CAPITAL’S ESG PROBLEM

TABLE OF CONTENTS

INTRODUCTION .............................................................................. 515
I. VENTURE CAPITAL ........................................................................... 520
   A. The Venture Capital Cycle .............................................................. 520
      1. Venture Capital Funds ................................................................. 521
      2. Venture Capital Investments ......................................................... 522
      3. Venture Capital Oversight .......................................................... 523
      4. Exits .......................................................................................... 524
   B. VC Investment Incentives ............................................................ 526
      1. Investment Decisions ................................................................. 527
      2. Exit and Deliver Profit ................................................................. 528
II. ENVIRONMENTAL, SOCIAL, AND GOVERNANCE .................. 528
    A. Modern Importance of ESG in Corporate Law ......................... 528
    B. What Is ESG Investing? ................................................................. 530
       1. Definition of ESG ..................................................................... 530
       2. ESG Active Investing ................................................................. 532
       3. ESG Shareholding ..................................................................... 533
    C. ESG in Public Companies ............................................................ 534
    D. Venture Capital’s Lack of Focus on ESG ..................................... 535
III. VENTURE CAPITAL’S ESG PROBLEM .................................. 536
    A. The Venture Capital Herd ............................................................. 537
       1. Social Connections and Structure of VC Deals ......................... 537

513
2. Lack of Diversity .................................................... 537
3. Herd Mentality ....................................................... 538
4. VC Herd Mentality Is Incompatible with ESG Investing ................................................ 539

B. VC’s Lack of Control .......................................................... 539
   1. Extreme Governance Complexity .................. 539
   2. Founder-Friendliness ............................................. 540
   3. Information Breakdown ......................................... 541

C. The Decline of IPO Exits .............................................. 542
   1. The Absence of IPO Discipline............................. 543
   2. The Rise of Killer Acquisitions .................. 545

CONCLUSION................................................................. 546
VENTURE CAPITAL'S ESG PROBLEM

INTRODUCTION

Venture capital (“VC”) is repeatedly described as one of the “crown jewels” of the U.S. economy for its role in financing startups and innovation. However, recent corporate scandals, including fraud, have exposed a darker side of the VC industry and the startups in which venture capitalists (“VCs”) invest. For example, Theranos received $686 million in VC funding yet proved to be nothing more than a “house of cards” once it came to light that Theranos falsified blood test results. When Theranos founder Elizabeth Holmes was convicted of fraud, many VCs tried to distance themselves, saying Theranos was an exception and that most of Theranos’s financing did not come from VC. Nevertheless, in the wake of Theranos, fraud and mismanagement of VC-backed companies has continued.

Another recent example of VC scrutiny was the collapse of a fraudulent cryptocurrency exchange, FTX. Some of the largest and most well-known VC funds—such as Sequoia Capital, NEA,
Tiger Global, and Softbank—were heavily invested in FTX when the company collapsed and are under scrutiny for their lack of oversight.\footnote{8} Other recent high-profile scandals at VC-backed companies include WeWork and Uber.\footnote{9} Moreover, several founders of lesser known VC-backed companies have also recently been arrested, charged, or convicted of defrauding investors.\footnote{10} These recent examples of fraud and mismanagement at VC-backed companies raise important questions about the proper role of VC and technology startups in our society.

These questions about VC are vital given VC’s outsized impact on the U.S. economy and how formerly VC-backed companies dominate the corporate landscape. For example, in 2022, VC funds raised $162.2 billion in U.S. capital to invest in startups, which was an all-time high.\footnote{11} However, this pales in comparison to BlackRock, a single investment management company with roughly $10 trillion of assets under management.\footnote{12} Additionally, VC provides funding to less than 0.5% of U.S. companies created every year.\footnote{13} Nevertheless, formerly VC-backed companies account for 41% of total U.S. market capitalization.\footnote{14} When looking only at U.S. companies started since 1996, the market capitalization of formerly VC-backed companies jumps to almost 76%.\footnote{15} The list of formerly VC-backed companies includes some of the most well-known companies like Facebook, Amazon, Apple, Netflix, Google, Twitter, LinkedIn, Starbucks, and Home Depot.\footnote{16}
VC is also synonymous with disruption and innovation. For example, VC-backed companies account for over 62% of research and development spending in the United States.\textsuperscript{17} This can lead to rapid technological advances that save lives, such as Moderna, a VC-backed company that developed a COVID-19 vaccine in record time.\textsuperscript{18}

However, VC’s quest for disruption and innovation does not necessarily produce an overall benefit for society. Meta founder Mark Zuckerberg famously said that the company’s early motto was “move fast and break things.”\textsuperscript{19} VC and the startups they fund may indeed have moved fast and broken many things. Recent academic literature has detailed the “notable” lack of diversity in startups and VC,\textsuperscript{20} the prevalence of securities fraud in private, VC-backed companies,\textsuperscript{21} antitrust issues in VC,\textsuperscript{22} and a lack of innovation.\textsuperscript{23} Another body of literature explores the phenomenon of VC-backed companies staying private longer, which leads to corporate governance issues.\textsuperscript{24}

Thus far, however, legal academic literature has not directly connected VC with another area of corporate law called “ESG.” Broadly speaking, ESG is an “umbrella term” used to describe the environmental, social, and governance issues of a company.\textsuperscript{25} In

\begin{itemize}
\item \textsuperscript{17} Will Gornall & Ilya A. Strebulaev, \textit{The Economic Impact of Venture Capital: Evidence from Public Companies} (Stan. Graduate Sch. of Bus., Working Paper No. 3362, 2021).
\item \textsuperscript{20} Jennifer S. Fan, \textit{Startup Biases}, 56 U.C. DAVIS L. REV. 1423, 1442 (2023) (detailing racial and gender bias in the venture capital and startup industries).
\item \textsuperscript{21} See Pollman, \textit{supra} note 4, at 382–83 (detailing how VC-backed startups pursuing innovation often “bump up against, disregard, or even intentionally disobey laws”).
\item \textsuperscript{23} Lee, \textit{supra} note 14, at 611.
\item \textsuperscript{25} Max M. Schanzenbach & Robert H. Sitkoff, \textit{Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee}, 72 STAN. L. REV. 381,
2021, U.S. investment funds that incorporated ESG principles into their investment strategies managed over $4.5 trillion in assets. This is only expected to increase as the U.S. Securities and Exchange Commission (“SEC”) is currently considering a regulation that would require public companies to disclose their material climate risks.

However, the VC industry has been slow to adopt ESG investment principles. In a 2021 survey of the fifty largest VC funds, only five of the funds’ websites “mentioned ESG or a commitment to sustainability.” Moreover, a United Nations working group, the Principles for Responsible Investment, recently criticized the VC industry for its lack of “ESG incorporation.”

This Comment aims to directly connect VC with ESG and identify why VC has been slow to adopt ESG principles. Part I provides an overview of VC funds, their investment cycle, and their incentives and goals when investing in startups. Part II analyzes ESG in general, then looks at ESG in the context of VC investing. Finally, Part III proposes three potential reasons for VC’s lack of focus on ESG.

