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Co-Invest at Your Own Risk: An Exploration of Potential Remedial Theories for Breaches of Rights First Refusal in the Venture Capital Context

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Co-Invest at Your Own Risk: An Exploration of Potential Remedial Theories for Breaches of Rights First Refusal in the Venture Capital Context

Keywords

Venture Capital Industry, Google, Breaches of Rights, Remedies for breaches of rights, Rights of first refusal, Theory of Monitoring Costs, Liquidated Damages Clause

CO-INVEST AT YOUR OWN RISK:
AN EXPLORATION OF POTENTIAL
REMEDIAL THEORIES FOR BREACHES
OF RIGHTS OF FIRST REFUSAL IN THE
VENTURE CAPITAL CONTEXT

ELIZABETH COSENZA *

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INTRODUCTION

Some of America's most successful public companies, including Microsoft, Dell, Apple Computer, Intel, Federal Express and Genentech, received venture capital financing at various stages of their development before going public.¹ The post-financing success of these companies has

1. See NAT'L VENTURE CAPITAL ASS'N, THE VENTURE CAPITAL INDUSTRY: AN OVERVIEW, <http://www.nvca.org/def.html> (last visited Sept. 25, 2005) [hereinafter THE VENTURE CAPITAL INDUSTRY] (noting that by 2000, venture-funded companies that had gone public represented over twenty percent of the aggregate number of public firms in the United States); William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473, 482 (1990) (observing that over the last twenty-five years, approximately 3,000 companies that have received venture capital financing have gone public). Of the \$8.25 trillion total market value of these public companies, venture-financed firms had a total market value of \$2.70 trillion, comprising nearly one-third of the total market value of all public companies in the United States. *The Venture Capital Industry, supra*; see also *Once Burnt, Still Hopeful: Has the Venture-Capital Industry Learnt its Lesson?*, ECONOMIST, Nov. 27, 2004, 16, 16-18 (“[V]enture capital firms may raise as much as \$25 billion this year [2004], compared with only \$11 billion in 1997.”). In addition, venture-backed firms comprised over eleven percent (\$460 billion) and thirteen percent (\$64.5 billion), respectively, of total sales (\$4.19 trillion) and profits (\$513 billion) of all U.S. public firms in 2000. *The Venture Capital Industry, supra*.

motivated small, privately-held companies to pursue venture capital funding. For instance, Google Inc. (“Google”), a Silicon Valley search engine company, received venture capital financing at several stages of its development prior to its initial public offering (“IPO”) in August 2004.²

Venture capital is independently-managed capital that is invested in equity or equity-linked³ securities of privately-held companies.⁴ An interesting question arises when an opportunity to invest venture capital in a privately-held company (*i.e.*, Google prior to its IPO) is withheld from a potentially interested investor. Consider the following hypothetical. Suppose that ABC LP, a venture capital fund (the “Fund”), and XYZ LLC, a professional fund manager (the “Manager”), entered into an agreement to co-invest in venture capital start-up companies. According to the agreement, the Manager was responsible to “prospect” and present investment opportunities to the Fund. The agreement granted the Fund a right of first refusal—the right to participate in any investment opportunity identified by the Manager in advance of all other potential investors and on predetermined terms.⁵ What if during the term of the contract the Manager identified an investment opportunity in Google (while still in its early stages of development) but breached the contract by failing to present that opportunity to the Fund? Suppose further that as a result of the breach, the Fund failed to invest in Google and, accordingly, lost that opportunity to participate in Google’s remarkable financial success. What, if any, remedy should be given to the Fund for the Manager’s breach in failing to present

2. The Google IPO raised \$1.67 billion (the fourth largest IPO of 2004). Google Inc., Prospectus, at 2 (Aug. 18, 2004) [hereinafter Google Prospectus], available at <http://www.sec.gov/Archives/edgar/data/1288776/000119312504143377/d424b4.htm>. The year 2004 witnessed the IPOs of sixty-seven venture-funded companies for a total of \$4.98 billion. Press Release, VentureOne, IPOs of U.S. Venture-Backed Companies Raise \$4.98 Billion in 2004 (Jan. 1, 2005), available at www.ventureone.com/ii/v1_4Q04_LiquidityPR.pdf.

