Uber-ized Corporate Law: Toward A 21st Century Corporate Governance for Crowdfunding and App-Based Investor Communications

J.W. Verret*

This Article begins with a thought experiment about how corporate governance of small public companies trading on new platforms—like crowdfunding portals (or alternatively, "crowdfunding exchanges")—might be expected to evolve to make corporate governance easier and more flexible for users. New opportunities could involve increased use of default rules whereby shareholders or owners defer direct participation in governance (in line with the Bainbridge director primacy argument), subject to default participation rules developed on crowdfunding platform apps (in a multitude of ways, including through open source methods).[1] They could also include more shareholder empowering regimes. In examining the heterogeneous corporate governance needs that crowdfunded firms are likely to have, this Article will link contributions from the New Institutional Economics, or "Theory of the Firm" Literature, to corporate entity formation to provide a flavor for the range of "outside the box" innovations that may be possible in a new and more competitive corporate chartering race free from the federal overlay.

Of all the claims made in this Article, the strongest is that increased use of arbitration—rather than litigation—to resolve shareholder claims against company defendants will be a necessary element to reinvigorated charter competition for crowdfunded firms. The SEC currently prohibits full use of arbitration of shareholder claims against companies. This Article argues that since antifraud actions under the Securities Exchange Act of 1934 and state corporate governance claims are now largely interchangeable, the SEC's intransigence on arbitration, in spite of federal case law favoring arbitration generally, must be addressed to make state law arbitration a viable alternative means of adjudication for states that compete with Delaware as sources of business entity law.

* The Author thanks the George Mason University School of Law and the George Mason Law School Law and Economics Center for Research support. I appreciate helpful comments from Stephen Bainbridge, Roberta Romano, Bruce Kobayashi and participants at the George Mason Law and Economics Center's Henry Manne Scholar Forum. Before they passed away, I received unparalleled mentorship from Henry Manne and Larry Ribstein that encouraged my development of the ideas in this article.

1. Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 583 (2003).

I. PRELUDE: A WINDOW INTO THE 21ST CENTURY WORLD OF CORPORATE GOVERNANCE

Imagine downloading a "crowdfund app"[2] and selecting a few dozen companies for purchase of shares costing roughly $100 each. When you set up your crowdfund app, you are prompted with a series of questions with choices. One might read: "Do you wish to (1) receive updates about company elections and participate in shareholder votes for the board; (2) select a default of voting for the management recommended slate of nominees in all elections; or (3) vote for management nominees unless a list of material negative events recommended by Crowdfund Inc. has occurred?" You may be notified with other messages: "You may change your voting defaults under the settings tab at any time," and possibly, "Do you want to be reprompted with this question any time you purchase new shares through Crowdfund App?"

Periodically, you may receive updates on your app. You check the app a few months later and find an update which states: "A bidder has made an offer of $120 for your share in Techmarket Inc., and will cease purchases when he has acquired 90% of the shares. If the bidder is successful in acquiring 90% of the outstanding shares, your interest may be frozen out and you may be required to accept an offer that may be lower than the tender offer. If so, you may also submit a request for appraisal at that time (see here for more about the appraisal process). The most recent closing price for one share is $110. Do you wish to accept?"

You select "no." A few days later, you receive another update: "The bidder has acquired a 90% stake in Techmarket Inc. and has invoked the freezeout statute. You may either accept the freezeout price of $110, or choose to join an arbitrated appraisal process. Pursuant to arbitrated appraisal, over a 24-hour period an independent accountant will determine whether to award you the freezeout price, or to award you an amount either higher or lower than the freezeout price. If you select arbitrated appraisal, and you wish to register your preference for the arbitrator (which includes an algorithmic weighting incorporating preferences submitted by both the controlling shareholder and frozen-out shareholders), a list of eligible arbitrators can be found at the link below accompanied by user ratings of those arbitrator candidates." Periodically, you check your crowdfund app to track the status of your investments; you examine updates about other pending litigation and elections in companies in which you are invested, selecting from menus if you choose to participate.

You may later open the crowdfund app to find an update stating: "Techmarket Inc.'s annual election is taking place in 30 days. You may access the proxy statement filed with the SEC at the following link. Your default settings are to vote with management unless the company has issued a restatement of its finances because of a significant prior fraud or error discovered in its quarterly reporting. The company has issued such a restatement in the last year. Please vote for a maximum of 12 candidates from the nominees provided by the Board of Directors or those nominated by shareholders with a greater than 5% stake in the company, who are allowed to nominate candidates pursuant to the company's corporate charter, included in the list below."

The app might also prompt: "You have subscribed to voting recommendations from Corporate Governance Analytics Inc. That crowdfunding portal analysis provider

2. Apps have become shorthand for computer operating applications utilized on smartphones.

recommends you vote for eight candidates from management and four candidates recommended by shareholders listed below. To follow that recommendation, click this button." Or, alternatively, if you do not have time or inclination to participate in that way, those decisions could all be made for you according to default actions you select per stock, or for all stocks, in your settings tab. These defaults provided to aid your decision-making on the app-based platform could be developed via an open source method, in which corporate governance professionals—like corporate lawyers—design the defaults and thereby attempt to augment their professional reputations.

II. CROWDFUNDING: AN EVENT WINDOW TO RENEW CORPORATE FEDERALISM

Investors and entrepreneurs will soon face corporate governance challenges as crowdfunded companies—traded on small crowdfunding portal exchanges—soon go online pursuant to a recent SEC rule.[3] Corporate governance entity forms created for large public firms may not be best for this novel, ultra small scale public firm. Similarly, existing off-the-rack LLC options intended primarily for private firms may not exactly fit (particularly Delaware's model). Moreover, powerful interest groups controlling corporate innovation in the leading state of entity formation may have conflicts that limit innovation sufficient to meet required needs. In any event, a federal overlay that selectively preempts corporate governance, and could preempt it further in unexpected ways, further limits incentives of states active in chartering competition to further innovate.

This Article argues that unless a complete rethinking of the federal overlay in corporate governance is undertaken, investors and entrepreneurs may miss their "Uber moment" in business entity formation competition as crowdfunding portals go online in coming years. Imagine if the Romans were prohibited from recognizing the separate entity formation that facilitated the creation of the aqueducts, or if the 19th century incorporation model (where state legislatures were required to pass a new bill to create every new business entity) was still in effect as the nation's economy entered the 20th century. That is the precipice on which business entity law currently sits.

In part, the new crowdfunding platforms are interesting for the simple fact that they open up the possibility for a new experiment in corporate governance. It may be the case that crowdfunding firms have unique dynamics very different from the type of firms currently traded on public platforms, and this Article will explore why that may be the case. But even if they are similar, crowdfunding nevertheless opens up an opportunity to apply corporate governance innovation to a totally new public exchange platform free from pre-existing path dependencies. O'Hara and Ribstein note that "amending a public corporation's charter is costly and cumbersome" and therefore incumbent public firms may find it costly to change their individual corporate charters to reflect economic need and must rely on new provisions in codes developed by other jurisdictions for innovative changes.[4] This does not entirely limit innovation; for example, Grundfest notes that many firms adopted new forum selection bylaws prior to Delaware specifically recognizing that option. It does suggest, however, that particularly paradigm-shifting corporate governance

3. Crowdfunding, 17 C.F.R. pts. 200, 227, 232, 239, 240, 269, 274 (2015), https://www.sec.gov/rules/final/2015/33-9974.pdf.

4. Larry E. Ribstein & Erin Ann O'Hara, *Corporations and the Market for Law*, 2008 U. ILL. L. REV. 661, 700 (2008).

innovation will require new initiative.[5] Thus, the advent of crowdfunding in itself may open a window for some of the ideas presented in this Article. The difficulty of changing paradigms for large publicly-traded firms suggests that innovation is more likely to begin with new firms entering the market. This is particularly true with respect to smaller firms funded by entirely new methods that are not subject to the path dependent pathologies[6] that currently drive choice of forum and choice of law for large public companies.

This Part of the Article below will explain what crowdfunding means and explore the unique economic attributes for small public firms to argue that crowdfunded firms will require innovative and heterogeneous options not presently permitted by the federal overlay in corporate governance. This Part will also explore two smaller firm, lightly regulated exchanges in the United States and Great Britain to develop useful insights for the crowdfunding platform world. This Part will also consider how crowdfunding's interaction with app-based user interaction will lower the costs of shareholder interaction with firms. Finally, this Part will explore how the unique attributes of crowdfunding are likely to help make federalism reforms that are likely to endure, based on a public choice analysis.

A. What is Crowdfunding?

Ethan Mollick defines crowdfunding as:

> [A]n open call, essentially through the Internet, for the provision of financial resources either in form of donation or in exchange for some form of reward and/or voting rights in order to support initiatives for specific purposes . . . [including] internet-based peer-to-peer lending . . . and fundraising drives initiated by fans of a music group . . . . Crowdfunding refers to the efforts by entrepreneurial individuals and groups—cultural, social, and for-profit—to fund their ventures by drawing on relatively small contributions from a relatively large number of individuals using the internet, without standard financial intermediaries.[7]

In a sense, crowdfunding in the United States has not really happened yet. Thus far, the SEC has prohibited sales of ownership in firms through this technology without registration as a securities exchange and without each individual project or firm on the platform registering as a public company. This results in ensuring that a multi-million dollar proposition remains outside the range of possibility for small scale projects and most firms contemplated on crowdfunding platforms.

In the USA JOBS Act, signed into law in 2012, Congress recognized the growth possibilities of crowdfunding and ordered the SEC to approve a light-touch regulation

5. *See generally* Joseph Grundfest, *The History and Evolution of Intra-Corporate Forum Selection Clauses: An Empirical Analysis* (Stan. L. Rev., Working Paper No. 427, 2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2042758 (observing that forum selection bylaws were adapting to allow intra-corporate litigation to occur in jurisdictions that specialize in that state's corporate law).

6. *See generally* Lucian Arye Bebchuck & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999) (analyzing structure-driven and rule-driven pathologies of prior corporate structures and their effects on new corporate structures).

7. Ethan Mollick, *The Dynamics of Crowdfunding: An Exploratory Study*, 29 J. BUS. VENTURING 1, 2 (2013).

regime for crowdfunding platforms. Once the SEC's rule implementing crowdfunding exchanges is fully implemented by crowdfunding portals, then some version of what has previously evolved in stunted quasi-crowdfunding platforms will be expected to thrive. But in advance of the rule's implementation, crowdfunding has been limited in that funders are prohibited by law from obtaining a direct monetary interest in the firms they fund.

Prior to crowdfunding going online with adoption of a final SEC rule, most crowdfunded projects do not include an equity ownership component, but instead consist of contributions in exchange for in-kind benefits. Kickstarter is the largest operator of such a pre-crowdfunding platform in the United States. One open question will be whether attributes seen on the crowdfunding pre-cursor Kickstarter will continue to hold as Kickstarter firms transition to crowdfunding platforms able to sell ownership equity. Agrawal posits that, though crowdfunding platform Kickstarter does not permit the issuance of equity shares, and indeed crowdfunding will not involve the sales of equity until the SEC's rules for crowdfunding pursuant to the JOBS Act are finalized, the dynamics of crowdfunding on the pre-cursors Kickstarter, and a European analogue Sellaband, can inform how some of the economics of equity crowdfunding are likely to play out.[8]

Kickstarter is the most popular of the pre-crowdfunding sites. Crowdfunding on Kickstarter has resulted in funds as small as $1000 to fund an event, clearly not what one would classically define as a firm, but for the top 50 largest projects funded by Kickstarter, 45 of them have become surviving business entities.[9] Mollick describes projects funded on Kickstarter as encompassing a wide variety of heterogeneous objectives. He generally divides those objectives into those encompassing a "patronage model" whereby funders act as philanthropists and do not expect a financial return, "reward-based" model where funders expect some in-kind benefit such as preferential access to a funded product, and an "investment model" through which funders seek to obtain profit.[10] The profit model on Kickstarter is somewhat limited, in that federal securities laws prohibit the sale of equity securities with registration absent some exemption (and the exemption for crowdfunded equity securities required by the JOBS Act which was just recently finalized).[11]

Mollick's study of crowdfunded firms suggests they often combine these objectives. Mollick notes one odd example of a Kickstarter project in which a user posted, as a joke, a proposal to fund a statue of Robocop to install in Detroit, which subsequently went on to raise $67,000 in six days.[12] This suggests a somewhat organic quality to crowdfunded

8. Ajay K. Agrawal et al., *Some Simple Economics of Crowdfunding* 5 (NBER, Working Paper No. 19133, 2013), http://www.nber.org/papers/w19133.pdf.

9. Mollick, *supra* note 7, at 2. The "Veronica Mars Movie" Project is one of the largest funded projects on Kickstarter. It was a fan-funded movie, continuing a story line from a canceled series, and raised $5.7 million by offering funders in-kind benefits ranging from regular movie productions updates (for $1 dollar contributors) to a role in the movie (for a single $10,000 funder) and a range of other benefits for funders in between. *The Veronica Mars Movie Project*, KICKSTARTER, https://www.kickstarter.com/projects/559914737/the-veronica-mars-movie-project/description (last visited Mar. 28, 2016).

10. Mollick, *supra* note 7, at 3.

11. The third model thus can only offer funders preferential access to purchase securities at a later date, some form of royalty sharing, or other close approximation of a future stream of revenue, while carefully avoiding the SEC's test for an equity security which is largely dependent on the presence of direct revenue sharing.

12. Mollick, *supra* note 7, at 3; *see also* Bryan Hood, *Detroit's Robocop Statue Almost a Reality*, N.Y. POST (Jan. 22, 2014, 6:13 PM), http://nypost.com/2014/01/22/detroits-robocop-statue-almost-a-reality/.

projects, with initiators at times unsure of the ultimate evolution of their project (and indeed, whether their proposal will be a one time discrete project or will evolve into a full fledged firm). Mollick posits that a number of features unique to Kickstarter help police fraud, "including threshold funding, active participation by large communities, frequent interaction between founders and potential funders, and the ability of founders to broadcast signals of quality through rich descriptions and biographic information."[13]

Mollick conducted a study of 48,500 crowdfunded projects with combined funding of $237 million on the Kickstarter website, and found that number of Facebook friends, geography, and underlying project quality are the key drivers of success in crowdfunded firms.[14] Mollick describes the geographic component as "founders proposing projects that reflect the underlying cultural products of their geographic area (such as country music in Nashville, Tennessee)."[15]

Mollick notes that in crowdfunded ventures "the money is raised up front, and, in the case of reward-based crowdfunding, without any clear legal obligation from the project initiator to deliver their promised rewards. For the dishonest, this creates an opportunity for fraud."[16] This Article will consider the potential corporate governance innovations which may serve to reduce agency costs that flow from this problem. And yet Mollick does not find a significant rate of fraud with respect to Kickstarter projects.[17] He does however find a significant delay rate, which could be merely a result of the unique risks and challenges of crowdfunded firms or which could result from opportunities for shirking created by the crowdfunding environment.