Section III.A explains that the first reason VCs lack focus on ESG is herd behavior in the VC industry. VCs largely rely on prior social connections when making investments. Moreover, the VC industry is “staggeringly homogeneous.” Together these factors lead to herd behavior, where individuals forgo independent decision-making, instead deferring to broader group decisions.

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30. See infra Section I.B.1.


32. See infra Section III.A.3.
However, ESG investing relies on identifying environmental, social, and governance issues in a company that other investors over-
look.33 Thus, VCs’ herd mentality may be prohibiting them from mak-
ing independent investment decisions based on ESG factors.34

Section III.B explains that a second reason for the lack of focus on ESG is that VCs now have less control over startups than in the past. Traditional literature theorizes that VC funds serve as effective monitors over startups, typically getting a seat on the board and other control rights as part of their investment.35 These control rights allowed VCs to implement reforms that addressed compliance, human resources, and other ESG issues. However, there is a modern trend of startups remaining private companies longer than they used to.36 This creates “extreme complexity” in the capital structure of VC-backed startups.37 This governance complexity hinders the ability of VCs to effectively monitor and oversee the startups they invest in.38 Compounding the extreme governance complexity is a trend toward “[f]ounder [f]riendly” VCs that provide considerable deference to startup founders, often forgoing information and control rights altogether.39 Together, the governance complexity and founder-friendliness mean VCs have less control over startups than they have had historically. This lack of control may be preventing VCs from implementing ESG principles in the startups, such as by demanding a diverse board or creating compliance programs that monitor environmental impacts.

Section III.C explains that a final reason for VC’s lack of focus on ESG is a decline in the number of VC-backed companies going public through an initial public offering (“IPO”). To make a profit, VCs need to “exit” their investment in a startup—typically when the startup goes public through an IPO or a larger company ac-
quires the startup.40 The lack of IPOs means there are more

33. See infra Section II.B.2.
34. See infra Section III.A.4.
36. See Elisabeth de Fontenay & Gabriel Rauterberg, The New Public/Private Equilib-
37. Will Gornall & Ilya A. Strebelev, Squaring Venture Capital Valuations with Real-
ity, 135 J. FIN. ECON. 120, 121 (2020).
38. Pollman, supra note 24, at 175, 177.
40. Lemley & McCreary, supra note 22, at 1.
acquisitions, which have created two perverse incentives for VC. First, IPOs have a “significant disciplining effect” on a startup by requiring public disclosures and scrutiny from investors.\(^\text{41}\) However, without the prospect of an IPO, a startup does not face the “intense . . . pressure to professionalize” such as by adopting a diverse board, or even coming into compliance with laws and regulations.\(^\text{42}\) Second, the decline in IPOs has led to a rise of “killer acquisitions” where a competitor buys a startup, only to shut it down to prevent competition.\(^\text{43}\) For example, Facebook has acquired then promptly shut down thirty-nine startups, which is almost half of the ninety-two total startups Facebook has acquired.\(^\text{44}\) Without the disciplining mechanism of an IPO, and especially if the startup is just going to be shut down after acquisition, the VC fund has no incentive to prioritize the ESG issues of the startup.

I. VENTURE CAPITAL

This Part details the cycle of a VC investment in a startup. The cycle follows VCs creating a fund, investing in a startup, monitoring the startup over a period of years, and finally exiting their investment, typically through an IPO or an acquisition. Then, this Part explores VCs’ incentives when investing in startup companies.

A. The Venture Capital Cycle

Venture Capital is the process by which VC funds invest in early-stage and high-risk startup companies, typically in the technology industry.\(^\text{45}\) The “prototypical start-up” is led by an entrepreneur who quits their job and receives VC funding to pursue an innovative idea.\(^\text{46}\) These early-stage startups are usually not yet profitable, have no working product, and have a high chance of failure; consequently, they are unable to obtain funding from

\(^{41}\) Jones, supra note 24, at 178.

\(^{42}\) Id.

\(^{43}\) Lemley & McCrary, supra note 22, at 63.


traditional sources, like loans from a bank. Instead, startups use VC to fund their innovative idea. In exchange for their investment, VCs receive part ownership of the startups.

1. Venture Capital Funds

This Comment refers to VC firms and VC funds interchangeably; however, they are distinct legal entities. A VC firm is the “franchise” and carries the name of the firm. The VC firm is also a management company that oversees and services multiple VC funds.

VC funds are organized as limited partnerships, which are partnerships between two or more people with at least one general partner (“GP”) and at least one limited partner (“LP”). GPs manage and control the partnership, which makes them liable for debts and obligations of the partnership. In contrast, LPs have little control over the partnership, so they are generally not liable for any obligations of the partnership.

VC funds typically have a lifespan of ten years. In the beginning, the GPs will solicit investment commitments from wealthy individuals and institutional investors—pension funds, mutual funds, insurance companies, university endowments, foundations, and sovereign wealth funds. These institutional investors, who agree to commit a certain amount of money to the fund, become LPs of the fund. To maintain LP status for the LPs, and thus limit liability, VC funds are often blind pools where the LPs relinquish

47. Darian M. Ibrahim, Debt as Venture Capital, 2010 U. ILL. L. REV. 1169, 1175 (2010) (noting that early startups are usually unprofitable and often spend millions of dollars a month because they put all their money towards research and development, marketing, and hiring employees).
49. Id.
50. See Gilson, supra note 1, at 1070; DEL. CODE ANN. tit. 6, § 17-101 (2023).
51. See, e.g., DEL. CODE ANN. tit. 6, § 17-403 (2023).
52. See, e.g., tit. 6, § 17-303.
53. Gilson, supra note 1, at 1071.
55. FELD & MENDELSON, supra note 48, at 168.
all investment decisions to the GPs of the VC fund.\textsuperscript{56} Thus, the GPs of a VC fund typically make and monitor all the investments of the fund.\textsuperscript{57} For this reason, when people refer to “venture capitalist[s],” they are usually referring to the GPs of a VC fund.\textsuperscript{58}

2. Venture Capital Investments

Once the GPs form a VC fund, they begin investing in startups. Typically, VC funds spend the first three to four years of the fund investing in startups.\textsuperscript{59} As noted above, these startups are typically unprofitable for long periods and may never be profitable, which makes them risky investments.\textsuperscript{60} To manage risk, VCs receive part ownership in the startup, almost always through convertible preferred stock.\textsuperscript{61} Unlike common stock, which founders and employees hold,\textsuperscript{62} preferred stock comes with special rights.\textsuperscript{63} These negotiated contractual rights typically include protective provisions, such as the right to veto significant company decisions; information rights, which define what the startup must disclose to the holder of the stock; and control rights, such as a seat on the startup’s board.\textsuperscript{64}