3. See A.B.A. COMM’N ON FED. REG. OF SEC., *Report of the Task Force on Regulation of Insider Trading, Part II: Reform of Section 16*, 42 BUS. LAW. 1087, 1130 (1987) (explaining that equity-linked securities are securities that provide an ownership stake in a corporation based upon conversion or exercise of a security or option into the common stock of the corporation). Examples of equity-linked securities are convertible preferred stock, convertible debt and warrants. *Id.*

4. Sahlman, *supra* note 1, at 482.

5. Jonathan F. Mitchell, *Can a Right of First Refusal be Assigned?*, 68 U. CHI. L. REV. 985, 985 (2001); see also Steinberg v. Sachs, 837 So. 2d 503, 505 (Fla. Dist. Ct. App. 2003) (“A right of first refusal is a right to elect to take specified property at the same price and on the same terms and conditions as those continued [sic] in good faith offer by a third person if the owner manifests a willingness to accept the offer.” (quoting Coastal Bay Golf Club, Inc. v. Holbein, 231 So. 2d 854, 857 (Fla. Dist. Ct. App. 1970))); Brian Welding Supply, Inc. v. Praxair, Inc., 94-1336 (La. Ct. App. 1995); 654 So. 2d 388, 389-90 (involving right of first refusal in sale of a corporation’s stock); F. HODGE O’NEAL & ROBERT B. THOMPSON, O’NEAL’S CLOSE CORPORATIONS § 7.5, at 20 (3d ed. 1996 & Supp. 2005) (stating that option agreements are the “most common of transfer restrictions” and these often take the form of a right of first refusal).

the Google investment opportunity to the Fund?

Significantly, no court has ever determined the appropriate measure of damages for the failure to present such an opportunity in the context of venture capital investment. While there is no authority on the issue, the law governing damages for breaches of stock and stock option agreements provides some guidance on how to resolve the question of damages in the Google hypothetical.⁶

Part I of the Article provides background on the venture capital industry, including a description of the economic impact of the industry in the United States and an overview of the industry's organizational infrastructure. Part I also considers the evolving nature of reputation as an enforcement mechanism in the venture capital industry and its proper role within a legal regime of damages. Part II sets forth a more detailed account of the Google hypothetical. Using the Google hypothetical as an illustration, Part III considers the applicability of the remedial theories of conversion, specific performance and expectation damages (each of which courts have applied to cases involving breaches of stock or stock option agreements) to the breach of the Fund's right of first refusal. Part IV provides a justification for the remedial outcome of the Google hypothetical and develops an analytical framework for the consideration of breaches of rights of first refusal based on an agency theory of monitoring costs.⁷ Part V considers the desirability and practicability of a liquidated damages regime as an alternative to the existing remedial frameworks governing breaches of stock and stock option agreements. Finally, Part V proposes a legally supportable methodology for the formulation of a liquidated damages clause in the venture capital context and concludes that such clauses should become standard in venture capital co-investment agreements.

6. See *Steinberg*, 837 So. 2d at 505 (distinguishing between the related rights of first refusal and options). By its very nature, a right of first refusal does not contain specific terms as to price because the terms necessarily are dictated by the third party offeror whose offer the holder of the right is bound to match. *Id.* An option contract, on the other hand, "is one in which a seller makes an irrevocable offer to sell on specified terms and which creates in a buyer the power of acceptance." *Id.*; accord ARTHUR L. CORBIN, CORBIN ON CONTRACTS § 261A (1963). Whereas a right of first refusal has no binding effect unless the offeror decides to sell the property subject to the right, an option compels performance within a specified time period, or if no time limit is mentioned, within a reasonable period of time. *Steinberg*, 837 So. 2d at 505. A right of first refusal therefore is not an option but may ripen into one when an offeror accepts a third party offer. *Id.* At the time of the Manager's identification of the Google investment opportunity, the Fund's "right of first refusal" matured into an option because the Manager became compelled to perform the contract by making an irrevocable offer to sell to the Fund on specified terms the investment in Google.