This suggests that a corporate governance modification or innovation which would be quite useful in this context would be a rule of review which focused on the initial intent of the entrepreneur as intended toward a legitimate business venture, albeit fraught with risk, as opposed to a purely fraudulent project. By contrast, the focus of fiduciary duties in traditional corporate law is on the day-to-day business decisions of the executives. It also suggests a role for arbitrators in engaging in the fact-based inquiry of whether a project's goals have indeed been met, and perhaps a default option then triggered to give the original funders a statutory referendum on whether to continue the firm's existence or liquidate it.

Agrawal examine a precursor to Kickstarter based in Amsterdam called Sellaband, which funded new music bands. Sellaband operated free from U.S. federal securities laws and was therefore able to share profits with funders.[18] The Sellaband platform took a role in the governance of funded projects, and after posting a profile of the band and a demo, would collect $10 futures investments in the band.[19] If the band failed to raise $50,000, funding was returned to investors. If it did, the money was used to fund production of an album recording, pursuant to a budget approved by the Sellaband platform. Kickstarter's role in reviewing projects on its platform was more limited—public disclosure indicates its diligence is limited to rooting out fraud, not to meter investment quality.[20] To the extent

13. Mollick, *supra* note 7, at 14 (describing the Robocop statute funding prank).
14. *Id.*
15. *Id.* at 2.
16. *Id.* at 11.
17. *Id.*
18. Agrawal et al., *supra* note 8, at 7.
19. *Id.*
20. *Id.* at 25.

that crowdfunding platforms themselves could potentially invest in some of their projects, it could serve to minimize agency costs along the Sellaband model, but they are unfortunately prohibited from doing so by the JOBS Act.

Agrawal describes how crowd-based diligence can also be effective in rooting out fraud, given that a large community of users can pool resources.[21] As crowdfunding platforms go online, crowdfunding investors or analysts could seek to build reputations as star pickers and thereby serve as repeat players, or informational intermediaries could evolve. Agrawal notes that another solution to reputational constraints and adverse selection problems on crowdfunding platforms is to break up the project financing into a series of milestones.[22]

Information problems not resolved by intermediaries could be resolved by the signal of an initial anchor investor. For example, seed funding from a venture capital (VC) could be a vitally important initial signal for crowdfunded entities. This way crowdfunders could free ride on the initial investment of diligence by the VC. On the other hand, the VC has a chance to observe what the firm does with the crowdfunded money to determine whether additional funding is worthwhile. They would also have a valuable signal in the publicly traded price of the crowdfunded firm which they might use to gauge the value of their investment through a market process. All of which will suggest a need for adaptive funding mechanisms that allow for the possibility of applying contingencies to shareholder rights that may not be permitted under existing federal corporate governance rules or state law regimes.

Focusing on Sellaband again for a moment, invoices were sent to Sellaband for payment of band expenses, and any profits were split equally between funders (who also get a free CD), artists and Sellaband. During the three-year period of the Agrawal study 34 albums obtained $50,000 in funding. Agrawal observed that crowdfunded investments under the Sellaband model are highly path dependent, and as amount previously invested grows, the propensity of investors to invest tends to accelerate quickly.[23] This suggests crowdfunding platforms may find value in more variability in the disbursement and control rights of different groups of shareholders, and may value a structure that facilitates giving different stages of preference to multiple classes of shares to attract large blocks of shares initially, as well as maintaining variable voting and cash distribution rights to facilitate subsequent rounds of funding. Delaware's corporate law code is far too rigid to accommodate such a level of flexibility in shareholder control rights, and the residual obligation of contractual good faith and fair dealing in Delaware's interpretation of its LLC code would similarly threaten full utilization of an entity form with necessarily fluid and variable control rights. Agrawal also notes how an initial tranche of "friends and family" investment tends to be local and signals to other, more distant investors, the entrepreneur's commitment to the project.[24]

If investments by large block investors can serve the same signaling function for crowdfunded firms (as if, for example, a VC fund offers a small slice of funding to a startup, but awaits further funding on a crowdfunded platform contingent on the firms ability to

21. *Id.* at 28.
22. *Id.* at 25.
23. Agrawal et al., *supra* note 8, at 16.
24. *Id.* at 19–20.

raise a block of funding via the crowdfunding portal), then that same signaling effect could facilitate crowdfunding. VC's are typically thought of as pre-IPO funders, but small tranches of crowdfunded capital could be contemplated betwixt rounds of funding from a VC firm. This may call for variability in share class rights, and indeed for an element of contingency in share class rights which could change upon subsequent rounds of funding. This suggests a need for more variability than can initially be expected from the Delaware corporate code or is permitted by the residual obligation of good faith and fair dealing in Delaware's LLC code. It may also demonstrate the folly of the NYSE's prohibition on dual class share issues for post-IPO firms—as a rule which crowdfunded exchanges should certainly not emulate (though, since the exchange's limits on dual class shares was a result of pressure from the SEC, there is reason to suggest they will similarly be pressured to do so). This sort of variability could be evidenced in several ways. For instance, there could be a right to issue shares with voting or outright control rights that trump the rights of existing shareholders. Relatedly, there is also the right to issue shares that have dividend rights that trump the rights of existing shareholders. These rights could potentially water down other rights of existing shareholders, upon a subsequent opportunity to obtain VC financing. All of which would be prohibited by nearly all national exchanges, including the Nasdaq's new venture exchange.

Agrawal, Catalini, and Goldfarb describe what is currently by far the greatest success story on Kickstarter, which was the development of the Pebble watch.[25] An entrepreneur had secured $375,000 from an angel investor to produce a watch which could synch with Blackberry and iPhone devices, but needed another $100,000 to finish production and was unable to obtain it. He turned to Kickstarter, where he promised funders a watch in exchange for every $120 contributed. He raised $100,000 within two hours, and an additional $10 million within 37 days.[26] He promised delivery by September 2012, but production fell behind and he was unable to deliver until May 2013 (though he did eventually fill all orders).[27] The competition of the Pebble watch eventually led Apple to respond by offering a smartwatch of its own. This example suggests the value of linking tranches of venture capital investments with crowdfunding tranches in an early stage startup.[28]

Some of the benefits of crowdfunding to issuers include an ability to bundle funding in-kind benefits, including participation in the underlying project itself and recognition for funders, as well as obtaining information such as the strength of a consumer preference for future production by their participation in equity funding.[29] Agrawal notes, for example, how funders were highly involved in the initial design of the Pebble watch, and suggested numerous modifications that were subsequently included in the watch.[30] This suggests that

25. *Id.* at 3–4.

26. *Id*. at 2.

27. *Id.* at 3.

28. Agrawal posits that some firms may actually prefer non-equity based crowdfunding to equity crowdfunding, as it could limit the dilution of subsequent rounds of financing to venture capital firms, and they note that after Pebble's successful crowdfunding venture it chose to obtain additional capital through a more traditional Reg. A offering. Additional flexibility and heterogeneity in share class differentiation could help to bridge that gap. Agrawal et al., *supra* note 8, at 6.

29. *Id.* at 11.

30. *Id*.

investors may need new means of communicating with entrepreneurs other than the classic modes of shareholder voting and shareholder proposals. It also suggests that potential for misapplication of controlling shareholder, equitable subordination, or veil piercing doctrine in this context to inhibit shareholder participation in idea development at crowdfunded firms.

B. The Economics of Crowdfunding Demonstrate that Crowdfunding Will Require a Level of Flexibility that Current Federal Preemption Would Not Facilitate

The last Section made some initial suggestions about corporate governance innovation which would be useful at crowdfunded firms, but this section will explore the range of corporate governance flexibility which will likely be required by crowdfunded firms in more depth based on application of the New Institutional Economic or firm theory economic literature. It will particularly explore innovation which would not be easily accommodated by the federal overlay present in the current corporate governance system. Some of these suggestions are speculative and may not ultimately prove in high demand for crowdfunded firms, while other unexpected innovations may develop in a corporate governance system freed from the federal overlay. Nevertheless speculation about useful corporate governance innovations in this space may help to convince readers of the range of potential innovations that will be precluded in the crowdfunding space as a result of the federal overlay.

1. Expected Demand for Arbitration

The fractionalization of ownership on crowdfunded platforms may be such that arbitration of claims could be a more useful means to determine the fact question of whether the crowdfunded entity operated within the boundaries of its stated objective. Fractionalized shares may be so small that shareholders in a class may be unable to monitor conflicts between attorneys and the represented class for example, and thus this Article will argue that they may require means of adjudicating their rights which represent a low cost to firms. Thus, traditional class actions may be expected to destroy the fledgling firm with long delays and expensive litigation, and thereby prevent accomplishment of some objective which the initial investors value highly. This may generate interest in an entity form that combines features of default corporations with features of LLCs, and may be more usefully enforced through an arbitration method of business code enforcement.[31] Schramm notes that particular emphasis on defining donor intent in the non-profit context can facilitate separation of ownership from control to such an extent that something

31. Some may argue that a new quasi non-profit business organization form which limits the profit maximization objective may be applicable for firms in this space, such as the LC3 organization form developed in Oregon and Washington state. The LC3 business entity form will not likely fit this model well, as that code form takes an already nebulous concept like the duty of good faith, loyalty, and care, which is currently interpreted within a loose profit maximization norm, and makes it even more nebulous. Bainbridge describes how stakeholder based duties for corporate directors would only make accountability problems worse, as directors would be able to "play off one constituency against another." Bainbridge, *supra* note 1, at 583. Thus, a contractually-based obligation drafted more specifically to the goal of the project is likely to prove far more useful in this context, particularly if it also utilizes an arbitration based framework for interpretation.

resembling more of a classic firm becomes possible.[32] Therefore, in lieu of nebulous fiduciary duty type standards, non-profit crowdfunding firms may find it helpful to more clearly explain the parameters of their mission, or the contours of a specific project or groups of projects. They may find it so helpful that agency costs can be policed through arbitration fact-finding to determine whether the contractual specification has been met.

Alchian and Demsetz and Fama and Jensen[33] explore the role of residual claimant owners in monitoring firm employees.[34] In some sense one type of project funded on Kickstarter, mixed motive firms, may be seen as blending the presence of residual owner monitors with partially non-profit firms. If the defining objective of the firm can be completed to achieve a fixed goal but will take place over an uncertain timeframe, then owners of mixed-motive crowdfunded firms can be thought of as residual claimants with a contingent claim. Once the firm's initial objective has been met, any subsequent profits are subject to an ownership claim pursuant to contractual rights provided in the charter. Before that time the firm's obligation can be thought of as unconstrained by a requirement to maximize profits. If the initial project has been met, and along the way it becomes clear that the one time project has generated spillover value that can become an enduring firm, shareholders may find value in a code that has a default means for the shareholders to reassess whether they want to firms separate existence to continue.

For example, consider the investor in a biotech development for a drug to cure an ailment affecting a very small number of victims, one of whom happens to be a distant relation or contact (e.g. Facebook "friend") of the investor. This model of financing is expected to grow in the future, which may well include crowdfunded financing.[35] For an investor/donor at the margin the lack of potential profit may have otherwise limited their interest. Investors may then buy in with a preference for some hope of profit, but which hope is seconded to a primary purpose of spending the maximum amount toward R&D required to cure the disease, even if it maxes out their investment.

A business entity charter for such an institution will likely not be well-served by a broad, indeterminate fiduciary duty obligation of managers to owners with all its attendant doctrinal baggage. It may also be ill-served by a pure fiduciary opt-out in an LLC form, as some intermediate third-party review could reduce agency costs and thereby prove helpful to both managers and investors, particularly with respect to the question of when it is necessary to continue a project's separate existence or require dissolution. In any event, this Article in a later Part will demonstrate that the dominant Delaware LLC entity form does not actually permit full fiduciary opt-outs for those firms that would seek a full opt-out.

These firms may be better served by a fact-based inquiry into whether the initial

32. *See generally* Carl J. Schramm, *Law Outside the Market: The Social Utility of the Private Foundation*, 30 HARV. J.L. & PUB. POL'Y 355 (2005) (emphasizing donor intent in a non-profit setting).

33. *See generally* Armen Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972) (showing the role of residual claimant owners); *see also* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership from Control*, 26 J.L. & ECON. 301 (1983) (demonstrating the same).

34. *See generally* Alchian & Demsetz, *supra* note 33 (showing the role of residual claimant owners).

35. Lia Steakley, *New Crowdfunding Sites Apply Kickstarter Model to Health and Medicine*, STANFORD MEDICINE (July 12, 2012), http://scopeblog.stanford.edu/2012/07/12/new-crowdfunding-sites-apply-Kickstarter-model-to-health-and-medicine/.

objective has been met should a shareholder challenge a firm that is seemingly dragging its heels to maintain discretion over the firm by delaying accomplishment of its objective. The firms may also be better served with a mode of arbitration that is not administered by judges, but instead is administered by professionals in that particular business, such as our example medical industry researchers.

Some have argued that the broad fiduciary duty obligations imposed by Delaware corporation law are gap fillers for contractual arrangements between shareholders and boards that cannot anticipate every contingency. Bainbridge describes the role of fiduciary duties as gap fillers for corporate contracts.[36] This may be true, but Delaware's fiduciary jurisprudence is not the only form of useful gap filler. The more specific goal-based review explored in this article could prove a more effective alternative in many crowdfunded firms, particularly mixed-motive firms. There may also be some expected demand for conflicts policies for board members serving in multiple business endeavors or methods of defining whether a non-profit "objective" has been met both would appear useful in this context and await legal innovation and interpretation.

Note also that this analysis does not suggest utilizing the Delaware corporate code or LLC code, or some variant, and merely arbitrating it with reference to Delaware precedent. Instead it suggests an entirely new form of code, with duties and obligations of corporate officers designed to be optimally determined via an arbitration model.

Williamson describes arbitration as a frequently superior means of enforcing contracts as, when it employs specialized arbitrators, can make use of superior information to slower and less efficient court based systems (particularly when a court will subsequently enforce the arbitrated award).[37] Williamson also notes that arbitrators have means of learning information during a controversy that are not as constricted as those in litigation.[38] Crowdfunding may well prove Williams right, if the federal overlay in corporate governance can be rescinded to allow arbitration-based alternatives to blossom.