VCs also manage risk by making staged investments in a startup.\textsuperscript{65} Each stage or round of investing is typically conducted every twelve to twenty-four months.\textsuperscript{66} Staged financing allows the VCs to continually monitor the startup for progress and abandon

\begin{footnotes}
\footnoteref{56}\footnotetext{Gilson, supra note 1, at 1070–71; see also Kupor, supra note 16, at 70.}
\footnoteref{57}\footnotetext{Gilson, supra note 1, at 1071.}
\footnoteref{58}\footnotetext{See Feld & Mendelson, supra note 48, at 4–5. To further limit liability, the GPs of a fund are typically another legal entity, such as an LLC. Id. at 168.}
\footnoteref{59}\footnotetext{See Kupor, supra note 16, at 66, 72. However, VC funds may still invest in a startup in years five or six of the fund. See id.}
\footnoteref{60}\footnotetext{Pollman, supra note 24, at 161, 165–66, 172.}
\footnoteref{62}\footnotetext{See Kupor, supra note 16, at 141. Employees typically only receive stock options, which give employees the right to purchase common stock in the future. Id. at 103.}
\footnoteref{63}\footnotetext{Feld & Mendelson, supra note 48, at 42. The preferred stock is typically convertible because there is an option to convert the preferred stock into common stock; however, that is beyond the scope of this Comment. See id.}
\footnoteref{64}\footnotetext{Id. at 77, 80–81, 97.}
\footnoteref{65}\footnotetext{Pollman, supra note 24, at 172–73. Traditionally, the first round of venture capital funding was called the Series A round, followed by Series B, and so on; however, more recently, a startup’s initial funding is called “seed funding.” Feld & Mendelson, supra note 48, at 43.}
\footnoteref{66}\footnotetext{Gornall & Strebulaev, supra note 37, at 121.}
\end{footnotes}
or stop funding a startup that is going to fail.67 Each round of financing comes with a new class of preferred stock, different information, and control rights.68 Adding to the complexity, VCs syndicate their investments, so multiple VC firms invest in a startup at each round.69 At each round of funding, one of the VC firms will be the “lead investor.”70 However, a VC fund that invests in a startup may not invest in every round of financing. Some VC funds will only invest in early rounds and stop investing in later rounds, while other VC funds only invest in later rounds of financing.71

3. Venture Capital Oversight

After investing in startups, VCs spend several years advising and growing the startups. As noted in Section I.A.2, VCs typically obtain control rights over the startups and invest in staged rounds every one or two years.72 According to traditional literature, this allows VCs to serve as effective monitors over startups.73 Staged financing and control rights give VCs a “lever to set milestones” for the startup to achieve.74 The startup typically must achieve the milestone before receiving a new round of funding.75 Initially, the milestones focus on making “a product or service that people want.”76 As the startup grows, the focus shifts to scaling manufacture, distribution, and sale of the product or service.77

These control levels can have a “disciplining effect” on startups.78 Startups that fail to reach these milestones may run out of funding and have to shut down.79 In extreme cases, VCs may

67. Gompers, supra note 35, at 1461.
68. Pollman, supra note 24, at 173–74.
70. Feld & Mendelson, supra note 48, at 12.
71. See id. at 9–10 (classifying VC funds as micro, seed stage, early stage, mid stage, and late stage, which all start investing in startups at different financing rounds).
72. Supra Section I.A.2.
73. Gompers, supra note 35, at 1462.
74. Pollman, supra note 24, at 186.
76. Pollman, supra note 24, at 167.
77. Id. at 168.
78. Id. at 186.
79. Id.
push to oust a founder from the company and bring in a professional CEO.\textsuperscript{80}

Besides setting milestones, VCs provide strategic advice and help startups achieve these goals. Some refer to VCs as “smart money” because of the many “noncash contributions” VCs provide.\textsuperscript{81} These value-adding services include providing strategic and business advice to management and the board, helping the startup navigate legal and employment issues, and bolstering the reputation of the startup.\textsuperscript{82}

The type of services and advice VCs provide changes over time as the startup grows. In the beginning, VCs provide startups with resources, strategy, and expertise in “launching [a] product or service to the market.”\textsuperscript{83} If the startup creates a successful product or service, then the VCs help the startup grow and scale its business.\textsuperscript{84} Towards the end, VCs help the startup with challenges involved with being a mature and complex company.\textsuperscript{85} At this point, VCs begin looking at ways to make a profit from their investment in the startup.

4. Exits

After VCs spend three to five years making staged investments and helping the startup grow and scale as a company, in the second half of the fund lifecycle, the VCs begin to look for ways to sell their investments and make a profit. VCs invest in private startups, which means that VC investments are generally illiquid—there is no public market to sell the investments.\textsuperscript{86} To achieve liquidity—and thus profits for themselves and the LPs—VCs need to find a way to sell their ownership position in the startup, which they call an “exit.”\textsuperscript{87}

\begin{footnotesize}
\textsuperscript{80} Blank, supra note 3, at 96.
\textsuperscript{81} Pollman, supra note 24, at 180; Gilson, supra note 1, at 1075.
\textsuperscript{82} Pollman, supra note 24, at 180.
\textsuperscript{83} Id. at 167–68.
\textsuperscript{84} Id. at 168.
\textsuperscript{85} Id.
\textsuperscript{86} See Darian Ibrahim, The New Exit in Venture Capital, 65 Vand. L. Rev. 1, 4–5, 10 (2012). This may be changing as more companies stay private for longer, and a “secondary market” for VC investments has emerged. Id.
\textsuperscript{87} Kupor, supra note 16, at 247.
\end{footnotesize}
a. Traditional Exits

There are two main ways for a VC fund to exit their investment: through an IPO of the startup or when a larger company acquires the startup. An IPO refers to the first time a company sells stock to the general public, typically using an underwriter to list the shares on a stock exchange. Traditionally, IPOs were favored and outnumbered exits through acquisition. For example, there were 276 venture-backed IPOs in 1999—an all-time high—compared with only 228 acquisitions that year. IPOs were favored because they tended to produce higher returns and provided a reputational benefit to VCs. For example, some of the IPOs in 1999 produced enormous returns, such as the $6.7 million VC investment in eBay, that turned into $5.1 billion once the company went public. Thus, IPOs have traditionally been considered the “gold standard” and critical to VC success.

b. Staying Private Longer

However, IPOs may not be the gold standard they formerly were. There is a growing body of literature describing the phenomenon of startups staying private longer. For example, in 1999, startups averaged 3.8 years from the first round of VC funding to IPO, while startups averaged 3.6 years from VC funding to exit by acquisition. Over the past twenty years, these periods have doubled, and in 2021, the average number of years from first VC funding to exit was 6.7 years for an IPO, and 6.1 years for an acquisition. This

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88. Lemley & McCreary, supra note 22, at 6–7.
91. See Gilson, supra note 1, at 1092; Black & Gilson, supra note 45, at 254 (explaining that the reputation from a successful IPO helps VCs raise successive funds).
93. Ibrahim, supra note 86, at 11.
94. NVCA YEARBOOK 2015, supra note 90, at 81.
has given rise to a growing number of “unicorns,” which are private companies valued at over $1 billion.96

There are two main explanations for the lack of IPOs and the trend of startups staying private longer. The costs of being a public company have increased, while the costs of staying private have decreased.97 Increased federal securities regulations have increased the regulatory costs of being a public company, while a decrease in securities regulations for private companies has shifted investments into private markets.98