7. See *infra* Part I.C for an introduction into an agency theory of venture capital investment.

I. THE VENTURE CAPITAL INDUSTRY

A. *The Economic Impact of the Venture Capital Industry in the United States*

The U.S. market for venture capital remained largely unorganized and fragmented throughout the late-19th and early-20th centuries. The first modern venture capital firm was established in 1946 when Massachusetts Institute of Technology (MIT) president Karl Compton, Massachusetts Investors Trust chairman Merrill Griswold, Federal Reserve Bank of Boston president Ralph Flanders and Harvard Business School professor General Georges F. Doriot formed American Research and Development (“ARD”) for the purpose of financing commercial applications of World War II technologies.⁸ The first investment made by ARD was in 1947—a \$200,000 investment in High Voltage Engineering Company formed by several MIT professors to develop X-ray technology for the treatment of cancer.⁹ In an effort to improve its chances of success, ARD assumed an active role in the management of High Voltage Engineering Company.¹⁰ When the company went public in 1955, ARD’s original \$200,000 investment had appreciated in value to \$1.8 million.¹¹ Through its investments in young, growth-oriented enterprises and its active participation in their management, ARD created the modern paradigm of venture capital investment in the United States.¹²

Prior to 1980, private equity remained a cottage industry with wealthy families and individuals making most of the private equity investments in the United States.¹³ As a result of various regulatory and tax changes, including the 1979 amendment to the “prudent man” rule of the Employee Retirement Income Security Act of 1974 (“ERISA”)¹⁴ and several modifications to the capital gains tax structure,¹⁵ private equity became the

8. See PAUL A. GOMPERS, HARV. BUS. SCH., A NOTE ON THE VENTURE CAPITAL INDUSTRY 5 (2001).

9. *Id.* at 6.

10. *Id.* at 5.

11. *Id.* at 6.

12. *Id.*

13. See Jerry Feigen, *Potential Exiting Through ADRs (and/or GDRs?) for International Private Equity Investors*, 13 AM. U. INT’L L. REV. 109, 110 (1997) (characterizing venture capital investment as a subset of private equity investment); George W. Fenn et al., *The Private Equity Market: An Overview*, 4 FIN. MARKETS, INSTITUTIONS & INSTRUMENTS 1, 2 (1997) (noting that the private equity market is a significant source of capital for various types of companies, including start-up firms, private middle-market and later-stage firms, firms in financial distress and public firms seeking buyout financing).

14. See Haksoo Ko, *Venture Capital in Korea? Special Law to Promote Venture Capital Companies*, 15 AM. U. INT’L L. REV. 457, 461-62 (1999) (discussing the amendment to the “prudent man” rule and its impact on venture capital investments).

15. *Id.* at 461. The enactment of various regulatory and tax changes, including the 1979 amendment to the “prudent man” rule of ERISA, 29 U.S.C. §§ 1001-1461 (1982), and

fastest growing market for corporate finance in the United States, expanding more rapidly than even the public equity market, the bond market and the market for private placement debt. By 1980, professional private equity managers, on behalf of institutional investors, began to undertake most of the investment in the private equity market.¹⁶ From 1980 to 1995, the amount of capital managed by the “organized private equity market” for venture-financed companies increased from \$4.7 billion

several modifications to the capital gains tax structure, including the Tax Reform Act, Pub. L. No. 95-600, § 135, 92 Stat. 2763 (1978), the Economic Recovery Tax Act, Pub. L. No. 97-34, § 101, 95 Stat. 172 (1981), and the Tax Reform Act, Pub. L. No. 99-514, § 301, 100 Stat. 2085, 2216 (1986), contributed to the growth of the venture capital industry in the United States. See GOMPERS, *supra* note 8, at 8 (recalling that prior to the amendment to the “prudent man” rule, pension funds could allocate only a limited percentage of their assets to venture capital investments and other investments in high-risk asset classes). The amendment explicitly permitted pension funds to invest up to ten percent of their funds in high-risk asset classes. *Id.* As a result, the annual influx of money into the venture capital industry by pension funds increased from an average of \$100 to \$200 million per year during the 1970s to nearly \$70 billion per year in 2000. *Id.* In the late 1980s, when individuals accounted for thirty-two percent of the participation in the venture capital market, pension funds represented only fifteen percent of the participants in the venture capital market despite controlling over \$3 trillion in funds. *Id.* By 1998, however, pension funds accounted for the largest percentage of participation—forty-seven percent—while the participation of individuals had declined to eleven percent of the market. *Id.*