2. Expected Demand for Non-Traditional Governance Structures

Another characteristic typical of projects operating on Kickstarter is that a small number of entrepreneurs work for the organization, which would serve to minimize the incidence of internal rent seeking within organizations between division directors in a large public firm.[39] So while crowdfunded firms will not obtain the same scale efficiencies as larger public firms, they will minimize some of the internal organizational monitoring costs typical of larger firms.

A case study of the largest profit-based crowdfunded project in the Pebble watch suggests that funders provided funding to the only verifiable aspect of the firm, meaning the biography of the inventor and the signal that he had been provided funding for his idea by a VC, but the production itself was almost exclusively outsourced.

If that dynamic holds true for crowdfunding as ownership in the new model,

36. Bainbridge, *supra* note 1, at 586.

37. Oliver E. Williamson, *The Economics of Governance*, 95 AM. ECON. REV. 1, 14 (2005).

38. Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. R. 519, 527 (1983).

39. DANIEL F. SPULBER, THE THEORY OF THE FIRM: MICROECONOMICS WITH ENDOGENOUS ENTREPRENEURS, FIRMS, MARKETS, AND ORGANIZATIONS 49 (Cambridge Univ. Press 2009).

crowdfunded firms may stay especially tight and small, merely internalizing the discovery of an idea and an individual's ability to utilize their networks in obtaining subsequent VC financing, and otherwise rely in large part on outsourced production. While this Article explores below that non-profit crowdfunded firms are likely to demand significant participatory rights, in cases as these the identity of the entrepreneur may be a substantial portion of the value of the organization, and so the entity may require strict limitations on shareholder participation rights.

If that is true, however, then contractual counterparties like suppliers may face significant hold up problems. Klein, Crawford and Alchian note that contractual counterparties in the development of firm-specific assets can have incentives to engage in opportunistic behavior once production has begun to appropriate quasi-rents.[40]

Klein and Leffler suggest that sunk investments like advertising to obtain brand name capital, combined with premium revenue streams, can serve as a signal that firms will not engage in such opportunistic behavior, but for a brand new startup like those anticipated on crowdfunding exchanges this may prove difficult. For those crowdfunded firms for which potential appropriable quasi rents are high, such as a new startup that has a totally new product which requires a unique production process and which outsources all of its production, Klein Leffler solutions will prove difficult for as long as the firm is unable to generate significant brand name capital.

Klein, Crawford and Alchian suggest that vertical integration is a solution to this problem. Thinking along a continuum of solutions it may be the case that partial integration, through partial sharing of control rights, could also serve to either minimize opportunistic behavior or, in the case of board seats, provide a low cost means of monitoring opportunistic behavior.

Williamson argues against the utility of suppliers placing monitors on corporate boards, in part because they can themselves use their positions to appropriate quasi-rents. Williamson describes providing seats on the Board of Directors as a cumbersome instrument to provide contractual enforcement to stakeholders, in that it "such protective powers as it possesses are compromised by inviting broad participation on the board."[41]

While this may be true in some cases for much larger firms, crowdfunded firms with a small number of large firm specific production contracts may find board placement of large suppliers a valuable tool of contractual bonding. Williamson warns that once a partisan constituent of the firm has obtained a board seat, they can use that position act opportunistically or log roll their votes with other members of the board.[42] If two firms have members on each other's boards, however, it could serve a hostage taking function that could facilitate contractual enforcement for each side.

In the general case if a single long-term supplier is the only constituent serving on the board the log rolling problem is limited, and in any event Williamson's critical analysis of constituent board members responds to a suggestion that constituent board membership should be mandated to serve some social democracy objective, not to board memberships

40. *See* Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978), *excerpted in* LOUIS PUTTERMAN & RANDALL KROSZNER, THE ECONOMIC NATURE OF THE FIRM 107 (2nd ed. 1996).

41. Oliver E. Williamson, *Strategizing, Economizing and Economic Organization*, 12 STRAT. MGMT. J. 75, 86 (1991).

42. Oliver E. Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1206 (1984).

contracted for by counterparties of startups. A member joining a board to serve a monitoring role would notably have an interest in significantly limiting their exposure to liability for disruptive action under whatever corporate governance duties they owe to the firm and its shareholders (which is as yet up for debate). Also note that Williamson assumes the standard board of directors, not one in which innovative changes in board structure and powers have been implemented.

This may provide some value to the provision of board seats that have some permanency, as joint monitoring mechanisms to limit hold up on firm specific contracts. If a contractual counterparty has a seat on the board, the firm's ability to engage in opportunistic behavior would be quite limited. For that to work, however, the ability of owners to select board members would need to be significantly limited. It also suggests that director independence requirements mandated by federal law would be counterproductive for these firms. Even if it isn't a question of board seats, but some other contractual control right, perhaps one that only kicks in upon a firm's inability to make good on a contractual commitment to a significant supplier, it is nevertheless another reason for potential demand for governance flexibility.

This Section has thus demonstrated that early stage crowdfunded firms will require significant flexibility in their ability to choose the makeup of the boards of directors that run the firm, or indeed will require flexibility for some alternative novel mechanism to oversee the firm.

3. Expected Demand for Novel Shareholder Participation for Some Crowdfunded Firms, Particularly Public Hybrid Firms with Constraints (Enduring or Limited) on the Profit Maximization Objective

Spulber notes that non-profit firms are defined as firms in which objectives cannot be separated from those of owners, and thus free transferability of ownership is not a function of non-profit structure.[43] Crowdfunded non-profit firms are likely to challenge this conventional wisdom, as the information efficiencies created by crowdfunding platforms economize on the costs of search and can better match funders with similar objectives. Thus, part of what makes crowdfunding unique is that reductions in the cost of search can actually make publicly traded non-profit firms a possibility.

A unique feature of crowdfunded firms, that otherwise share some characteristics of non-profit firm objectives, is that the group of owners may be so large (and search costs of owners finding each other who share the same objective are reduced by the crowdfunding platform innovation) that transferability of interests among that group may be possible. This could allow for both market-based valuation of the firm and provide liquidity benefits to the individual funders. In order to enforce objectives, those firms may be designed to provide unique control rights to those owners. In the purely non-profit publicly traded firm, the market value of the share would be the right to control the non-profit. In a mixed-motive crowdfunded firm, the value would include a profit distribution contingency.

For example, with respect to the Kickstarter financed fan film the "Veronica Mars Film Project" explored above, the entrepreneur financing the project was the director of

43. SPULBER, *supra* note 39.

the original TV series.[44] If, after crowdfunding goes online, such a project were organized as a for-profit firm operating over a crowdfunding platform, it is unlikely shareholder participation in governance would fit. The relationships and creative capital are all unique to the project's originator.

For other publicly traded, non-profit projects operating on crowdfunding platforms, the identity of the initial entrepreneur may not be as firm specific, and funders may highly value the ability to participate in the selection of managers or board members to maintain the character of the firm. Kuaan models non-profit firms as an example of consumers integrating into the production process of the firm.[45] This appears to characterize many projects funded on Kickstarter. Thus, a part of what is being traded is the right to proportionate shareholder control of the non-profit firm (and also, for some firms, the right to profits for value created by the non-profit if it subsequently "converts" to a for-profit firm).

This suggests a departure from the board-centric model of Bainbridge,[46] which would otherwise typically be associated with the contractarian analysis utilized in this Article. The Bainbridge model is one centered in the neoclassical firm with a wealth maximization objective.[47] This as we have seen is likely to be modified should the type of projects seen on Kickstarter also transition over to crowdfunded platforms.

Bainbridge's director primacy model provides tremendous descriptive power for large publicly traded firms.[48] He notes one of the primary reasons why his board centric model describes many public firms is that it "provides a hierarchical decision-making structure well suited to the problem of operating a large business enterprise."[49] This function of the director primacy model may have limited application to crowdfunded firms as they may simply be too small and operate by horizontal consensus. Then again, some firms seeking to grow and move to large securities exchanges may adopt governance models based on the Bainbridge director primacy model out of recognition that path dependencies could develop making transition to another governance structure costly down the line.

Bainbridge also focuses on conflicts of interest among groups of shareholders like union pension funds,[50] which may justify limits on shareholder control rights for some firms. While some of the shareholders he observes in the large public company context may be restricted from investing in crowdfunding ventures, there are still other conflicts we might expect that would cause the same problem. For example, if there is asymmetry of information between shareholders and competitors about the value of a new innovation, then competing firms may obtain control of crowdfunded startups in order to vote to replace the managing entrepreneur and stifle the competitive innovation that might threaten their competitive advantage in the market.

Bainbridge's argument is at heart a contractarian one, and therefore, the general arguments in favor of director primacy for large public companies does not preclude the utility of alternative arrangements for firms with different unique needs who contract for

44. *The Veronica Mars Movie Project*, *supra* note 9.
45. SPULBER, *supra* note 39.
46. Bainbridge, *supra* note 1, at 583.
47. *Id.* at 558.
48. *Id.*
49. *Id.* at 572.
50. *Id.* 583.

alternative arrangements. In particular, those smaller and early stage firms likely to trade on crowdfunded exchanges may have unique requirements such that shareholders and boards will demand more shareholder empowering methodologies. Fama describes reasons why security holders may want to abdicate their control rights to managers, including their ability to diversify risk, and that manager's opportunity wages may depend on the success of the firm—suggesting there may be many situations in which managerial control and the separation of shareholder ownership from control could be optimal.[51] Some crowdfunded firms may reflect this description. Others in which shareholder interests are firm specific and less diversifiable like fan-financed entertainment projects may be better paired with voting control depending on whether there are substantial firm specific quality to the entrepreneur.

In sum, we can expect some instances in which the Bainbridge director primacy model will continue to have force in the crowdfunding context. But even in those instances, the types of shareholder conflicts necessitating limits on shareholder control rights is likely to be unique, and innovation inhibited by the federal overlay will prove a challenge. For other firms more shareholder participation will likely be demanded, but rigid shareholder participation approaches favored by the federal overlay—like voting for directors and voting for shareholder proposals—may also prove to be a poor fit. Either way, flexibility in corporate governance will be essential in the crowdfunding world.

4. Expected Demand to Facilitate Adaptive Funding Methods

Delaware corporate law and Delaware alternative entity law both stand for the proposition that, even though a board or manager may be permitted to take an action by the state's code, they may be found to have violated either their fiduciary duties (or in the case of an LLC that has opted out of fiduciary duties, their still enduring "duty of good faith and fair dealing")[52] in so doing. Further, the SEC has pressured the large national exchanges to limit the ability of listed firms to issue dual class shares with unique control rights once a firm has gone public. This Section will show how those constraints contained in the federal overlay, and within the Delaware dominant business entity model, will ill serve crowdfunding firms.

Prior literature on the economics of entrepreneurship considers the agency costs that arise when performance is unobservable.[53] Some have observed venture capital firms have developed mechanisms to address these costs, as in the allocation of control rights or in the form of unique combinations of convertible securities.[54] In addition to specialized monitoring, venture capital firms can also provide human capital to new entrepreneurs in the form of un-conflicted consulting advice.[55]

Fama and Jensen, in "Separation of Ownership from Control," argue one mitigating factor in larger organizations, in which decision management and decision control are

51. KROSZNER & PUTTERMAN, *supra* note 40, at 305; Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980).

52. Larry E. Ribstein, *The Uncorporation and Corporate Indeterminacy*, 2009 U. ILL. L. REV. 131, 158 (2009).

53. SPULBER, *supra* note 39, at 172.

54. *Id.* at 173.

55. *Id.*

disaggregated, is agency costs are lower because of monitoring among and between employees—creating internal systems of checks and balances.[56] For a crowdfunded entity mirrored on the Pebble model, that would not be the case, suggesting another reason why the joint VC funding and crowdfunding model is likely to be replicated on many crowdfunded firms, particularly those like Pebble which rely on a small number of employees for large scale and outsourced production. Utilizing a firm structure for venture capital investments in projects allows use of the signal provided by a venture capital investment to provide information to much smaller investors who can minimize their risk through diversification but also are a result of their greater diversification not interested in expending much monitoring costs. Crowdfunding investors also minimize their risk through fractionalized investments. The crowdfunding participants may have different risk preferences and/or different budget constraints from the VC firms, but the signal of an initial VC investment provides value to them. The VC can minimize its up-front investment to a little less than the amount required by the firm.

One of the benefits of publicly traded securities identified by Fama as a means to minimizing agency costs is the signal that publicly traded equity serves in evaluation of managerial performance.[57] For a venture funded enterprise, adding a layer of crowdfunded equity provides venture capital firms with such a signal to evaluate their investment, determine whether to exercise any contractual control rights they possess or exercise conversion rights in their securities, and allows them to assess the viability of future investments. This dynamic was exactly how the most successful venture on Kickstarter operated in the story of the Pebble watch previously described in this article. This suggests that corporate governance needs unique options for crowdfunding firms that make use of this dynamic which may include dealing with transition problems as firms obtain small initial investments from VC firms with high specialized monitoring: then firms obtain rounds of capital from crowdfunded finance and then perhaps obtain additional rounds of funding from a VC. Negotiations expected to take place with VC firms during these transitions should be expected to include changes in control rights that may be restricted by Delaware's residual obligation of good faith and fair dealing and by the federal overlay.

As one example, the ability to issue multi-class shares after initial shareholders are issued with specified rights, without fear of fiduciary duty litigation or "duty of good faith and fair dealing" litigation—which are risks inherent in Delaware corps and LLCs—could present a problem. And the listing requirements of exchanges that limit your ability to do so should not be replicated as an SEC-mandated element of crowdfunding platforms, though it is unclear whether that will be the case. Preferred stock has been one way to traditionally limit conflicts between different classes of investors.[58] But in this instance, multiple rounds of financing that move between VC block investors and public funding may require highly contingent residual control rights for crowd investors, which is not favored by the equitable principles in the Delaware code.

Fama and Jensen describe capital market financing in publicly traded companies as uniquely designed for "activities optimally carried out with large quantities of long-term

56. *See generally* Fama & Jensen, *supra* note 33, at 11 (discussing how management decisions are impacted by ownership and control).

57. *See generally* Fama, *supra* note 51.

58. SPULBER, *supra* note 39, at 173.

assets that are difficult to value and that are more efficiently purchased by residual claimants rather than rented."[59] They contrast that description of publicly financed projects against those financed through proprietorships or partnerships with restrictions on withdrawal rights for residual claimants as "when the important asset in an activity is the human capital of existing decision agents."[60] They also note:

> [A]t various stages in the life of a venture it may be best carried out under different organizational forms. For example, it may be first organized as a proprietorship and then, with increasing demands for financing risk investments, converted to a partnership or a closed corporation, and then to an open corporation.[61]

The transition they describe is not costless, however, and there may be path dependencies that limit the freedom to convert entity form. Members of the partnership, which potentially have what Fama and Jensen describe as widely different consumption preferences, may not be predisposed to support the conversion, for instance as a form of holdout problem. Therefore, it is possible that what crowdfunding will do is create a transition space for firms that may be otherwise constituted as partnerships, but which are facing increasingly intense capital financing needs. This change may also characterize some of the smaller firms trading on pink sheets.