The trend of companies staying private longer has led to a sharp decline in the number of IPOs.99 For example, in 2021, 181 venture-backed companies went public, compared with 1,357 startups that were acquired.100 Contemporary scholars still highlight the importance of an IPO to simplify “governance complexity while providing liquidity.”101 However, startups increasingly have to “sell out in order to succeed.”102

B. VC Investment Incentives

This next Section will explore how VC firms make investment decisions and the incentives of VCs while doing so. Early-stage startups lack financial information, so VCs primarily evaluate the founders of the startup when making investment decisions. Thus, VCs heavily rely on social connections when deciding where to invest. After VCs invest in a startup, they rely on other VCs to continue investing in the company, so they have a motivation to quickly grow and scale the startup—making it an attractive

96. See Aileen Lee, Welcome to the Unicorn Club: Learning from Billion-Dollar Startups, TECHCRUNCH (Nov. 2, 2013, 2:00 PM), https://techcrunch.com/2013/11/02/welcome-to-the-unicorn-club/ [https://perma.cc/PK9E-9SE6]. In 2013, VCs began referring to private companies valued at $1 billion as “unicorns” because it was extremely rare for private companies to reach this size. Id. As of early September 2023, there are 700 unicorn companies in the United States. See Jordan Rubio, Unicorn Companies Tracker, PITCHBOOK: NEWS & ANALYSIS (Sept. 1, 2023), https://pitchbook.com/news/articles/unicorn-startups-list-trends [https://perma.cc/9ZQ7-5ZQ7].

97. See de Fontenay, supra note 24, at 463–69 (arguing that the deregulation of private securities markets is the greater contributor to the decline in IPOs).

98. Id.

99. See NVCA YEARBOOK 2015, supra note 90, at 81; NVCA YEARBOOK 2022, supra note 95, at 37.

100. NVCA YEARBOOK 2022, supra note 95, at 37–38.

101. Pollman, supra note 24, at 162.

102. Lemley & McCreary, supra note 22, at 7.
investment to others. Finally, VCs are intermediaries, investing money on behalf of the LPs of the fund. Thus, in the later years of a fund, VCs have a strong incentive to exit their investments to deliver profits to the LPs.

1. Investment Decisions

As previously noted, VCs invest in startups, which are often nothing more than an entrepreneur with an idea. So, VCs cannot rely on traditional quantitative financial data. Instead, VCs primarily evaluate the founders of the startup. This is supported by a recent study of VCs at 681 VC firms. According to the study, VCs place the most significant importance on the founders of the startup. Specifically, 95% of VC firms in the survey said that management or the founding team was an important factor when selecting investments and almost 50% of VC firms said the founders were the most important factor. To put this into perspective, only 37% of respondents said that business-related factors were the most important when selecting investments.

However, only some founders are able to get their “[f]oot in the [d]oor” and pitch a VC firm on their startup. VCs heavily rely on their social connections when screening for potential startup investments. According to a recent study, over 30% of potential investments are found through VCs’ professional networks, another 20% are referred from other VCs, and another 8% of potential investments are referred from startups currently funded by the VC. Other studies show similar results: most potential

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104. Id. at 43 (“When the ‘business’ is nothing more than a very small collection of individuals—in some cases only one or two founders—with an idea, much of the [VCs’] evaluation will focus on the team.”).
106. Id. at 177.
107. Id.
108. Id.
109. See Kupor, supra note 16, at 124–26 (“Your ability to find a warm introduction to a venture capitalist, while not a requirement, is often a screening heuristic that venture capitalists use as a gauge . . . of a successful founder.”).
111. Gompers et al., supra note 105, at 175 (showing that only 10% of potential investments come directly from company management reaching out to VCs).
investments come from VCs’ networks.\textsuperscript{112} This means that of the entrepreneurs who lack social connections, few are able to “beat a path to the VC’s door.”\textsuperscript{113} Moreover, many VCs will only invest in “entrepreneurs with whom they have a prior connection.”\textsuperscript{114} In the absence of other metrics to evaluate a startup, such as financial data, these prior social connections allow VCs to filter through hundreds of potential investments per year and, on average, to choose four startups in which to actually invest.\textsuperscript{115}

2. Exit and Deliver Profit

As previously noted, VCs’ investments are illiquid, with no easy way to turn their preferred stock into cash.\textsuperscript{116} So, to make a profit, VCs must “exit” their investment through an IPO or acquisition.\textsuperscript{117} Thus, from the outset, “[VCs] . . . are focused on an ‘exit strategy’: a way to turn [their] equity into liquid cash.”\textsuperscript{118}

II. ENVIRONMENTAL, SOCIAL, AND GOVERNANCE

This Part begins by discussing the prevalence of ESG in modern corporate law and why ESG is relevant today. Then, this Part explores the various ways people use the term ESG and comes to a precise definition for this paper. Next, this Part explores why public companies and investors in public companies care about ESG. Finally, this Part concludes by showing that VC investors, and the companies they back, have been much slower than others to adopt ESG investing principles.

A. Modern Importance of ESG in Corporate Law

Investing based on environmental, social, and governance principles is “growing explosively.”\textsuperscript{119} Broadly speaking, ESG investing is an investment strategy emphasizing a company’s “governance

\begin{itemize}
\item \textsuperscript{112} Lee, supra note 14, at 639.
\item \textsuperscript{113} Gompers et al., supra note 105, at 175.
\item \textsuperscript{114} Feld & Mendelson, supra note 48, at 35–36.
\item \textsuperscript{115} See Gompers et al., supra note 105, at 170.
\item \textsuperscript{116} See supra Section I.A.4.
\item \textsuperscript{117} Lemley & McCreary, supra note 22, at 6–7.
\item \textsuperscript{118} Id. at 6.
\item \textsuperscript{119} Quinn Curtis, Jill Fisch & Adriana Z. Robertson, Do ESG Mutual Funds Deliver on Their Promises?, 120 Mich. L. Rev. 394, 395 (2021).
\end{itemize}
structure or the environmental or social impacts of the [company’s] products or practices.”

As discussed below, ESG investing is an elusive term, and there is not one agreed upon definition.

Regardless of the precise definition, however, discussions about ESG permeate modern business, legal, and political discourse. It has been said that “ESG investing, once a sideline practice, has gone decisively mainstream.” In 2021, U.S. investment funds that incorporate ESG principles managed over $4.5 trillion in assets, which is projected to more than double by 2026 and reach $10.5 trillion. This stems from large institutional investors publicly supporting and creating ESG funds. One example is BlackRock, a prominent institutional investor who manages over $10 trillion in assets. BlackRock’s CEO, Larry Fink, made waves in the corporate community in 2020 when he wrote in his annual letter to CEOs that climate change is a “defining factor” in investment analysis. According to Larry Fink, public companies have a duty to deliver long-term value to their shareholders, which includes “sound environmental, social, and governance practices and policies.”