The Tax Reform Act of 1978 lowered the capital gains tax to twenty-eight percent without changing the top marginal tax rate. *Id.* Prior to the Tax Reform Act of 1978, the capital gains tax rate was 49.5%, and the maximum marginal tax rate was seventy percent. *Id.* The difference between the tax rate on capital gains and the highest marginal tax rate on normal income thus was 20.5%. *Id.* By lowering the capital gains tax to twenty-eight percent, the tax favorability of capital gains increased to forty-two percent. *Id.* The Economic Recovery Tax Act of 1981 further reduced the capital gains tax to twenty percent but also lowered the maximum marginal tax rate on normal income to fifty percent, thereby decreasing the capital gains tax favorability to thirty percent. *Id.* The Tax Reform Act of 1986 finally eliminated the tax differential between capital gains and normal income. *Id.* These enactments created incentives for individuals with high taxable income to invest in venture capital because gains on such investments are realized principally in the form of long-run capital gains. *Id.* Nevertheless, capital gains legislation had only a modest impact on the overall money flow into the venture capital industry. Up to seventy percent of capital invested during the 1980s came from tax-exempt sources, such as university endowments, trusts, pension funds and foreign companies, for which changes in the tax code had no effect. *Id.* Recent capital gains tax legislation under the George W. Bush Administration is expected to further contribute to the industry's expansion. See LATHAM & WATKINS L.L.P., JOBS AND GROWTH TAX RELIEF RECONCILIATION ACT OF 2003: A \$350 BILLION TAX RELIEF PACKAGE REDUCING INDIVIDUAL INCOME TAXES AND PROVIDING TAX RELIEF FOR DIVIDENDS AND CAPITAL GAINS (Jan. 6, 2003), http://www.lw.com/resource/Publications/ClientAlerts/client_alert/ (select “Show Client Alerts from 2003” from drop-down list; search for: “Tax Relief Reconciliation Act”; then select “Alert No. 299”) (noting that on May 28, 2003, the Jobs and Growth Tax Relief Reconciliation Act, Pub. L. No. 108-27, § 105, 117 Stat. 752, 755 (2003), was enacted, which, *inter alia*, accelerated previously enacted reductions in marginal tax rates and provided for a maximum fifteen percent tax rate on qualified dividend income and long-term capital gains).

16. GOMPERS, *supra* note 8, at 8. See also Fenn, *supra* note 13, at 2 (referring to the limited partnership as the vehicle for organizing this activity, which arose in part from the need for greater institutional participation in the industry).

to over \$175 billion (approximately a 3700% increase).¹⁷ During this time, small, private companies increasingly started to emerge in the United States, reflecting a fundamental shift away from large, public company innovation.¹⁸ The “innovative fecundity” of these small companies, coupled with the increasing institutionalization of private equity investment, provided a fertile climate for venture capital growth in the United States.¹⁹

By the mid-1980s, returns on venture capital investments began to decline because of the influx of inexperienced venture capitalists into the market and the saturation of investment in various industries.²⁰ With the onset of disappointing returns, investors began to commit less capital to the industry.²¹ By the early 1990s, however, the surge of the IPO market and the exit of many inexperienced venture capitalists from the market contributed to the reversal of this pattern.²² In fact, new venture capital commitments increased twenty-fold from 1991 to 2000.²³ At the height of the IPO market in 1999 and 2000, venture capital investments achieved unprecedented returns of 163% and 209.96%, respectively.²⁴

17. See Fenn, *supra* note 13, at 2, 4 (defining the “organized private equity market” as professionally managed equity investments in the unregistered securities of private companies). Private equity also encompasses other markets that are distinct and separate from the organized market. *Id.* at 4. One such market is the angel capital market. See *id.* (referring to investments by wealthy individuals in small, closely-held companies). A third market is the informal private equity market. In this market, unregistered securities are sold to institutional investors and accredited individuals. This market also consists of small corporate offering registrations issued directly to the public by small firms that are exempt from registration with the Securities and Exchange Commission (the “SEC”). *Id.* A fourth distinct market is the Rule 144A private equity market. *Id.* at 5. Underwritten private equity offerings that are largely bought by the public trading desks of institutional investors characterize the Rule 144A market. *Id.*

18. See PAUL A. GOMPERS & JOSH LERNER, *THE VENTURE CAPITAL CYCLE* 326, 326 (1999) (“The breadth of technology appears wider today than it ever has been before.”).

19. *Id.*; GOMPERS, *supra* note 8, at 9. Despite its dramatic growth and increased significance for corporate finance in the last two decades, the venture capital market has received scant attention in the financial press and scholarly literature. This lack of attention is due in part to the nature of the investment instrument itself. See Fenn, *supra* note 13, at 1. Private equity securities are exempt from registration with the SEC because they are issued in transactions “not involving any public offering.” 15 U.S.C. § 77d(1)-(2) (2000). The non-public nature of these transactions often makes analyzing developments in the industry difficult.