This further suggests a need for contractual flexibility in crowdfunded firm governance, as there may be a wide heterogeneity in the relative mix of capital intensive versus human capital elements of the firm's investments, and therefore a wide range of optimal levels of restrictions on the rights of residual owners. Some theorize that firms can create managerial tournaments to incentivize managers within firms.[62] Fama describes this function as a means of limiting agency costs that flow from the separation of ownership and control.[63] To the extent that crowdfunded enterprises will be relatively small startups with a relatively flat management structure, this is not likely to have as much significance as it does for large publicly traded firms.

However, if the crowdfunded startup's best alternative is instead a proprietary owner fully funded with debt, the possibility of obtaining future equity interest in the firm may serve to provide a cost-effective means of financing, despite the presence of residual agency losses. Jensen and Meckling note that a market for managerial talent and a market in the company's stock both serve as constraints on agency costs.[64] Crowdfunding for many smaller startups will be characterized by a relatively higher level of firm-specific executive talent and by a relatively illiquid secondary market for the firm's securities relative to larger firms on public markets. This suggests that the traditional importance that Delaware law and the federal overlay place on shareholder voting rights as agency cost-monitoring mechanisms is misplaced for many firms in the crowdfunding context.

59. KROSZNER & PUTTERMAN, *supra* note 40, at 342.
60. *Id.*
61. *Id.* at 344.
62. SPULBER, *supra* note 39, at 273.
63. Fama, *supra* note 51, at 295.
64. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 338 (1976).

5. Expected Demand to Facilitate Their Organic Growth

Agrawal describes the shift from non-equity crowdfunding to equity crowdfunding as associated with the question of whether investors want to merely pre-order a single, specific product, or instead want to invest in future projects due to "the creator's ability to generate equity value by building a company rather than just delivering a product."[65] For some entrepreneurial projects, crowdfunding could be thought of as a form of purely pre-order contracting through which a group of entrepreneurial consumers could seek financing for production of an item they wish to see invented and which they hope to purchase in the future. That partial bundle could grow on a crowdfunding platform into the type of bundle of contracts that characterize a firm. In this instance, as well, the firm may need to substantially limit the control rights of residual claimants. Otherwise, the pre-order customers could strategically vote to vitiate their contracts through voting to dissolve the firm once production has begun, and then later renegotiate the price once the product-specific investments have been made.

To limit that sort of strategic behavior, the control rights of owners would need to be limited by the firm's organizational structure. However, if production is never achieved, such a firm may require some means of dissolution, which may then require arbitration of whether dissolution is appropriate. Or it may involve set time limits on the life of the firm, subject to production quotas. We should expect corporate governance innovations demanded for this subset of crowdfunded firms to reflect the fact that what is being traded initially on crowdfunding platforms is not ownership in a firm, but ownership in a set of multilateral contracts, which could eventually become a firm.

The nexus of contracts that firms represent have historically been a bundle of contracts that have an entrepreneur as its center establishing, relationships with employees, suppliers, customers, and capital. But crowdfunded projects can begin as a collection of promises by consumers to pay for a particular good and agglomerate, such that they can catch the attention of entrepreneurs and providers of additional capital, and then grow from a bundle of customer pre-orders to an entrepreneurial project, and then finally to a full fledged firm. Just as Coase talks about the boundaries of the firm being grounded in the utility of the price system,[66] we can think of some crowdfunding entities and projects as a more organic method of growth around the boundaries of the effectiveness of the price system. This type of growth can be viewed as a means of delineating firm boundaries more efficiently than large initial investments to entrepreneurs, who are making educated guesses about whether the scope of their production represents the efficient frontier of their firm based on educated guesses about the operation of the price system. For example, a crowdfunding project could also be structured as a form of research tournament,[67] with control of the firm acceding to whomever fulfills the contractual requirements as defined in the contract and interpreted by a designated arbitrator.

The "Penrose Effect" explains that managers learn through the strategic deployment of resources and can redeploy their attention as they master the strategic needs of existing projects, but the boundaries of multi-project firms are a function of diminishing returns to

65. Agrawal et al., *supra* note 8, at 68.

66. R. H. Coase, *The Nature of the Firm*, RASMUSEN, http://www.rasmusen.org/g751/06b-readings/3-coase1937.pdf (last visited Mar. 28, 2016).

67. SPULBER, *supra* note 39, at 184.

the rate of redeployment of additional managers.[68] Crowdfunding might be viewed as a more organic means of growth for Penrose Effect problems in young firms whose only alternative means of financing is solely VC investment. Consider a fan-based *Star Trek* film being developed on Kickstarter. The development of such a project may create a firm that is good at doing those types of projects, and the initial funders of the project may want to capture some of the subsequent agglomeration benefits of the project as a full fledged, multi-project firm develops out of it.

As the crowdfunding industry integrates a for-profit character to some projects on crowdfunding platforms, it may be that the collective input of the firm, and the governance of the individual project, develop spillover value that crowdfunding entities want to capture. Blair noted that a distinct attribute of firms facilitated by corporate organizational law is a firm's ability to facilitate firm-specific investments of capital by firm contractual counterparties.[69] The independent life of the firm allows free entry and exit of investors and managers without threatening the independent existence of the firm, and thereby facilitates longer-term contracts between the firm and contractual counterparties. As a current project-based model of funding projects on Kickstarter morphs into ownership, unique corporate governance innovations geared toward crowd-funded firms will likely take this into account.

Demsetz saw economization of specialized information in the production of goods as defining the contours of firms, and described how:

> continuing association of the same persons makes it easier for firm-specific and person-specific information to be accumulated . . . . Knowledge about the objectives and organization of the firm is learned 'cheaply' through continuing association, and so is knowledge about the capabilities and limitations of the persons involved in this association.[70]

But for small novel projects at the earliest stage, it is unclear whether this is the case, and therefore whether a firm will arise from the specialized knowledge acquired via the initial project. Crowdfunding ownership for such projects can help a crowdfunded projected obtain a premium for the possibility that this will be the case by proving funders of the project an equity claim on a potential future firm. Thus, crowdfunding has the potential to allow large scale, diversified equity funding of innovation at a stage so early that it is not yet clear whether a fully fledged firm will develop from a single team project. There may be an in between where equity crowdfunding projects could include purchase of rights to a succession of projects, with some mechanism for return of the investment in the event of failure and/or a contingent claim on the firm that results from the individual project. In the spectrum between the crowdfunded project as merely a form of "pre-order" and a fully functioning crowdfunded firm as a "nexus of contracts"[71] in the traditional sense, some crowdfunded equity could be thought of as a "bundle of projects" in succession. The rights of shareholders could be variable based on how the succession of projects proceeds, and could be highly contingent based on subsequent rounds of equity financing.

68. KROSZNER & PUTTERMAN, *supra* note 40, at 180.
69. SPULBER, *supra* note 39, at 69.
70. Harold Demsetz, *The Theory of the Firm Revisited*, 4 J.L. ECON. & ORG. 141, 157 (1988).
71. Fama, *supra* note 51, at 290.

Equity claims could be contingent and become debt upon failure to meet a delivery date, for example. If funding is that tightly tied to rounds of projects, then shareholder duty litigation in state and federal court could risk destroying the ability of the firm to finish the bundle of projects. This suggests a heightened need for limited and predictable arbitration based remedies. This comports with how Williamson elaborates on the boundaries of firms as alternatives to private exchange and to account for evolving bilateral exchange conditions as "the degree to which the transaction in question is supported by durable investments transaction-specific assets—by which I mean assets that can only be redeployed to alternative uses and users only at a loss of productive value."[72]

The initial investors in projects funded on Kickstarter or on new crowdfunding exchanges may eventually evolve into firms with these transaction specific assets, or not, at the initial startup stage for a small firm with a speculative plan for growth it may be unclear, and investors may simply want an ownership structure that allows them to capitalize on value in the eventuality that the one-time project evolves into a firm with indefinite life. Cookie-cutter application of governance structures applied to larger, established firms, or mandated by the federal overlay, could risk destroying these projects through bureaucratic management or abusive litigation. In essence, the transition from individual projects funded on Kickstarter as a form of consumption expenditure to crowdfunded projects can allow packaging of consumption of an individual project with speculative investment in the potential that a firm will arise out of the project. Thus, we see that the organic growth character to crowdfunded firms ties into all of the particular needs recognized for crowdfunded entities explored in this Section.

6. Expected Demand for Unique Dissolution Procedures

Coase describes the organization of activities within firms as a function of the cost of using the pricing mechanism to allocate goods and services in production.[73] The managers of individual projects on a crowdfunded platform will be uniquely situated to determine the value of whether project specific contracts and assets can be utilized repeatedly in additional projects. As crowdfunded firms are able to provide ownership interest to dispersed owners, they will be better able to agglomerate projects that share a similar objective into the same firm and economize on the costs of production through centralized management of activities for which managerial coordination is more efficient than market allocation. If the evolution of the Kickstarter platform is any guide, the boundaries of these firms will likely develop through a fairly fluid evolutionary process that managers may be tempted to abuse. As such, particularized innovations in methods for dissolution of projects that have lost their ongoing value are likely to be needed in the crowdfunding context. This unique means of dissolution may also require an off-the-rack option for third party appraisal of the value of the firm or project. In a later Part, this Article explores how the mandatory appraisal process utilized in Delaware is flawed.

The goal of this Section is not to accurately predict all of the unique corporate governance attributes that investors and entrepreneurs will require in the crowdfunding space. It is merely to demonstrate that a simple economic analysis of crowdfunding suggests it will require a highly heterogeneous set of options, some of which will need to

72. Williamson, *supra* note 37, at 8.

73. SPULBER, *supra* note 39, at 92.

be newly designed. When combined with the next Section of this Article, analyzing the current state of competitive corporate federalism, the analysis will demonstrate that without significant limitation on the federal overlay in corporate governance, it is unlikely the corporate governance will evolve and innovate sufficiently to make the most of crowdfunding's potential.

C. One Perspective on Uberization: An Interest Group Story Suggesting Crowdfunding Can Make Corporate Federalism Stick

There is reason to believe that, should competitive, state-based incorporation receive a new jolt of energy from the reforms suggested in this Article, they may just have staying power to survive any future attempts toward federalization. Rauch and Schleicher describe how a key determinant of "sharing economy" firms is that they have been able to rally local citizens to their support because of highly popular services.[74] The characteristics of crowdfunding seem to share some of these attributes that have helped Uber and AirBnB become successful despite the powerful interest groups interested in maintaining the current system. The fact that there is a federalism aspect to the reforms offered here also offers hope; Greve argues that the American citizenry is uniquely comfortable with the key attributes of federalism, particularly as compared to Europe, and so he expresses hope for the future of competitive federalism in the United States.[75]

Weingast notes that in order for a federalist system to survive it must be self-enforcing, meaning that the architecture of the underlying interest group coalitions must ultimately support maintaining a federalist structure.[76] In light of the Weingast thesis, there is reason to doubt that Delaware, the dominant domicile of incorporation for half of all public firms, alone will sufficiently discourage an inefficient federal overlay. It is instead more likely that a balance incorporating challengers to Delaware will more effectively preserve a federal system. If a federal overlay serves to inhibit other states from challenging Delaware's dominance, Delaware would not have an incentive to reduce federal preemption but would instead appreciate how federal preemption preserves its dominant position in the market. But if instead federalism reforms actually make the system more competitive, then it may be more likely to stick. Parts II and III of this Article make precisely that argument.

One mechanism Weingast describes to preserve federalism is citizen consensus; he presents a historical anecdote in the use of citizen consensus to maintain local power during England's Glorious Revolution.[77] If crowdfunding manages to obtain a critical mass of retail popularity, then that retail popularity might be expected to serve the market-preserving mechanism similar to the context that Weingast describes (as retail popularity has helped Uber at all levels of government). Weingast also suggests a balance between

74. Daniel E. Rauch & David Schleicher, *Like Uber, but for Local Government Policy: The Future of Local Regulation of the "Shared Economy"* 3 (Geo. Mason L. & Econ., Working Paper No. 15-01, 2015), http://ssrn.com/abstract=2549919.

75. Michael S. Greve, *Against Cooperative Federalism*, 70 MISS. L.J. 557, 604 (2000).

76. Barry R. Weingast, *The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development*, 11 J.L. ECON. & ORG. 1, 3 (1995).

77. *Id.* at 18.

coalitions can serve as a mechanism of market-preserving federalism as well.[78] He notes that during conflicts between the North and South during an era of Jacksonian democracy, the conflict resulted in a balanced respect for federalism, as "each worried that the other might come to dominate the national government, allowing it to use national power for its own regional purposes. Because the problem was symmetric, both sides agreed to limits on national authority as a means of limiting the ability of the other to dominate."[79]

Weingast credits federalism and decentralized government authority in China as a key institutional condition for its unprecedented growth in recent times.[80] Weingast notes, consistent with Macey's public choice analysis of federalism, that as China's regional governments became increasingly successful, and as the rents provided to federal officials were maximized by merely restraining their urge to federalize, the regional governments were increasingly able to maintain their autonomy.[81] Weingast notes that major economic upheaval can upend the institutional dynamics that support federalism.[82]

One example of such a broad delegation of power to the states, which endured for a long time and has only come under fire relatively recently, was the McCarran-Ferguson Act delegating the regulation of insurance companies to states.[83] As evidence that codification protecting state corporate law is possible at the federal level, consider the Securities Litigation Uniform Standards Act, which preempted state litigation of shareholder claims under the Securities Exchange Act. It explicitly carved out state litigation of shareholder claims under state corporate law and preserved those actions from federal pre-emption in order "to preserve the expertise and efficiency of Delaware courts and case law."[84] This suggests that federal laws preserving aspects of state business entity law can at times endure if the interest group calculus is just right.

Macey theorizes federalism can endure because the federal government can obtain rents solely by virtue of "permitting independent or concomitant state regulation at little or no political cost to itself," and he predicts that "Congress will delegate to local regulators only when the political support it obtains from deferring to the states is greater than the political support it obtains from regulating itself."[85] According to Macey's theory, any federalism legislation will endure only so long as it is able to create a sufficient number of interest groups before the next major impetus for federal regulation, such as a future financial crisis or scandal.[86] Interest group pressure from delegated state and local formation entities can limit the impetus to develop a federal response.