Legal institutions are also grappling with issues related to ESG. In 2021, President Biden issued an executive order directing the federal government to identify and mitigate “climate-related financial risk[s].” Following this mandate, the Department of Labor enacted a final regulation that would allow the fiduciaries of public retirement and pension plans to consider ESG factors when

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120. Schanzenbach & Sitkoff, supra note 25, at 388.
121. Id.
making investment decisions on behalf of the retirement plan.\textsuperscript{128} The SEC is also exploring ESG regulations and issued a proposed regulation in 2022 that would require public companies to disclose climate risks that are “reasonably likely to have a material impact on their business” in their registration statement during an IPO and during periodic reports.\textsuperscript{129}

B. \textit{What Is ESG Investing?}

The term “ESG” evolved from several related but distinct terms, including “Corporate Social Responsibility” and “Socially Responsible Investment.”\textsuperscript{130} In this way, it is an umbrella term. However, this also means that there is not one agreed upon definition or meaning. This Section will describe the two main usages of the term “ESG investing.” First, some use the term ESG to describe investing for moral or social reasons. Others use the term to describe an active investment strategy which uses ESG criteria to identify issues that may impact a company’s financial performance. Although the results are mixed, a growing body of research does show that companies who address ESG issues have increased their financial performance. Thus, this Comment uses the second definition of ESG and assumes that ESG investing is a profit seeking activity.

1. Definition of ESG

As noted above, there is not one agreed-upon definition of ESG. Instead, there are at least two usages of the term ESG investing.\textsuperscript{131} The first usage of the term ESG investing is to describe investing for moral or ethical reasons.\textsuperscript{132} People using ESG in this way are


\textsuperscript{129} Press Release, SEC, supra note 27.


\textsuperscript{131} See Curtis et al., supra note 119, at 402.

\textsuperscript{132} Schanzenbach & Sitkoff, supra note 25, at 389–90 (referring to ESG investing for ethical or moral reasons or to benefit a third party as “collateral benefits ESG”).
often expressing an ideological preference. This leads people—depending on their political leaning—to refer to ESG investing as “sustainable” investing, while others refer to it as “woke capitalism.”

The second use of the term ESG investing is as a “profit-seeking, active investment strategy.” A growing body of literature connects ESG investing with higher, long-term “risk-adjusted returns for shareholders.” That is, ESG investing can “obtain[] better returns with less risk.” Thus, ESG investing allows investment managers, shareholders, and companies to consider environmental, social, and governance “issues which have . . . a material impact on investment value.” There is debate over whether ESG investing is associated with higher returns, with studies showing mixed results. However, the majority of studies show that ESG investing does improve financial returns, while a relatively small percent of studies show a negative relationship.

133. See, e.g., Pollman, supra note 130, at 26.
135. Schanzenbach & Sitkoff, supra note 25, at 389.
139. See TENSIE WHelan, ULRICH ATz, TRACY VAN HOlt & CASEY CLARe, N.Y.U.: STern CTrr. FOR suStAINABLE BUSS., ESG AND FINANCIAL PERFORMANCE: UNCOVERING THE RELATIONSHIP BY AGGREGATING EVIDENCE FROM 1,000 PLUS STUDIES PUBLISHED BETWEEN 2015–2020, 4 (2022), https://www.stern.nyu.edu/sites/default/files/assets/documents/NYU-RAM_ESG-Paper_2021%20Rev_0.pdf [https://perma.cc/TV4B-DG2C] (comparing 245 ESG studies and finding that 58% showed a positive relationship between ESG and financial performance, while only 8% showed a negative relationship, and the remaining studies showed either neutral or mixed results).
140. See id.
This Comment uses the second definition—ESG investing as a tool to improve risk-adjusted returns—not as investing for moral or ethical reasons. That is, this paper assumes that ESG investing is a “profit-seeking, active investment strategy,” not an expression of ideological preference.141

2. ESG Active Investing

ESG investing can improve long-term, risk-adjusted returns in two ways. First, investors can use ESG factors as an active investment tool.142 An active investing strategy is when investors conduct “independent assessment[s]” of companies and then create a portfolio of companies to invest in based on these assessments.143 In contrast, passive investing involves no independent stock picking, and investors instead choose to invest in a market index such as the S&P 500.144 Thus, active investors can use ESG factors as a screening tool when making investment decisions.145

The goal of active investing is to “beat the market” by identifying information about companies that other investors in the market have overlooked.146 This means that active investing—compared to passive investing—will only improve returns if the investor can identify factors not already reflected in the stock price.147 Thus, active investors can use ESG factors to identify companies that are mispriced, and then make a profit by “placing bets for or against those stocks.”148 For example, a “risk-return ESG analysis” of a fossil fuel company might identify litigation and regulatory risks that are not reflected in the company’s current share price, so avoiding that investment will “improve risk-adjusted return.”149

141. Schanzenbach & Sitkoff, supra note 25, at 389.
142. Id. at 437.
144. Id.
145. See Curtis et al., supra note 119, at 404 (describing various ways that mutual funds use ESG factors to screen potential investments).
146. See Hunt, supra note 143.
147. Schanzenbach & Sitkoff, supra note 25, at 437.
148. Id.
149. Id. at 398.
3. ESG Shareholding

The second form of ESG investing is commonly called “active shareholding” or “stewardship.”150 Public companies are required to hold annual shareholder meetings.151 At these annual meetings shareholders vote, typically via a proxy, on various corporate decisions.152 Shareholders vote on things like changes to the company’s bylaws, non-binding resolutions, and adding directors to the company’s board.153 Thus, these decisions can have a large impact on a company.

The “shareholding” approach to ESG investing is when existing shareholders use their voting power to engage with the company on ESG issues the company faces.154 The goal is to “improve corporate policies” or at least “prevent bad decisions,” and thus improve risk-adjusted returns.155 A common method is for a group of shareholders to launch a “proxy fight,” which is an attempt to win a seat on a company’s board during the annual meeting.156 For example, Engine No. 1, a hedge fund, invested in ExxonMobile, claimed the company was at “existential risk” for its lack of focus on renewable energy, and launched a proxy fight, winning three seats on Exxon’s board.157 However, proxy fights are expensive and can range from one hundred thousand dollars to over a million dollars.158 Thus, ESG shareholding can only improve long-term investment returns

150. See id. at 444–45 (referring to shareholders engaging with company management on ESG issues as “active shareholding”).
151. See DEL. CODE ANN. tit. 8, § 211 (2023).
152. See tit. 8, § 212(b) (granting shareholders the right to vote via proxy at annual meetings).
153. See tit. 8, § 141(k) (granting shareholders the right to remove a director from the board); tit. 8, § 109(a) (giving shareholders the power to adopt, amend, or repeal bylaws); tit. 8, § 146 (allowing corporations to submit matters to a shareholder vote).
154. Schanzenbach & Sitkoff, supra note 25, at 444; see Curtis et al., supra note 119, at 405.
155. Schanzenbach & Sitkoff, supra note 25, at 444.
157. See Justin Jacobs, Signs of Change at ExxonMobil a Year After Hedge Fund Proxy Fight, FIN. TIMES (May 24, 2022), https://www.ft.com/content/545d2d07-ac24-436e-bfab-b9c077f56415 [https://perma.cc/H3H7-59GC].
if the benefits from the investor’s “activism” outweigh the costs of “monitoring” and voting.159

C. ESG in Public Companies

The driving force behind ESG investing is investor demand. Individual Millennial and Gen Z retail investors support ESG significantly more than investors from older generations.160 This demand among the younger generation of investors is pushing large institutional investors to offer ESG investment funds.161 For example, in 2020, the net flow of assets into ESG funds was double the net flow in 2019, and ten times the net flow in 2018.162 In response, institutional investors have largely supported ESG investing. In a recent survey, nearly 80% of institutional investors indicated they plan to increase the number of ESG related funds over the next two years.163

Investor demand for ESG is also pushing institutional investors to pursue ESG shareholding. In 2022, shareholders filed 471 ESG-related proposals to Russell 3000 companies, which made up the majority of shareholder proposals received.164 These shareholder proposals support a wide range of environmental and social issues such as climate-related disclosures, racial equity and civil rights, and political contribution disclosures.165 The shareholder proposals also focus on governance issues such as eliminating dual-class shares and supermajority voting.166

Thus, the demand for ESG investing is pushing public companies, and institutional investors who invest in public companies, to increasingly care about ESG issues. So, in the public markets, ESG

159. See Schanzenbach & Sitkoff, supra note 25, at 444.
161. See Curtis et al., supra note 119, at 404 (“Many retail investors express strong preferences for ESG investing, and the mutual fund market is driven largely by those preferences.”).
162. See id.
163. PwC, supra note 122, at 9.
165. Id. at 2–4.
166. Id. at 4–5.
investing—both as a screening tool and as a way to engage with companies—proliferates.

D. Venture Capital’s Lack of Focus on ESG

Although ESG permeates corporate law discussions in public companies, VC has “largely been left by the wayside” when it comes to ESG.167 The Principles For Responsible Investment, a United Nations-backed group, has recently criticized the VC industry for the “lack of formal, standardised ESG incorporation.”168 Other academics have highlighted VC’s role in bringing about potentially destructive technologies that pose risks to “privacy, inclusion, and human rights.”169 Although some in the VC industry are working to implement ESG principles, most of the industry is not. In a 2021 survey of the fifty largest VC funds, only five of the funds’ websites mentioned ESG or a commitment to sustainability.170

The only ESG-related issue that VCs appear to be paying some attention to is climate change; however, even this is to a varying degree. VC was an early supporter of environment-conscious investing, and between 2006 and 2011, VCs invested over $25 billion into the “cleantech sector.”171 However, the energy sector grew out of favor with VCs, and VC’s investment in cleantech “has declined sharply since 2011.”172 As recently as 2019, cleantech startups still struggled to get VC funding.173 There has been a recent uptick, and in 2021, VCs again began investing into cleantech startups.174 However, almost 80% of VC funding still goes toward software development and consumer and business products and services, with a continued lack of focus on energy and cleantech

168. DUNBAR, supra note 29.
174. See NVCA YEARBOOK 2022, supra note 95, at 27.
Moreover, the VC industry has taken steps to reduce climate-related disclosures.176

Aside from making some investments into “cleantech,” the VC industry appears to be lacking in many other areas of ESG, such as diversity. For example, a 2018 study of the VC industry shows that diversity significantly improves the financial performance of individual venture-backed startups and the overall performance of VC funds.177 However, diversity continues to be lacking in VC industry, both at the startup level and at the firm level.178 For example, from 2020 to 2021, only 2% of VC funding went to startups founded solely by women, which was the lowest percentage since 2016—despite women founding over 38% of new businesses in the United States.179 In 2020, only 2.6% of VC funding went to startups with Black and Latino founders.180 Overall, this shows that compared to other areas of finance and investing, VC is lagging on ESG incorporation.

III. VENTURE CAPITAL’S ESG PROBLEM

This Part argues that there are at least three different factors contributing to VC’s slow adoption of ESG investing. First, this Part explains that the VC industry exhibits herd behavior. This herd behavior is incompatible with ESG as an active investment strategy. Second, this Part examines how VCs may have less control over startups than they did in the past. This may be preventing VCs from engaging in ESG shareholding while they are investing

176. Compare NVCA YEARBOOK 2015, supra note 90, at 74 fig.3.39 (charting “Clean Technology Investments By Year” since 1995), with NAT’L VENTURE CAPITAL ASS’N YEARBOOK (2020), https://nvca.org/wp-content/uploads/2020/03/NVCA-2020-Yearbook.pdf [https://perma.cc/3FAR-JPHS] (removing “cleantech” as an investment sector and not mentioning “clean” or “climate” anywhere in the report). The 2022 report does mention the number of “cleantech” investments that year in one sentence, but it has still removed cleantech as its own sector from all the charts and figures and stated that cleantech “spans multiple industries,” which obscures what these investments are. See NVCA YEARBOOK 2022, supra note 95, at 27.
178. See Fan, supra note 24, at 381–83.
179. Id. at supra note 20, at 1442.
180. Id. at 1442–43.
in a startup. Finally, this Part examines how the decline in IPOs may be contributing to the VC industry’s lack of focus on ESG.

A. The Venture Capital Herd

1. Social Connections and Structure of VC Deals

As noted in Part I, VCs rely on social connections when making investments. Also as noted in Part I, VCs make staged, syndicated investments, with multiple VCs investing in each round of startup funding. Because of the staged and syndicated financing of VC-backed startups, different VCs often sit on startup boards together and negotiate financing deals together. Thus, VC is a “close-knit” and “highly social[]” industry.

2. Lack of Diversity

As noted in Part II, the VC industry has a striking lack of diversity. This means that the VC industry is highly concentrated and “staggeringly homogeneous.” Eighty percent of partners at VC firms are male, but this number increases to 91% when you only consider partners who hold at least one startup board seat. Moreover, almost 30% of VC partners are graduates of just two schools—Harvard Business School and Stanford Graduate School of Business. There is also a lack of geographic diversity, with an overwhelming majority of VC funding going to startups in just three areas: San Francisco, New York City, and Boston. For example, in 2021, VCs invested $332 billion into startups. Of that, over $256 billion went to startups in California, New York, and

181. See Gompers et al., supra note 105, at 175.
182. Bartlett, supra note 69, at 55.
183. Mallaby, supra note 92, at 177 (“Geographically and mentally, they cluster. Because they are first and foremost networkers . . . .”).
185. Fan, supra note 20, at 1441–42.
187. Lerner & Nanda, supra note 175, at 250.
188. Id. at 250–51.
189. Id. at 249.
190. NVCA Yearbook 2022, supra note 95, at 6.
Massachusetts.\textsuperscript{191} In contrast, in 2021, VCs invested roughly $2.5 billion in Virginia startups.\textsuperscript{192}

3. Herd Mentality

The importance of social connections and the lack of diversity in the VC industry leads to herd mentality. Herd mentality is a “behavioral bias” where individuals forgo independent decisions, instead deferring to broader group decisions.\textsuperscript{193} There is evidence that VCs display herd behavior. In a recent survey of VCs, founders, and startup lawyers, over a quarter mentioned the “herd mentality” of the VC industry, even though no survey question asked about herd behavior.\textsuperscript{194} Another example of herd behavior is that many VC funds and startups decided to bank at just one bank—Silicon Valley Bank (“SVB”).\textsuperscript{195} After SVB announced a plan to restructure its balance sheet amid heavy losses, the VC industry displayed its herd mentality by organizing a bank run and withdrawing over $40 billion from the bank in one day.\textsuperscript{196}