This inquiry is analogous to Uber's challenge to the established rent-seeking networks created and supported by Uber's competitors. Uber is essentially a self-regulator of the relationship between drivers and riders, and in most jurisdictions it has been able to endure only because the outpouring of support from dedicated users is more significant than the

78. *Id.* at 21.
79. *Id.*
80. *Id.* at 22.
81. Weingast, *supra* note 76, at 23.
82. *Id.* at 27.
83. *See* Jonathan R. Macey, *Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public-Choice Explanation of Federalism*, 76 VA. L. REV. 265, 280 (1990).
84. Ribstein, *supra* note 52, at 158.
85. Macey, *supra* note 83, at 267.
86. *Id.*

rents obtained by taxi regulators. Macey describes this support as either coming from regulated entities directly, or indirectly by way of the regulators themselves.[87]

One can imagine that if banks, entertainers, and non-profit charities, all of whom have a right to residual interests in their future revenue, traded as part of crowdfunded firms, organizing a "save crowdfunding" campaign similar to the Uber campaigns at the grassroots level would be more likely than a "save Delaware corporate law" campaign targeted to all shareholders of Delaware companies. Perhaps the Olsonian interest group dynamics of crowdfunding will allow for a more cogent defense against future federal overreach. An illustrative hypothetical is the repeal of an explicit federal law protecting the internal affairs doctrine advocated by this Article. Such a repeal may be more difficult to get past interest groups than piecemeal, creeping, or implicit preemption of individual slices of the doctrine and state corporate codes by indirect agency action.

Macey notes that the fact that the federal government has not already created federal corporation law and fully preempted the states is evidence that there are already interest group pressures that insulate state corporate law from complete federal preemption.[88] And yet, the analysis in the next Section of this Article demonstrates that those interest group pressures are not always successful, and have allowed federal law to inhibit some of the available field of innovation. This future partial preemption presents a risk that the return to any new innovation may be subsequently dissipated by federal intervention.

D. A Second Perspective on Uberization: App-Based Interaction Changes the Information Cost. Conventional Wisdom of the Collective Action Story of Corporate Law

Rauch and Schleicher attribute to "sharing economy" firms the general attribute of "a stark reduction in transaction costs that allows for radically disaggregated consumption" with that reduction in costs often resulting from a combination of new digital means of information transmission and app-based interaction.[89] Bainbridge notes that one of the principal attributes of a corporation is a collective action problem because shareholders are rationally apathetic.[90] Indeed, much of corporate law scholarship in some way references the Berle-Means vision of corporations as characterized by overwhelming collective action problems that many corporate commenters either requires a strong federal hand in governance, deference to manager-centric governance models like the Bainbridge director-primacy model, shareholder empowering regimes, or particular mandatory provisions in state corporate laws. Scholars on all sides of these debates tend to reference the Berle-Means hypothesis as a starting point. And yet, the Berle-Means collective action hypothesis is likely to lose much of its explanatory power in the crowdfunding world.

Although this Article observes that crowdfunding will decrease the costs of shareholder participation, it is nevertheless neutral on the question of shareholder primacy

87. *Id.* at 268. Macey's explanation may demonstrate the differences between the initial "Schumer bill of rights" introduced prior to Dodd–Frank and the subsequent legislation that was adopted, in which some provisions were shifted from mandatory to permissive opt-in approaches (such as an independent chairman for public company boards). The changes explored in this Article may enhance these existing interest group pressures and add new interest groups, such that the reforms may stick.

88. *Id.* at 279.

89. Rauch & Schleicher, *supra* note 74, at 11.

90. Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1745 (2006).

versus board primacy. If Bainbridge's observation about boards as necessary intermediaries between shareholder participation and executive action endures in this technology, then we would expect those firms in which shareholders have chosen defaults to delegate authority to be more successful, and crowdfund portals to strongly recommend board-centric defaults via their app.

Agrawal points to three elements of internet-based interaction that explain the rise in crowdfunding. As search costs for projects and communications costs decrease, greater funding in much smaller increments is possible. That has a follow on effect of allowing for greater funding in much smaller increments.[91] That has a further follow on effect, which reduces risk exposure through diversification.

We might expect that crowdfunding could link well with app-based user experiences. Indeed, the crowdfunding pre-cursor Kickstarter utilizes app-based interaction that is popular among its users. Konsynski and Bush explore the platform-based development model that has evolved in software development in the last decade for new web browsers and iPhone applications.[92]

Mollick notes that:

> The innovative ability of online communities has been of increasing interest to scholars (Baldwin et al., 2006; David and Shapiro, 2008; Von Hippel, 2005), and crowdfunding represents a concrete way in which online communities can influence the creation of new ventures. Crowdfunding also suggests a path by which user innovators, who are often the sources of radical innovations, might transition to entrepreneurship (Franke and Shah, 2003; Shah and Tripsas, 2007).[93]

This suggests that for a subset of firms in which donors tend to get highly involved in projects via some crowdsourced method, as was the case with development of the Pebble watch on Kickstarter, investors will want a high level of interaction with entrepreneurs. This may be best achieved through traditional corporate governance like shareholder voting or shareholder referendums, but for many firms those traditional methods may likely be outdated for this purpose, which again suggests that the more flexible and adaptive means of corporate governance innovation will be required than the federal overlay in corporate governance presently permit.

Kobayashi and Ribstein note how limits on intellectual property protection for corporate governance innovations can inhibit private production of law.[94] Open source production can serve as a solution to the problem of insufficient intellectual property protection, explored under certain conditions.[95] In this instance we might expect, for example, corporate attorneys to participate in the creation of new governance arrangements via an open source platform in order to establish or maintain their reputation with potential

91. Agrawal et al., *supra* note 8, at 7.

92. Amrit Tiwani et al., *Platform Evolution: Coevolution of Platform Architecture, Governance, and Environmental Dynamics*, 21 INFO. SYS. RES. 675 (2010).

93. Mollick, *supra* note 7, at 14

94. Bruce Kobayashi & Larry Ribstein, *Choice of Form and Network Externalities*, 43 WM. & MARY L. REV. 79 (2001).

95. Eric von Hippel & Georg von Krogh, *Open Source Software and the "Private-Collective" Innovation Model: Issues for Organization Science*, 14 ORG. SCI. 208, 209 (2003).

advisory clients. Or crowdfunding exchanges and their participants may collaborate to solve problems in crowdfund governance. Rauch and Schleicher note the benefits of digital ratings systems as a substitute for reputation, and we should also expect that technology will have important implications for minimizing agency costs in the crowdfunding environment, including by facilitating the development of informational intermediaries.[96]

E. Analogue to Crowdfunding?: The U.S. Over-the-Counter Pink Sheets Market

An examination of the American Over the Counter (OTC) Market shows that, for the most part, the persistence of various elements of the federal overlay ultimately makes study of this market of limited value for understanding crowdfunding. One exception is that, in the absence of some of the federal overlay in this space, exchanges are observed to take an interest in limiting agency costs for investors on their exchange consistent with Mahoney's argument in "Exchange as Regulator."[97] Otherwise there appears at present, in the absence of additional empirical work, little to suggest that corporate governance attributes present on OTC exchanges can inform expectations for crowdfunding.

Mahoney argues that private exchanges can have incentives to develop governance arrangements suitable for the firms that trade over its platform, and thereby internalize the benefits of increased comparability between products by shareholders.[98] This stands in contrast to the Easterbrook/Fischel argument that national securities regulation is required to facilitate optimal disclosure rules because of comparability externalities. In the same way, we could expect exchanges to also share an incentive to develop corporate governance rules for firms listed on the exchange, and indeed exchanges have a history of doing so.[99] Thus, under the right circumstances crowdfunding exchanges may end up playing a role in the creation of corporate governance arrangements.[100]

96. Rauch & Schleicher, *supra* note 74, at 9.

97. Paul G. Mahoney, *The Exchange As Regulator*, 83 VA. L. REV. 1453, 1455 (1997).

98. *Id.*

99. *Id.* at 1461–62.

100. A majority of OTC firms are incorporated in Delaware and Nevada. Ulf Bruggemann et al., *The Twilight Zone: OTC Regulatory Regimes and Market Quality* 9 (ECGI, Working Paper No. 224/2013, 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2290492. To date there has been no comprehensive study in the literature examining corporate governance attributes among pink sheet firms, suggesting an important avenue for further empirical study. If Pink Sheet and grey market firms make use of heterogeneity, how do they do it? If not, why? Could it be because of path dependencies for those firms that were previously listed on NYSE or NASDAQ and were delisted, that have trouble subsequently reorganizing their firms into an LLC structure with more freedom? Could it be because you hope to get back onto NYSE or NASDAQ, and you expect that changing your corporate governance choices to non-compliant would be a bad signal to investors or to those exchanges? Bruggemann's Table 2, Panel D suggests an avenue for possible future empirical work, as it suggests Nevada might be challenging Delaware as a domicile for some publicly traded OTC firms. Notably, the Bruggemann study finds that a majority of new firms operating on OTC exchanges, who remain on the exchange over the sample period, are formed in Nevada. *Id.* at 23. Future data collection should further break down their chart into out-of-state vs. in-state, corporate vs. LLC, and further breakdown into choices for LLC charter, presence of a control shareholder, industry, size, etc. Those breakdowns should occur by exchange. You have one exchange with no exchange listing requirements, another with no exchange listing requirements but with SEC registration, and a third with both corporate governance listing requirements and SEC regulation. If there are differences in out-of-state formation or entity choice that are solely attributable to which platform you use, then you may have (1) evidence of federal overlay inhibiting entity formation competition, or (2) attorney or underwriter bias, if they markedly differ for platforms, or you may have evidence of situations in which Delaware's network effects are

Mahoney notes that exchanges face a challenge in capturing the return to their innovations insofar as information like public price discovery over the exchange is non-excludable, but he argues that exchanges have restrictive rules that substitute for intellectual property rights to accommodate that challenge.[101]

However, since the dual class share litigation and since Sarbanes–Oxley, it has become clear that, at least with respect to large national exchanges regulated by the SEC, it may be the case that the SEC views the exchanges as a tool through which to expand the reach of its regulatory authority into state corporate law. Trading regulations like the "trade through" rule adopted by the SEC further limit the incentives of national exchanges to compete on quality of productions of services like listing standards; thus, for large national exchanges like the NYSE, listing standards are developed by regulatory fiat from the SEC and the Congress rather than as a quality signaling mechanism for exchange customers.

The OTC facilitates quotes for shares on a "Bulletin Board" that are registered and regularly file with the SEC, and though the OTC doesn't have its own corporate governance requirements,[102] Bulletin Board firms are nevertheless subject to the constraints of Sarbanes–Oxley, Dodd–Frank and the Williams Act.[103] Thus, the traditional bulletin boards are more like national exchanges like the NYSE than how we expected crowdfunding platforms to operate.

"Pink Sheet" shares traded over-the-counter, however, operate with some of the same freedoms from the federal overlay that we might expect to occur on a crowdfunding platform.[104] In 2010 the OTC markets traded 8000 securities, of which 4500 were not registered with the SEC.[105] Those not registered with the SEC are nevertheless subject to state blue sky regulation.[106] The Bulletin Board firms are all required to register with the SEC, but Pink Sheet firms are only required to register in certain circumstances.[107] For those Pink Sheet firms which are not required to register with the SEC, and therefore required to comply with state Blue Sky laws, Bruggemann describes blue sky regulation in this context as fairly light touch.[108]

---

not insurmountable for smaller publicly traded firms.

101. Mahoney, *supra* note 97, at 1456.

102. Bruggemann et al., *supra* note 100, at 15.

103. A new NASDAQ exchange, called BX Venture Market, would seem to be another useful analogue, but that exchange will be subject to the full panoply of the federal overlay (with the one exception from NASDAQ's corporate governance listing standards being firms will not be required to have a majority independent board). *See* Jeff Schwartz, *The Twilight of Equity Liquidity*, 34 CARDOZO L. REV. 532, 532 (2012) (proposing a lifecycle model in which regulations would adapt to firms as they age).

104. Bruggemann et al., *supra* note 100, at 6.

105. *Id.*

106. *Id.*

107. *Id.* at 7. Bollen and Christie describe four distinct types of firms trading exclusively on the Pink Sheets, including highly distressed firms or firm equity recently issued after a bankruptcy proceeding, microcap stocks too small for larger exchanges and trading in very small increments (or "penny stocks"), large foreign issuers who want to access U.S. liquidity but want to bypass more heavily regulated exchanges (Nestlé or Nintendo) and companies that are closely held and trade infrequently. Nicolas P.B. Bollen & William G. Christie, *Market Microstructure of the Pink Sheets*, 33 J. BANKING & FIN. 1326, 1327 (2009).

108. "In 42 states, issuers are exempt from registration and 'blue-sky compliant' if they are published in 'a nationally recognized securities manual' such as Mergent's (formerly Moody's) Manuals, Standard & Poor's Corporation Records, and others. The providers of manuals perform a (basic) review of documents supplied by the issuer, e.g., examine business description, corporate history and financial statements." Bruggemann et al.,

Consistent with the Mahoney hypothesis of exchange regulation, the OTC exchanges provide transparency rules for even Pink Sheet and grey market firms, including through a rough classification system that rates them as "current information available, limited information available, no information available" and a fourth warning signal for firms labeled "caveat emptor" which have both failed to provide information to investors and which engage in unusually high levels of unsolicited communication to potential investors.[109] The Jiang study found that the introduction of the OTC categories resulted in a shift of liquidity away from firms in the lower tiers and toward firms in the higher tiers, and they argue that indicates exchanges can provide useful governance innovations despite cost constraints. Schwartz argues that the Pink Sheets are dogged by their reputation as a haven for firms that have been delisted from other exchanges for poor performance.[110] Even if Pink Sheet firm governance were more readily available, it may be that the exchange's reputation as a haven for troubled, delisted stocks drives potential emerging firms to other forms of financing, such as private placements, and therefore the Pink Sheets do not serve as an informative model for crowdfunding.

But a majority of firms on the Pink Sheets are not delisted. The Bruggemann study found that over a ten year sample, only 17% of them were previously delisted from an exchange requiring SEC registration, and roughly 10% eventually rise to the traditional exchanges.[111] OTC exchanges can include firms incorporated outside of the United States, as they find that roughly 10% of new firms incorporate outside of the United States or Canada.[112] Schwartz's argument also does not explain why large firms disclosing a wealth of information choose to list their American Depository Receipts on the Pink Sheets.

Pink Sheet issuers are still subject to the general prohibition against fraud.[113] Thus the Securities Exchange Act overlay described in the next Section may still be present on these markets in part to the extent they provide voluntary disclosures that open up potential corporate governance litigation, though certainly not to the same degree given how little they end up disclosing merely to achieve compliance by being listed in the S&P or Moody's book. Also the fact that the Securities Exchange Act prohibition against fraud applies to the Pink Sheets, and therefore the SEC's reluctance to permit shareholder arbitration for corporate governance claims still applies, suggests that the OTC markets provide at best a very limited window into the possibilities available for small publicly traded firms free from the federal overlay.

supra note 100, at 8.

109. *Id.* at 8–9.

110. Schwartz, *supra* note 103, at 47.

111. Most OTC firms are below $20 million market cap, a quarter of them are below $5 million, they tend to be much more volatile and have much lower liquidity relative to other exchanges, average annual returns of -27%, and individuals firms have outsized annual returns ranging from +100% to -95%. Bruggemann et al. find that OTC firms filing disclosures with the SEC have higher liquidity and more efficient price discovery than firms that do not, and they find the same with respect to non-listed firms that publish in Moody's or Standard & Poor's, which they suggest indicates that shareholders in OTC firms are efficiently taking into account information provision by OTC firms in their pricing. Bruggemann et al., *supra* note 100, at 9.

112. *Id.* at 23.

113. *See* Joseph I. Goldstein et al., *An Investment Masquerade: A Descriptive Overview of Penny Stock Fraud and the Federal Securities Laws*, 47 BUS. L.J. 773, 810 n.184 (1992) (citing cases where Pink Sheet issuers were still subject to the general antifraud provisions of federal securities laws).

F. Analogue to Crowdfunding: The London AIM Market

The London AIM Market provides evidence that a new era of chartering competition on crowdfunding platforms freed from the federal overlay might then also evolve symbiotically with new crowdfunding platforms that serve a gatekeeper rule to crowdfunded firms and which may play a role in entity formation as well, and possibly thereby involve private entities more directly in the business entity formation and code production process in some way. The London AIM market was created in 1995 and was designed to attract listings from smaller companies in the U.K. and overseas by offering less stringent listing requirements for particular corporate governance arrangements than those required for larger companies on U.K. exchanges.[114] 3610 companies have listed on AIM since its inception and have raised 92.6 billion euro in the process.[115]

On London's AIM Market, corporate governance is a much more flexible and firm-specific affair. It includes a significant role for a company's nominated advisor (or "Nomad") in determining which provisions otherwise required for larger companies should be adopted by the AIM listing.[116] Notably, the London AIM market has very few mandatory corporate governance requirements, but each listing on the AIM market has a Nomad, most of whom also serve as a broker in the issuer's securities, which advise the new issuer about its corporate governance choices. That dynamic suggests the possibility for useful vertical integration in the provision of unique corporate governance arrangements for operators of exchanges or brokers on lightly regulated exchanges if freed from a strong federal overlay.

A firm serving as a Nomad for an AIM-listed company may also serve as a broker for the company's securities.[117] Most Nomads serve both roles on the AIM exchange.[118] Most of the companies listed on the AIM exchange are less than $25 million market cap, and only a handful have a market cap of greater than $100 million.[119] Thus, the AIM market is roughly characterized as hosting firms somewhat larger than expected crowdfunding firms, but somewhat smaller than the expected size of the Regulation A market under the newly enhanced JOBS Act.

This indicates that, generally speaking, the benefits that Mahoney ascribes to exchanges may also apply to active brokers on crowdfunding exchanges. They may thereby afford a role to private parties in the corporate governance innovation process. The limited availability of data about the corporate governance choices that AIM firms actually make

114. *AIM Factsheet*, LONDON STOCK EXCHANGE (2015), http://www.londonstockexchange.com/statistics/historic/aim/aim-statistics-archive-2015/june-15.pdf.

115. *Id.* at 3.

116. The London Stock Exchange describes the process for becoming a "Nomad." Approval as a Nomad demonstrates that a firm has fulfilled the strict eligibility requirements set by the London Stock Exchange. A Nomad is the primary regulator of an AIM company, making the role demanding yet rewarding. An applicant seeking approval as a Nomad must: be a firm or company, not an individual; have practiced corporate finance for at least the last two years; have acted on at least three relevant transactions during that two year period; and employ at least four "qualified executives." The AIM Rules for Nominated Advisers also detail the ongoing responsibilities of a Nomad and set out the review and disciplinary procedures. *Becoming a Nomad*, LONDON STOCK EXCHANGE (2015), http://www.londonstockexchange.com/companiesandadvisors/aim/advisers/becoming/nomad.htm.

117. *AIM Factsheet*, *supra* note 114, at 11.

118. *Id.* at 18.

119. *Id.* at 18–32.

otherwise does not currently help with understanding the expected needs of crowdfunding firms, but nevertheless it might afford a ripe area for future empirical inquiry.

III. THE STATE OF CORPORATE FEDERALISM

Business entity law has been around for some time and has been an important contributing factor to the economic systems that develop and utilize them. Corporate law was key to building the Roman aqueducts, and critical to the industrial revolution; now a newly competitive and innovative model for the production of corporate law will be critical to make the most of technological advances that are reducing the cost of individual interaction seen in crowdfunding platforms that will soon go online after the SEC's final rule on federal crowdfunding is finalized.

The mere fact that the economics of crowdfunded firms—explored in Part II—suggests a demand for more flexible innovation in corporate governance does not mean the states will be in a position to make that innovation available to firms and investors. For example, Bainbridge and Henderson recently designed a novel approach to the structure of boards of directors in which other business entities can themselves serve as members of the board. This would allow board member companies to economize on scale and scope, have more directed compensation and liability incentives than the current model, better expose the market for board membership to market forces, and provide reputational constraints for repeat player board member firms.[120] Bainbridge and Henderson note that federal rules which would prevent their idea were not necessarily even designed to prevent entity membership on the board, but the effective consequence to references to natural persons in the federal rules effectively precludes their innovation from being implemented.[121]

This Part considers a natural experiment. The federal overlay for public firms was peeled back just a little, in the case of a few marginal exemptions from NYSE listing requirements regarding board structure for publicly traded, master limited partnerships. The findings were a wealth of innovation and heterogeneity.

A. When The Federal Overlay Is Rolled Back, Innovation Sprouts: The Case of Publicly Traded Master Limited Partnerships

Though the overwhelming majority of publicly traded firms utilize the corporate form, with its mandatory fiduciary duty regime, a small minority of public firms operate as either LLCs or LLPs.[122] Most of those are operated as some variation of a type of public firm that was provided some limited relief from exchange listing requirements by the NYSE

120. Stephen M. Bainbridge & M. Todd Henderson, *Boards-R-Us: Reconceptualizing Corporate Boards*, 66 STAN. L. REV. 1051, 1077 (2014).

121. *Id.* at 1100.

122. Looking more broadly to the master limited partnerships that continue to operate using a limited partnership form, Goodgame notes that, as of 2012, there were 87 energy-related MLPs traded on public markets. John Goodgame, *New Developments in Master Limited Partnership Governance*, 68 BUS. LAW. 81, 83 (2012). While they have traditionally been organized as limited partnerships, more recently some of them have organized as LLCs. *See id.* at 88–91 (discussing the "public LLC model"). These energy firm MLPs make up the vast majority of publicly traded alternative entities on United States exchanges. *Id.* at 83.

and NASDAQ.[123] There is a substantial amount of heterogeneity in the organization choices made by the firms. All of those LLCs opted out of appraisal rights entirely.[124] Some of them held annual meetings, some did not, and some members (shareholders) held voting rights without making financial contributions.[125] Some opted out of fiduciary duties completely, some did not, and most had some hybrid formulation of obligations owed by members of the LLC to each other.[126]

The governance of publicly traded, master limited partnerships (MLPs) provide a small-scale case study in the adaptability and heterogeneity of business organizational form. Master limited partnerships form a small subset of publicly traded companies in which the federal overlay has been moderately lifted by the exchanges. They were created pursuant to a tax exemption for energy companies that allows them to avoid entity level taxation if they make regular distributions of earnings to investors. Under exchange listing rules, MLPs are not required to have a majority of independent directors, a nominating committee, or a compensation committee.[127] MLPs and other public companies are otherwise subject to the same set of federal securities laws.[128] Thus, with this relatively minor exception from the federal overlay, a wide diversity of governance arrangement has evolved.

Goodgame considers one of the dominant organizational features of the master limited partnership its contractual provisions providing for the regular allocation of distribution payments to equity holders acts as an effective substitute for equity participation in governance.[129] Goodgame notes that some MLPs have equity holder participation in governance as features, but those MLPs generally do not provide for the same regular distribution mechanisms as MLPs that do not provide for direct participation in the selection of directors.[130]

Goodgame generally describes a great deal of heterogeneity in organizational form, as some MLPs provide for annual elections; some have staggered boards. Some MLPs have poison pills; others do not. Some choose default fiduciary duties; some opt out of fiduciary duties. But, they generally choose to opt out of rules favored in the public context, as they have stronger contractual requirements to distribute all their earnings on a quarterly basis.[131]

123. Gomtsian notes that there were 20 publicly traded LLCs, all of which were formed in Delaware, as of September 2013. Suren Gomtsian, *The Governance of Publicly Traded Limited Liability Companies*, 40 DEL J. CORP. L. 207, 222 (2015). Most of those were energy companies that had previously been energy master limited partnerships, and a handful of others were private equity funds and hedge funds that obtained most of their capital through private offerings under Regulation D but created entities to supplement their capital by raising money in the public markets. *Id.* The number of members in these 20 LLCs ranged from 2000 to 98,000. *Id.* at 224.

124. *Id.* at 231.

125. *Id.* at 234.

126. Gomtsian, *supra* note 123, at 234.

127. *Id.* at 264.

128. *Id.* at 271.

129. Goodgame, *supra* note 122, at 88.

130. *Id.* at 83.

131. They also have an innovative governance style similar in many ways to the organization board member proposal advanced by Bainbridge and Henderson and referenced above. Bainbridge & Henderson, *supra* note 120, at 1097. MLPs are typically controlled by a sponsoring general partnership, which reserves contractual control of the board of directors for the sponsoring general partnership by reserving a majority of board seats for individuals selected by the general partnership.

Structural heterogeneity in governance tends to adapt to the particular needs of individual firms. Those firms with more dependable and steady streams of cash flow tend to substitute earnings distribution and regular fundraising from capital markets with agency monitoring measures for traditional governance arrangements.[132] One can readily think of other governance arrangements which could be useful, such as a different appraisal process tailored to handle the unique needs of biotech firms—which lack cash flow for long periods.

This limited innovation leads one to wonder what level of innovation may have been possible in the absence of the full federal overlay. As these public firms were all formed in Delaware, note that even in the publicly traded alternative entity context, there is one clear item that you cannot contract out of, namely "the implied covenant of good faith and fair dealing."[133] One then further wonders that if that binding constraint in the Delaware alternative entity code had not been present, and if another state were operating an alternative arbitration based mode of corporate law, what additional adaptive governance modes would have been developed for the MLP and MLP LLC space.

IV. ARBITRATION OF DISPUTES BETWEEN SHAREHOLDERS AND BOARDS, AND A CODE ADAPTED FOR THAT PURPOSE TO COMPETE WITH DELAWARE

A. Arbitration is Key to Challenging Delaware

Bainbridge notes that North Dakota's recent attempt to compete with Delaware was doomed to fail because it was not actually innovative. Rather, it merely adopted provisions already allowed by the Delaware code that shareholders and managers had declined to choose for their organizational structures.[134] North Dakota also failed because it sought to compete with Delaware through a litigation-driven code despite Delaware's clear advantage in providing consistent, predictable business litigation.

Roe notes that one reason states have difficulty competing with Delaware is—in attempting to create the specialty business courts necessary to compete with the Delaware litigation model—states find that a coalition of local trial lawyers and interest groups push back for fear of lacking competitive advantage in a pro-business forum for local cases.[135] This may be a challenge unique to replication of the Delaware model, as replicating a new court of equity to compete with Delaware would entail creating a forum that not only adjudicated state corporate code cases, but that also obtained jurisdiction over contract disputes. An arbitration alternative may not bring the same baggage with it from a local interest group perspective and so may be more likely to succeed.

Kahan and Klausner argue that a lack of heterogeneity in firm organizational contracts can be traced to a combination of learning and network externalities.[136] Despite the

132. John Goodgame, *Master Limited Partnership Governance*, 60 BUS. LAW. 471, 488 (2005).

133. *Id.* at 488.

134. *See generally* Stephen M. Bainbridge, *Why The North Dakota Publicly Traded Corporations Act Will Fail*, 84 N.D. L. REV. 1043 (2008) (predicting and explaining why North Dakota's publicly Traded Corporations Act will not be successful).

135. Mark J. Roe, *Delaware and Washington as Corporate Lawmakers*, 34 DEL. J. CORP. L. 1, 6 (2009).

136. *See generally* Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (Or 'The Economics of Boilerplate')*, 83 VA. L. REV. 713 (1997) (presenting "a theoretical, institutional, and empirical analysis of how increasing returns—specifically, learning externalities and network

presence of these network effects, however, they do not account for how the economics of innovation in corporate law would change if the presence of potential federal pre-emption of new innovations were reduced or if the dominance of Delaware's state-based forum were sidestepped with an arbitration alternative. Perhaps those paradigm shifts would be enough to promote more innovation in contractual terms. Indeed, the case of Master Limited Partnerships is instructive for the possibilities in innovation when the federal overhang is lifted.

Furthermore, the speed and ease with which investors can obtain information and third party assessments about governance arrangements should shift when crowdfunded shares are traded through app-based platforms, making things like attorney familiarity with corporate codes less important. Kahan and Klausner note that switching costs may prevent firms from changing their governance choices after going public.[137] Nevertheless innovation at the crowdfunded firm level may support innovation in large public firms, as it could mean that innovative governance modes developed at a smaller scale, may stick with firms as firms grow and become a part of the large publicly traded landscape.[138]

Kahan and Klausner argue that underwriters can serve to coordinate innovations in governance and resolve the challenges posed by network effects. For instance, they can commit to subsequently recommend new innovations in future offerings to create network benefits for early adopters.[139] Exchanges and crowdfunding platforms can provide a similar form of commitment if they participate in advising new issuers and if they can operate free from pressure by the SEC.

Kobayashi and Ribstein show that the existence of network effects does not necessarily preclude innovation in corporate law.[140] They challenge Kahan and Klausner's network externality hypothesis. They define the network hypothesis in this context as that "[a]n example might be large corporations' long-term use of Delaware law in order to take advantage of judicial and legal expertise and other benefits they expect the Delaware legal 'network' to continue to produce."[141]

They show that once the federal tax law overlay changed to permit entity competition for firms, then network effects did little to impede the move to LLCs.[142] In much the same

externalities—influence standardization, customization, and innovation in corporate contracts").