In the context of investing, herd behavior manifests as investors “ignoring substantive private information” and instead mimicking the investment decisions of others.\textsuperscript{197} This herd behavior leads VCs to chase and invest in the “same ‘hot’ firms and technological fields.”\textsuperscript{198} It also leads VCs to invest in “popular assets that lack sound economic fundamentals, often with no or limited due diligence.”\textsuperscript{199} For example, one venture capitalist followed a herd of

\textsuperscript{191} Id. at 30.
\textsuperscript{192} Id. at 29.
\textsuperscript{193} Darian M. Ibrahim, Crowdfunding Without the Crowd, 95 N.C. L. REV. 1481, 1492–93 (2017) (identifying herd behavior as a problem with crowd funding).
\textsuperscript{194} Lee, supra note 14, at 658.
\textsuperscript{197} See David S. Scharfstein & Jeremy C. Stein, Herd Behavior and Investment, 80 AM. ECON. REV. 465, 466 (1990) (studying factors that lead to herd behavior in investing).
\textsuperscript{198} Lee, supra note 14, at 652 (arguing that VC herd behavior limits their ability to drive innovation).
\textsuperscript{199} Id. at 653.
other VCs and invested over $4 billion into WeWork based on a

twelve-minute tour of the company’s headquarters.200

4. VC Herd Mentality Is Incompatible with ESG Investing

As noted in Part II, one of the primary ways investors use ESG

is as a screening tool when deciding where to invest.201 The theory

is that ESG factors allow an investor to consider risks that other

investors in the market have overlooked. In this way, ESG invest-

ing is a contrarian approach that identifies mispriced investments.

However, herd behavior eliminates individual assessment, instead
deferring to the group. Thus, this herd behavior may be incompat-

ible with ESG investing.

B. VC’s Lack of Control

As noted in Part I, traditionally, VCs are thought to monitor

startups effectively.202 However, recent academics and commenta-
tors have noticed that many VCs have less control over startups

than they have had traditionally. This lack of control indicates that

“[VCs] may not always be the strong monitors they are assumed to

be.”203 The lack of control may also explain why VCs are slow to

adopt ESG investing.

1. Extreme Governance Complexity

As noted in Part I, VC firms typically negotiate for control and

information rights through their convertible preferred stock.204

VCs also monitor the startups through staged financing, allowing

VCs to “periodically abandon projects.”205 These contractual rights,

including board seats and staged financing, allow VCs to serve as
effective monitors over the startups in which they invest.206

200. See Eliot Brown & Maureen Farrell, The Cult of We: WeWork, Adam

201. See supra Section II.A.
202. See supra Section I.A.3.
204. See supra Section I.A.2.
205. Gompers, supra note 35, at 1461.
206. Gilson, supra note 1, at 1074.
However, Part I also details how companies are staying private longer. This leads to the governance structure of VC-backed startups growing increasingly complex over time. As previously noted, VCs finance startups every one to two years, and each round of staged financing creates a new class of preferred stock, which comes with different information or control rights. According to a recent study, the average unicorn startup has eight different classes of stock. This leads to “extreme complexity of these companies’ financial structures.” As a startup matures, “it expands the number of participants with varied interests and claims affecting its governance structure.” Then, as the governance structure grows increasingly complicated, the costs for monitoring and obtaining adequate disclosure increase.

2. Founder-Friendliness

Compounding the extreme governance complexity of VC-backed startups is a decline in active corporate governance by VCs over startups. This decline in active corporate governance has been labeled the “founder-friendly era.” Increasingly, startups have been able to negotiate for founder-friendly financing terms. The founder-friendly era began with Google “[d]efying Valley tradition” by going public in 2004 with a dual-class share structure. The first class of shares—issued to founders Larry Page and Sergey Brin, among others—had ten votes per share, while the second class of shares issued to the public during the IPO only had one vote per share. This trend has continued. In 2017, 67% of U.S. venture-backed startups that went public used super-voting shares for founders, which gave them ten votes per share. These super-
voting shares “diluted the discipline and accountability” that VCs traditionally provided as an investor and member of the startup’s board.\textsuperscript{220} The less control that VCs have over the startup, the less VCs can implement internal compliance programs or prioritize the corporate governance of the startup.\textsuperscript{221}

One particularly notable example is Theranos, which received $686 million in VC funding, yet founder Elizabeth Holmes retained 98.3% control over the company.\textsuperscript{222} Holmes achieved this by pushing “founder-friendliness to the max” and demanding that her Theranos stock had one hundred votes per share.\textsuperscript{223} According to Holmes, with this stock structure, the Theranos board was “just a placeholder.”\textsuperscript{224}

Another example is Uber. During later rounds of financing, investors were competing to invest in Uber.\textsuperscript{225} This competition gave Travis Kalanick, Uber’s founder, bargaining power and allowed him to “strip[] some major investors of all ‘information rights,’” and to give himself super-voting shares—again, ten votes per share.\textsuperscript{226} Kalanick also was able to convince VCs to accept an “observer” seat on Uber’s board—essentially a board seat without voting rights.\textsuperscript{227}

3. Information Breakdown

As noted in Part II, shareholders only have an incentive to engage with the company on ESG issues if the expected benefits of the “investor’s activism” outweighs the increased monitoring and engagement costs.\textsuperscript{228} However, the extreme governance complexity of VC-backed startups and the trend toward founder-friendliness may contribute to VCs deciding that the benefits of engaging with

\textsuperscript{220} Jones, supra note 24, at 174.

\textsuperscript{221} Fan, supra note 24, at 363 (“[T]he less power venture capitalists have, the less governance is prioritized.”).

\textsuperscript{222} Blank, supra note 3, at 100.

\textsuperscript{223} Mallaby, supra note 92, at 340.

\textsuperscript{224} John Carreyrou, Bad Blood: Secrets and Lies in a Silicon Valley Startup 298 (2018).

\textsuperscript{225} Mike Isaac, Super Pumped: The Battle for Uber 97 (2019).

\textsuperscript{226} Id.

\textsuperscript{227} Id. at 99.

\textsuperscript{228} Schanzenbach & Sitkoff, supra note 25, at 444.
a startup on ESG issues are outweighed by the increased monitoring and engagement costs.