137. *See id.* at 727–29 (explaining situations in which switching costs occur; switching costs happen "[w]hen internal learning or network benefits are present").

138. As a critical mass of smaller firms develops with more innovative governance models, and as they grow to become larger public firms, governance innovations that begin on smaller crowdfunded exchanges could develop some of the network effects of their own that lower switching costs for existing firms and for new entrants to larger exchanges.

139. Kahan & Klausner, *supra* note 136, at 737–39.

140. *See* Ribstein & Kobayashi, *supra* note 94, at 82 ("The data indicate that the inherent characteristics of the business forms, such as their state tax implications, are much more significant factors in choice of organizational form than network externalities.").

141. *Id.* at 110. Kobayashi and Ribstein note that one recent and unanticipated innovation in organization structure was the series LLC, which allowed great subdivision of assets and liabilities within an umbrella holding structure. Bruce H. Kobayashi & Larry E. Ribstein, *Delaware for Small Fry: Jurisdictional Competition for Limited Liability Companies*, 2011 U. ILL. L. REV. 91, 105 (2011). This is the type of unanticipated innovation in organizational structure this Article seeks to encourage through elimination of the federal overlay in corporate governance.

142. *See* Ribstein & Kobayashi, *supra* note 94, at 84–86 (describing the tax code and LLCs in relationship to the business form selected).

way, removal of the federal overlay will be key to overcoming the Delaware effect in the public company context. Perhaps what is going on is that network effects for large public companies only matter because the federal overlay is the source of the "lock in." Without the federal overlay, network externalities do not matter any more, as they did not with the switch to LLCs for smaller or non-public businesses once tax code constraints were lifted. Kobayashi and Ribstein describe a number of solutions to network externality limitations, including bundling the law of the new entity form with aspects of the old from during the transition.[143] The use of bundling to aid the transition may be more difficult in this context as the old and new products are much more distinct. It is difficult to say how much of the law of Delaware corps will apply in the arbitrated LLC context, for example.[144] They describe a number of other sources of lock-in, including conflicts of interest from interest lawyers who prefer standardization.[145] The large public company context may exhibit this conflict as underwriters who prefer Delaware because they get advisory opinion business later on.

Kobayashi and Ribstein find that competition for out of state LLC formation is chiefly a function of court quality. Furthermore, any competition through innovation of organizational arrangements is not a reliable predictor of firm choices of where to organize.[146] This provides powerful evidence that the Delaware effect, or the high preference firms place on Delaware as a choice of forum, out measures all other variables in chartering competition for alternative entities. This observation supports the argument of this paper that in order to enhance chartering competition, a clear route must be established for alternative dispute resolution mechanisms other than court adjudication based on the Delaware model. While the Delaware effect does not make innovation completely impossible, as for instance in the series LLC innovation which began outside of Delaware, it does suggest that if other states were able to compete on adjudication forum as well as code flexibility the level of innovation in corporate codes might be substantially increased.

B. Does Ribstein's Uncorporation Thesis Fill the Gap in Demand?

Ribstein describes how "uncorporations" or LLCs, LLPs, and other alternative entity forms allow for more flexible private contracting to develop contractual devices that can substitute for what firms might see as flaws in Delaware's code and adjudication model for the standard corporation.[147] Ribstein ascribes some general features to uncorporate firms and others to corporate firms, including a different approach to lock-in of capital and to the free transferability of shares, and argues different approaches to corporate governance needs in the more adaptive alternative entity space can achieve some of the ends of

143. *See id.* at 113 (explaining "the move to a new standard can be facilitated by linking or bundling it with an existing standard form in order to utilize case law and other interpretive materials").

144. But in some limited senses it could work—for instance—class arbitration methods might draw on some, but not all, procedures present in common law class actions to facilitate the new litigation approaches. But generally the basic obligations and duties of directors, officers, and the corporate governance structures of new crowdfunding firms may morph so distinctly that bundling would not be particularly useful.

145. Ribstein & Kobayashi, *supra* note 94, at 115.

146. Kobayashi & Ribstein, *supra* note 141, at 135–36 (stating "most movement that can be explained by court quality and series provisions is movement to Delaware").

147. Ribstein, *supra* note 52, at 133.

corporation law without the indeterminate code that Carney and Shepherd ascribe to Delaware corporation law.[148]

Ribstein notes however a number of dubious cases in which Delaware courts struggle to implement the legislature's intent to promote freedom of contract in alternative entity law.[149] Ribstein notes Delaware has recognized the right of LLC's to force arbitration,[150] but any doctrine creep of the duty of good faith and fair dealing or legislative change could risk that right. In any event it is not likely to do much good for public companies until a right to arbitrate federal securities act claims is recognized.

The Delaware Court of Chancery has interpreted the covenant of good faith and fair dealing as requiring the court to examine the "spirit of the agreement" and apply to doctrine on that basis, indicating room for expansion of the doctrine in the future to substantially limit freedom of contract.[151] Thus, though Ribstein may well have been right that problems inherent to the corporation form will be resolved by migration away to alternative entities like LLCs, it is unlikely that will occur within the Delaware LLC form. This structural limit on contractual freedom within the Delaware LLC code will match with the interest group politics within Delaware explored by Macey and Miller to significantly limit innovation within the Delaware LLC code.[152] As we have further seen, the federal overlay does not support a fully adaptive model for publicly traded firms. Much like model codes, federal corporate governance provisions tend to be uniform and do not facilitate adaptive selective by organizers.

Kobayashi and Ribstein argue, for example, that fiduciary duty opt-outs are efficient for many firms because of the specter of Type I errors, in which judges inaccurately deem management decisions to violate fiduciary duties, may exceed any benefits that shareholders obtain through the possibility of fiduciary duty litigation.[153] Kobayashi and Ribstein argue that as Delaware and Nevada compete for LLC formation, Nevada's competitive advantage is that it can bond to maintain a bright line, low liability rule, while Delaware's competitive advantage is its ability to administer a regime with less clear rules but more predictable courts. Therefore, Nevada can compete in a space which Delaware may not wish to enter, as doing so would devalue the institutional investments it has made with its current system.[154]

Kobayashi and Ribstein note one advantage which allows Nevada to uniquely compete with Delaware is its small population, which generates greater assurance that Nevada will not arbitrarily change its corporate code because it is more dependent on chartering revenues than states with larger populations.[155] Kobayashi and Ribstein also note Nevada's reputation as a gaming center reduces its sensitivity to any reputational

148. *Id.* at 140–45.

149. *Id.* at 153–65.

150. *Id.* at 161.

151. Mohsen Manesh, *Express Contract Terms and The Implied Contractual Covenant of Delaware Law*, 38 DEL. J. CORP. L. 1 (2013), http://www.djcl.org/wp-content/uploads/2014/06/EXPRESS-CONTRACT-TERMS-AND-THE-IMPLIED-CONTRACTUAL-COVENANT-OF-DELAWARE-LAW.pdf.

152. Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 471 (1987).

153. Bruce H. Kobayashi & Larry E. Ribstein, *Nevada and the Market for Corporate Law*, 35 SEATTLE U. L. REV. 1165, 1175 (2012).

154. *Id.* at 1177.

155. *Id.* at 1178.

effects derived from being a lax jurisdiction state.[156] The dynamic between Delaware and Nevada which Kobayashi and Ribstein describe could play out even stronger in an arbitration regime, and it could occur over a greater number of participants in the race to charter firms.[157]

Ribstein and Kobayashi remind readers a lack of diversity in corporate governance items may not necessarily reflect lack of competition but instead may suggest demand for uniformity in rules for which uniformity is efficient—such as rules regarding the relationship with the organization and third parties such as the law of veil piercing.[158] Thus, it would be a mistake to suggest that any instance of uniformity in corporate governance is necessarily value reducing. Given the first part of this Article's consideration of likely demanded heterogeneity and the second half of this Article's exploration of federal constraints on adaptability, there is reason to believe a substantial amount of uniformity for publicly traded firm governance is artificial and crowdfunding offers an initial opportunity to test that hypothesis.

The new era of chartering competition may elevate the public LLC to eclipse the corporate form for public firms according to the Ribstein Uncorporation thesis. Alternatively, it may substantially hybridize our existing understanding of the boundaries between corporations, LLCs, and other entity forms. In any event, no matter where the innovation happens, whether in some new type of business entity or by way of modifications of the LLC code, it is not likely to happen in Delaware and therefore will not happen until network effects inherent in the Delaware code—and magnified by the federal overlay—are alleviated through an arbitration-based business entity code framework is possible.

C. The Federal Government and Delaware Both Discourage Arbitration for Public Company Shareholders

Note that, although Delaware has innovative arbitration provisions for contracts, conducted by Delaware judges, the current Delaware statute prohibits use for corporations and effectively does so for publicly traded LLCs because it requires all parties bound by arbitration to actually sign the LLC agreement.[159] This requirement is effectively prohibitive in an environment of highly disbursed and traded securities. This Section will

156. *Id.*

157. Kobayashi and Ribstein note legal system quality is a key factor in choice of entity formation for LLCs favoring Delaware. Kobayashi & Ribstein, *supra* note 94, at 127. Kobayashi and Ribstein note there may be reasons why smaller firms will be less interested in tailoring unique organizational forms because they are less likely to be involved in litigation. *Id.* at 97. However the decrease in search costs for organizational tailoring associated with app-based governance may result in renewed tailoring of organizational form for smaller firms. Furthermore, intermediaries and gatekeepers to small firm exchanges may have an interest in facilitating organizational tailoring for smaller firms particularly if they have a role in designing that organizational form in managing the arbitration forum. They note local lawyers may use their participation in drafting organizational statutes to develop reputations that can help them obtain clients to compete with other lawyers in-state. *Id.* at 98. If the mode of innovation in corporate law assumes an open-source character, in which local attorneys can take credit for particular adaptations of the corporate code, then they can establish national reputations as organizational lawyers in competition for clients on a much larger scale.

158. *Id.* at 100.

159. GREGORY V. VARALLO ET AL., PRACTITIONER'S GUIDE TO THE DELAWARE RAPID ARBITRATION ACT 17 (2015), http://www.rlf.com/Files/11206_DRAA%20Book%20Final.pdf.

explore how Delaware discourages arbitration, but first it should be noted that until the SEC permits arbitration for federal securities claims by shareholders, arbitration of state corporate law claims will likely be useless. This is because of the ever increasing overlap between securities actions under the federal laws and state law corporate governance claims. Even if Delaware's code explicitly permitted arbitration of state corporate governance claims, we should expect nearly all those claims would find a new home as they morph into Securities Exchange Act claims.

Thompson and Sale describe private rights of action under the Securities Exchange Act as being interpreted by federal courts in such a way that they could "annex" corporate governance; this observation is not withstanding the internal affairs doctrine itself.[160] Thompson and Sale describe state corporate governance as essentially relegated to the contacts of corporate acquisitions and self-dealing transactions. They also observe that otherwise the fundamental regulation of company behavior has been preempted by the federal government by way of private shareholder litigation under Rule 10b-5.[161] Thompson and Sale describe that most private litigation under the Securities Exchange Act is brought after a public company corrects a prior earnings misstatement, and combines elements of loyalty and care claims, and might have been made pursuant to state law.[162] Thompson and Sale also note that securities fraud claims often charge that misstatements are made for the purposes of benefiting insiders which clearly overlap with state duty of care claims.[163]

The mechanisms of state and federal shareholder claims are also quite similar, with typical use of class action mechanisms being largely driven by attorneys.[164] This analysis suggests that any attempt to arbitrate shareholder claims at the state level will be largely ineffectual without a concomitant recognition of the shareholder's right to arbitrate federal securities claims as well, as any arbitration of the former may simply result in the migration of shareholder claims to the latter. If, on the other hand, firms and shareholders choose to maintain shareholder litigation in a judicial forum, but select arbitration of federal securities claims, the extent of federal preemption of state internal affairs through private litigation under the '34 Act may be reduced.

Kobayashi and Ribstein note that:

> [m]ass production and sale of litigation or arbitration kits, perhaps supplemented by low-cost assistance as to how to use the kits, might allay these concerns by better enabling consumers to arbitrate individual claims. This would provide a compromise between the duplication of effort involved in thousands of

160. Robert B. Thompson & Hillary Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859, 860 (2003).

161. *Id.* at 861. Thompson and Sale argue SEC rulemakings under Item 303 of Regulation SK functionally displace the state law duty of care and that a requirement in the Sarbanes–Oxley Act that CEOs must certify financial statements pre-empts part of the state law duty of care. They list a number of further functional items which preempt state corporation law in the Sarbanes–Oxley Act. *Id.* at 873. Thomson and Sale cite no federal restrictions under Sarbanes–Oxley limiting the ability of firms to provide loans executives effectively replace a piece of the duty of loyalty. *Id.* at 877.

162. *Id.* at 889.

163. Thompson & Sale, *supra* note 160, at 901.

164. *Id.* at 904.

individual claims and the agency costs inherent in class actions.[165]

This idea becomes even more helpful, and cheaper, in the context of app-based governance. It is unlikely however that Delaware will ever permit shareholders in public companies to fully arbitrate all claims against companies and their directors outside of the Delaware court system. The Macey/Miller interest group analysis of Delaware corporate law, which explores how the development of Delaware law reflects in part the preferences of the bar in Delaware, presents a powerful argument for why the interest groups represented in the Delaware bar would quickly press a solution in the legislature to any effort to diminish the rents they obtain in the system.[166]

Recent events provide a concrete example of the Macey/Miller Delaware interest group theory. In response to a Delaware Supreme Court opinion finding that companies had the right to adopt bylaws imposing the English fee-shifting rule on plaintiff shareholders who failed to win on any claims, the Delaware legislature quickly responded with an amendment to the DCGL prohibiting fee-shifting bylaws for any "internal corporate claim," which is to say any claim brought pursuant to Delaware corporate law.[167] This result was clearly motivated by a fear that plaintiffs would migrate out of Delaware and bring claims in other jurisdictions that are less likely to enforce the fee-shifting bylaw, or otherwise bring fewer claims. In recent work, Bainbridge, who has often defended the Delaware courts and code, cites this incident as Delaware's "self-inflicted wound."[168]

Allen argues that from a purely doctrinal standpoint, there is no reason Delaware law should not be willing to accommodate mandatory arbitration for corporate claims.[169] She cites *American Express Co. v. Italian Colors Restaurant*, finding that the Federal Arbitration Act (FAA) authorizes mandatory arbitration provisions in commercial contracts that prevent class actions, and *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, in which the Delaware Court of Chancery upheld a board bylaw requiring that Delaware corporate claims be litigated exclusively in Delaware courts, as demonstrating sufficient doctrinal basis for Delaware courts to uphold mandatory arbitration provisions for corporate claims arising under Delaware law.[170] After that litigation, the Delaware Supreme Court upheld the validity of a board bylaw imposing the English fee-shifting, loser pays rule on shareholder plaintiffs bringing corporate litigation.[171]

As previously mentioned, the Delaware legislature quickly responded by invalidating board action imposing fee-shifting, but accepting the validity of forum selection bylaws. The Delaware legislature's rapid overturning of a holding which threatened the litigation bar's rents suggests one should not rely on Delaware doctrine alone in this analysis, but

165. Bruce H. Kobayashi & Larry E. Ribstein, *Law's Information Revolution*, 53 ARIZ. L. REV. 1169, 1199 (2011).

166. Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 471 (1987).

167. ATP Tour, Inc. v. Deutscher Tennis Bund, 91 A.3d 554 (Del. 2014).

168. Stephen M. Bainbridge, *Fee Shifting: Deleware's Self-Inflicted Wound* (UCLA Sch. L., Law-Econ Res. Paper No. 15-10, June 29, 2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2624750.

169. *See generally* Claudia H. Allen, *Bylaws Mandating Arbitration of Stockholder Disputes?*, 39 DEL. J. CORP. L. 751 (2015).

170. *Id.* at 753.

171. *Id.* at 765; ATP Tour, Inc. v. Deutscher Tennis Bund, 91 A.3d 554 (Del. 2014).

instead should keep a keen eye on the interest group calculus of the Delaware bar.[172]

Even if Delaware law were to expressly recognize a company's right to adopt arbitration, Delaware courts may still review the decision to adopt an arbitration provision or the decision to exercise it. The unique equity jurisdiction of Delaware courts has a shared trait with the "Hotel California" in that one can "check out any time you like, but you can never leave."[173] For instance, in *Schnell v. Chris-Craft Industries* the Delaware Supreme Court held that "inequitable action does not become permissible simply because it is legally possible."[174]

Allen notes the general assumption that arbitration must necessarily obviate class action procedures.[175] This would represent a substantial change to the process of corporate adjudication, as a significant percentage of both direct and derivative claims are brought as class actions. If that is what shareholders and firms value, it may be utilized. If, however, many particularly large institutional shareholders were reluctant to give up a class based approach, then some hybrid form of class arbitration could be developed. But a new hybrid class arbitration procedure could be designed to accommodate some of the procedures used to certify and prosecute class actions, but in a much faster, more predictable way than that seen in the Delaware courts in a less indeterminate manner. The first bylaw proposed for a company listed with the SEC, which sought arbitration in 1990 and was denied, provided for a form of class arbitration.[176] Allen notes how Delaware courts attempted to provide for arbitration by Delaware judges in that spirit for private contracts (an arbitration procedure that would expressly not apply to disputes in corporations or for publicly held alternative entities).[177]

Though that innovation was subsequently challenged as violating open government rules, it may be the case that Delaware would respond to a renewed federalism race in which it was losing substantial market share with some kind of arbitration forum, likely composed of Delaware judges. While such an innovation may present useful choices for new firms, it would likely always be constrained by the gravitational forces of Delaware's interest group politics and would therefore likely lose a renewed entity formation race. The SEC staff strongly disfavors arbitration for private claims under the securities laws, despite the fact that they should be perfectly legal.[178] When previous large corporate IPOs have

172. Allen argues that if Delaware law found that firms were not permitted under Delaware law to adopt mandatory arbitration, the FAA would preempt Delaware law. Allen, *supra* note 169, at 770–71. That presumes, however, that a court wouldn't find that the internal affairs doctrine requires a reading of the FAA that, since Congress did not directly express an intent to preempt state law, the matter should be left to the states. And in any event, this Article argues in another part that arbitration is not likely to take off until roadblocks to mandatory arbitration at the SEC are lifted, and until the legislative recommendations described in this Article are passed into law (which includes a strong codification of the internal affairs doctrine.)

173. Eagles, Hotel California (Asylum Records 1977).

174. Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971). While Delaware's alternative entity statutes permit arbitration, Delaware law still maintains the contractual duty of good faith and fair dealing requirement that presents a risk you cannot fully contract away. Allen, *supra* note 169, at 772. And in any event, it is unlikely the interest groups in Delaware would ever permit a full arbitration regime to replace fiduciary litigation for large public companies in Delaware courts.

175. Allen, *supra* note 169, at 754.

176. *Id.* at 802–03.

177. *Id.* at 771–72.

178. This is a rather incredible position, since private rights of action were never actually intended by the drafters of the Securities Exchange Act, but were instead created by courts decades later. Chief Justice Rehnquist

included in their organizational documents a provision requiring mandatory arbitration of all shareholder claims, the SEC staff have refused to accelerate the registration statements of those companies on the grounds that a provision in the Securities Exchange Act of 1934, which forbids waivers of provisions contained in the Securities Exchange Act, forbids mandatory arbitration.[179] SEC Staff has similarly disallowed shareholder proposals for mandatory arbitration on the same basis.[180] Therefore, we see that in order for arbitration to work, it must be expressly permitted at both the state and federal level simultaneously. In this area federal preemption actually supports Delaware's dominance of the state entity formation race and inhibits state challengers who might develop an entirely new mode of corporate governance with a host of possible governance innovations.

D. Arbitration Will Require a Novel Code Design, and (Initially) an Advisory Opinion Mechanism

Kobayashi and Ribstein note a tradeoff in that lawmaking by arbitration reduces incentives to produce law, and thereby inhibits positive externalities to non-litigants.[181] If the arbitration body and the producer of the corporate code are the same entity, then it may internalize that effect and thereby have incentives itself to create law through opinions that deal with unanticipated situations—as for example in the form of advisory opinions.[182]

described the private right of action under the Act as a "judicial oak" grown from a "legislative acorn." Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975). Thus, one reason why arbitration will be vital to reinvigorating charter competition is that private Act litigation will continue to creep into issues covered by the internal affairs doctrine, and indeed if state law claims become subject to an arbitration process, and are coupled with codes that reduce the range of litigation permitted, migration of otherwise state law claims to federal claims would rapidly increase. Note that for crowdfunded firms on a federal platform, an express right to sue is statutorily defined and linked to 12(a)(2) damages for securities offerings. *See* Securities Act of 1933, §12(a)(2). Thus, a crowdfund issuer could still opt-out of Act liability, and state crowdfunding platforms should be able to opt-out of Act liability if the SEC were properly applying the law, and possibly also completely opt-out of securities liability.

179. Allen, *supra* note 169, at 776.

180. *Id.* at 779.

181. Kobayashi & Ribstein, *supra* note 165, at 1207. Another way in which a more streamlined arbitration process is likely to be helpful is in the process whereby the value of minority shareholders' interest is appraised. This could take place when an entity is dissolved or when a freezeout merger is accomplished and a controlling shareholder with a minimum percentage of ownership "freezes out" by statutory right the remaining holdout shareholders. Delaware's own Chief Justice Strine bemoans the state of Delaware's appraisal process: "The concept of fair value under Delaware law is not equivalent to the economic concept of fair market value." William J. Carney & George B. Shepherd, *The Mystery of Delaware Law's Continuing Success*, U. ILL. L. REV., at *28, http://www.illinoislawreview.org/wp-content/ilr-content/articles/2009/1/Carney.
pdf. Carney and Shepherd identify four Delaware merger fairness and appraisal actions that took an average of 8.7 years to resolve. *Id.* at 45. Carney and Shepherd note that what could otherwise be a simple process of appraising company value has been made unnecessarily difficult by Delaware's indeterminate approach to company evaluation, which utilizes, rather than a market based measure, a judicial fairness opinion which is guided by a nebulous concept of a fair pro-rata apportionment of the pre-merger value for the shareholders. *Id.* at 25.

182. One other way in which a different corporate code could be uniquely different from Delaware would be a different means to sift through derivative cases (assuming derivative actions are a concept used in the new code) such that some outside panel of experts in the field, like VC or techies, determine whether a funded business was a good faith venture or in fact a fraudulent sham enterprise, in much the same way that med mal cases in many states use a panel of MDs to sift through cases before they go to trial.

Innovations in the use of concrete advisory opinions will likely also form a part of a new code. Delaware judges dance with this approach through use of dicta and extensive speeches and articles to telegraph expected changes in the law. Indeed, they permit other federal courts and the SEC to request what is effectively an advisory opinion from the Delaware Supreme Court. A more direct advisory opinion mechanism could offer a clearer picture for business entity formers by way of advisory opinions—as perhaps a collective vote of arbitrators on annual interpretations of the corporate code that have precedential value or otherwise respond to requests for clarification. In order to compete with Delaware's initial advantage in its extensive precedential authority, providing determinate corporate codes might require an advisory based means of interpretation to supplement case law precedent, particular in the early years of a new competitor jurisdiction with a new non-judicial forum just getting off the ground. Indeed, Kamar discusses no-action letters by the SEC, issued in response to requests for guidance from private parties, at the federal level that minimize indeterminacy in the securities laws.[183]

Allen notes arbitration provisions can include substantial flexibility in design by contract, incorporating modified versions of nearly any concept seen in common law litigation, including a process for the creation of case law.[184] Black notes among the benefits of arbitration over litigation are "faster and less expensive proceedings," "decreased risk of aberrational jury verdicts," "more accurate outcomes because of arbitrator expertise or the application of trade rules, and "better protection of confidential information."[185] She also notes one typically referenced drawback is limitations on appeals,[186] though the Financial Industry Regulatory Authority's (FINRA) process for arbitration appeals to an appeals board is a notable exception.[187]

E. Blending the Economics of Crowdfunding Firms with a New Corporate Law System Free of the Federal Overlay

Some crowdfunded firms currently operating on Kickstarter mix profit motives with non-profit social objectives. Many states, including the Delaware corporate code, recognize some form of public benefit corporation that merges for-profit and non-profit goals. The federal overlay becomes quite awkward if one of these chooses to issue public shares in these types of entities.

This Article further explores how crowdfunded firms are likely to require a level of flexibility that has thus far been impossible in state charter competition under the federal overlay, particularly the overlay of private litigation pursuant to the Securities Exchange

183. Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1922 n.56 (1998).

184. Allen, *supra* note 169, at 796, 798, 800.

185. Barbara Black, *Arbitration of Investors' Claims Against Issuers: An Idea whose Time has Come*, 75 L. & CONTEMP. PROBS. 107, 119 (2012).

186. *Id.* at 120.

187. Black cites as evidence that arbitration can work effectively even in the context of shareholder claims against large companies. One example in which it was permitted, and in which a class based arbitration mechanism was acknowledged as the appropriate mechanism, involved a dispute over dividend payments for Surgut shares traded in the U.S. but subject to Russian Federation Laws, provided for class arbitration of shareholder claims in an international forum, and was upheld. *Id.* at 117.

Act.[188] Until crowdfunding goes online, the prospect of non-profit business entities being "publicly traded" and the unique issues posed by publicly traded firms of this nature will not be faced. The federal overlay represented by SEC rules promulgated under the auspices of the Securities Exchange Act, with its investor profit focus, will significantly limit freedom of innovation in corporate governance for these types of entity forms, and thereby upend the typical interest group politics of federal preemption in corporate governance in the area of what this Article explores as "publicly traded non-profits" or "publicly traded charities."

Agrawal notes philanthropic entities are increasingly asking for defined benchmarks of success from grantees.[189] It could be that review of activity by a board or by an external reviewing entity such as an arbitration body or the crowdfunding platform itself could simply involve verification that the entity has achieved its benchmark. It may be the case that shareholders could commit themselves to subsequent rounds of funding in advance, premised on the entity's meeting a series of benchmarks.

For some types of crowdfunded firms, the market for corporate control could prove useful, but for others in which the leadership of the entity has some firm specific attribute the market for corporate control could be unworkable. Shareholder preferences may significantly discount high residual agency losses resulting from these organizational forms. For example, an investor preference may reflect high utility in the ability to say one is a shareholder in their favorite band. A potential investor could exhibit a strong investor preference in the ability to share in any profits through the development of a drug targeting a very small population of patients but nevertheless be willing to see the investment as a donation if development costs dissipate all profits.

Part III has demonstrated arbitration will be an essential component of a reinvigorated corporate federalism. Even if many firms do not necessarily select an arbitration-based alternative, successfully challenging Delaware's dominance may require development of at least one successful arbitration based alternative regime. That will require federal recognition of arbitration rights for firms and their shareholders.

Part I of this Article demonstrated that crowdfunding opens up an event window for recharging corporate federalism and entity formation competition and also demonstrated how crowdfunded firms will have unique and heterogeneous needs outside the range of what is presently available. Part II demonstrated how and why the federal overlay restricts that available range of innovation. Part III demonstrated that an arbitration-based means of adjudication and a corporate code designed to be arbitrated will be key components to challenging Delaware's network effects. The final Part of this Article develops some

188. Many of the firms currently funded on a crowdfund pre-cursor called Kickstarter (which allows dispersed retail funding of projects, but does not permit distribution of profits, and instead features distribution of in-kind benefits; i.e., fans funding their favorite band via the online platform do not obtain a share of future profits, but may obtain preferential access to discounted concert tickets) operate under a norm that one would characterize as a strange mixture of profit motive and charitable donation. That strange brew is likely to explode in publicly traded entities as crowdfunding comes online, and despite well-supported firm theory evidence that such a mixed motive firm will be poorly run, nevertheless is expected to represent a strong consumer preference on these platforms going forward. Many states, including Delaware, have attempted to innovate to meet their consumer demands with some version of "public benefit" corporations. Indeed, the Cato Institute is organized through such an entity form as a non-profit corporation organized under the laws of Kansas.

189. Agrawal et al., *supra* note 8, at 6.

predictive analysis for the various means by which these new innovations might evolve—first over the crowdfunding platform and then possibly spilling over into renewed innovation for larger public firms.

V. CONCLUSION

Even if not all of the innovations evolve in the new world I am suggesting, some of them might, and they might create things like a functioning arbitration system that could fundamentally alter the current state of corporate federalism. Even if only some of them crossover into the large public company space, it could substantially alter state chartering competition in that sphere as well—particularly as smaller sized firms grow and transition from being crowd funded to being large public firms. This Article suggests an initial incursion into the federal overlay in corporate governance that could, initially, enhance the incredible benefits of crowdfunding and ultimately may completely reshape corporation law itself.