For example, FTX raised over $2 billion in VC funding, including funding from Sequoia Capital, Tiger Global, and Softbank—all leading VC firms.\footnote{Wasserman, supra note 7; Robert Burgess & Chris Hughes, Opinion, *FTX Benefited from Venture Capitalists’ Suspension of Disbelief*, BLOOMBERG (Dec. 5, 2022, 7:00 AM), https://www.bloomberg.com/opinion/articles/2022-12-05/venture-capital-was-complicit-in-the-collapse-of-ftx [https://perma.cc/WH6A-W5VT].} However, FTX resisted creating an official board of directors—VC’s main control mechanism—until January 2022, after FTX had gone through multiple rounds of financing and raised over $1 billion in VC funding.\footnote{See Eliot Brown, Peter Rudgeair & Berber Jin, *Silicon Valley Poured Money into FTX, with Few Strings Attached*, WALL ST. J. (Nov. 10, 2022, 5:17 PM), https://www.wsj.com/articles/silicon-valley-poured-money-into-ftx-with-few-strings-attached-11668103682 [http://perma.cc/NKA3-G3Y7].} Even when FTX founder Sam Bankman-Fried created an official board, the VC investors did not get any board seats.\footnote{See Wasserman, supra note 7; Griffith & Yaffe-Bellany, supra note 8.} According to one commentator, this is another example of VCs letting founders behave like “monarchs.”\footnote{See Wasserman, supra note 7 (“When founders are allowed to act like monarchs, their startups are more likely to fail—often with dire consequences for customers, employees, investors, and society.”).}

As startups stay private longer, there is a “costly patchwork of conflicting information rights” among investors, with many investors owed no information whatsoever.\footnote{De Fontenay, supra note 24, at 481.} This is compounded by an increase in the power of startup founders.\footnote{See Wasserman, supra note 7.} Together, this means that it is very costly for VCs to effectively monitor and oversee a startup, let alone implement internal compliance programs that address ESG issues. Thus, the high information and monitoring costs may outweigh the benefits of VC’s engaging with startups on ESG issues.

C. The Decline of IPO Exits

As noted in Part I, traditional literature on VC argues that a healthy public stock market that allows VC funds to take a startup public through an IPO is “critical” to VC success.\footnote{Black & Gilson, supra note 45, at 245.} However, the lack of IPOs and the accompanying rise of companies staying

\begin{flushleft}
\footnote{231. See Wasserman, supra note 7; Griffith & Yaffe-Bellany, supra note 8.}
\footnote{232. See Wasserman, supra note 7 (“When founders are allowed to act like monarchs, their startups are more likely to fail—often with dire consequences for customers, employees, investors, and society.”).}
\footnote{233. De Fontenay, supra note 24, at 481.}
\footnote{234. See Wasserman, supra note 7.}
\footnote{235. Black & Gilson, supra note 45, at 245.}
\end{flushleft}
private longer may explain VCs’ lack of focus on ESG for two reasons. First, IPOs act as a disciplining mechanism for companies. Second, the rise of “killer acquisitions.”

1. The Absence of IPO Discipline

The prospect of an IPO places a “significant disciplining effect” on startups. To conduct an IPO, a startup must make extensive disclosures about the company through a registration statement. This disclosure includes all “material” information about the startup, including material risk factors. As noted in Part II, a startup going public soon may also need to disclose material climate-related risks. Importantly, once a startup goes public through an IPO, the company faces many periodic reporting requirements. These periodic reporting requirements, which include annual and quarterly disclosures, cover a “remarkably broad” amount of company information; for example, they include audited financial statements, business and legal risks, internal controls, and governance information such as executive compensation.

A recent example of an IPO imposing a disciplinary effect on a VC-backed startup is WeWork. WeWork’s prospectus—which ultimately led to a failed IPO—exposed the company’s enormous losses, inappropriate loans to the founder, and “byzantine” corporate structure. The prospectus also exposed how WeWork’s
founder and CEO, Adam Neumann, sold trademarks related to the word “We” to his own company for over $5.9 million. These disclosures turned off investors, and WeWork had to cancel its IPO. Thus, WeWork’s IPO acted as a disciplining mechanism and “did what broken private governance had failed to do.”

However, as previously noted, startups stay private longer, and the number of IPOs has plummeted. The lack of IPOs means that startups no longer “face intense external pressure to professionalize.” The lack of scrutiny from the press and investors lets “problems fester” inside startups.

A common metric in ESG investing is board diversity. As shown in Section III.A.2, diversity is lacking across the VC industry, and VCs seem reluctant to improve diversity. However, according to a recent survey of the VC industry, one of the only times that VCs consider board diversity is when the company is about to go public. But when a startup is not about to go through an IPO, board diversity is not a “must” and thus remains a “nascent concept.”

Without the “disciplining mechanism of IPOs,” VC may be slow to adopt ESG principles such as increasing board diversity. This may, in part, explain why VC has been slow to adopt ESG.
2. The Rise of Killer Acquisitions

As noted in Part I, there are two main exit paths for VC funds—
IPO or acquisition. As IPOs have become increasingly rare, VC funds predominately exit their investments after the startup they are backing is acquired by a larger company.

Industry competitors acquire a large portion of venture-backed startups. This has given rise to a trend in the past decade of “killer acquisitions,” where industry incumbents “acquire an innovative target and terminate the development of the target’s innovations to preempt future competition.” Indeed, in 2017 alone, Alphabet, Amazon, Apple, Facebook, and Microsoft spent $31.6 billion on acquisitions. Facebook’s history of acquisitions is particularly notable. Facebook has acquired over ninety startups, including clear rivals such as Instagram. Out of Facebook’s ninety-two total acquisitions, they have shut down thirty-nine of these companies. Similarly, as of 2018, Alphabet (formerly Google) has acquired 270 companies, shutting down many of them within days of acquisition.

Although IPOs typically produce higher returns than acquisitions, acquisition by industry incumbents may produce higher returns than other types of acquisitions. The industry incumbent may pay a premium for a nascent competitor because of the added value that comes from “controlling strategic complements that could otherwise destabilize their core business.” For example, Instagram received venture financing that valued the company at $500 million; then, a week later Facebook acquired it for $1

254. See supra Section I.A.4.a.
255. Lemley & McCreary, supra note 22, at 7.
256. Id. at 12.
257. Cunningham et al., supra note 236, at 650; see also Leah Nylen, FTC Seeks to Stop ‘Killer Acquisitions’ with Information Demand, BLOOMBERG LAW (Apr. 20, 2023, 3:14 PM), https://news.bloomberglaw.com/antitrust/ftc-seeks-to-stop-killer-acquisitions-with-information-demand [https://perma.cc/ZM24-7EKX] (“‘Killer acquisitions’—where a dominant player buys a rival upstart to keep it from growing into a viable competitor.”).
259. Lemley & McCreary, supra note 22, at 21.
260. Wu & Thompson, supra note 44.
261. See id.; Lemley & McCreary, supra note 22, at 64.
262. Lemley & McCreary, supra note 22, at 38, 41, 45; see Cunningham et al., supra note 236, at 658–59.
263. Lemley & McCreary, supra note 22, at 21–22, 37.
This indicates that Facebook paid a premium because Instagram was a nascent competitor. Facebook was “squashing a potential rival.”

This trend of killer acquisitions may negate any incentives VC funds have to adopt ESG principles. A common argument for adopting ESG investment principles is that companies who adopt ESG will be more profitable in the long run. However, if the VC fund knows that a startup they invest in is likely to be acquired, then shut down, there is no incentive to prioritize the ESG issues of the startup.

**CONCLUSION**

ESG investing is rapidly growing, which is sparking widespread debate, and calls for regulatory reform. However, the debate largely centers around incorporating ESG principles in large and established public companies. There is less focus on building sustainable and diverse companies from the ground up. This Comment explores a few potential reasons for the lack of focus on ESG at startup stage companies. This Comment does this through the lens of venture capital—the primary funding mechanism of technology startups.

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