20. GOMPERS, *supra* note 8, at 9.

21. *Id.*

22. *Id.*

23. See *id.* at 3 (recounting that the relationship between IPO market activity and capital contributions was largely due to the link between increased investment returns and the availability of profitable exit opportunities, *i.e.*, IPOs, for venture capital investments).

24. David Rosenberg, *The Two “Cycles” of Venture Capital*, 28 IOWA J. CORP. L. 419, 420 (2003); Lisa Bransten, *Venture Firms Face Backlash From Investors*, WALL ST. J., Apr. 29, 2002, at C1. The Cambridge Associates L.L.C. U.S. Venture Capital Index (the “Venture Capital Index”) maintains historical returns on venture capital investments. See, *e.g.*, CAMBRIDGE ASSOCS. L.L.C., CAMBRIDGE ASSOCIATES L.L.C. QUARTERLY END-TO-END RETURNS (providing quarterly end-to-end returns from 1981 to March 2005) (2005),

In 2001, as a result of the collapse of the technology sector, which previously had served as the catalyst for the venture capital boom of the late 1990s, and the accompanying decline of the IPO market, the venture capital market again experienced a detumescence.²⁵ For the year ending September 30, 2001, the annual rate of return on venture capital investments fell to -47.17% from over 200% in the prior year.²⁶ Although the venture capital market continued to decline in the years after 2001, it appears recently to have signaled a turn-around. In 2004, venture capital investments totaled \$20.9 billion, and the average rate of return reached 10.12%.²⁷

As evidenced by its recent resurgence, venture capital will continue to play an integral role in U.S. corporate finance. The magnitude of innovative outputs by the industry's entrepreneurial constituency, the existence of liquid markets for the achievement of profitable exits²⁸ and the willingness of investors and financial intermediaries to work in inherently risky climates sustains the venture capital market's viability as a source of financing.²⁹

B. An Overview of the Organizational Infrastructure of Venture Capital

The venture capital industry's cadre of entrepreneurs is responsible for the innovation that drives the investment process.³⁰ Because entrepreneurs themselves rarely have the necessary capital to bring their ideas to fruition, they rely on venture capital investors for financing.³¹ Venture capital is a

available at https://www.cambridgeassociates.com/Indexes/VC_Historical_endtoend>Returns.pdf (providing figures through March 2005). Each quarter, the Venture Capital Index is updated to reflect the net returns on all the U.S. venture capital funds and the one, three, five and ten-year rolling return for U.S. venture capital. Cambridge Assocs. L.L.C., Introduction and Methodology, https://www.cambridgeassociates.com/Indexes/services_research_proind_vci.asp (last visited Sept. 15, 2005).

25. See Press Release, PricewaterhouseCoopers, Venture Capital Investing Flat Q4 2002 (Jan. 28, 2003), available at <http://www.pwc.com/gx/eng/main/home/index.html> (click on "Press Room"; select "Press Releases" then "2003 Press Releases"; scroll down to "28 January 2003" and select the article) (noting that "[v]enture capital investing has continued to decline since the unprecedented run-up that peaked in 2000.").

26. See *Small Expectations: Things are Likely to Get Harder Rather Than Easier*, ECONOMIST, Nov. 27, 2004, at 9, 9-12 (listing strategies of venture capital investors to make money).

27. CAMBRIDGE ASSOCS. L.L.C., *supra* note 24, at 1; CAMBRIDGE ASSOCS. L.L.C. U.S. VENTURE CAPITAL INDEX, https://www.cambridgeassociates.com/Indexes/cambridge_VC_Index_with_Graph.pdf (last visited Sept. 15, 2005).

28. Venture capital investments typically are exited, or "harvested," via an IPO.

29. See Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1074 (2003) (stressing the importance of venture capital investments' limited duration).

30. GOMPERS & LERNER, *supra* note 18, at 3.

31. See David Rosenberg, *Venture Capital Limited Partnerships: A Study in Freedom of Contract*, 2002 COLUM. BUS. L. REV. 363, 364 ("Entrepreneurs solicit the participation of venture capitalists because young companies, particularly those experimenting with high-

particularly valuable source of financing for high-growth, start-up and early-stage companies with limited access to traditional funding alternatives.³² Venture capital investors eventually exit, or “harvest,” their ownership interests in such companies, either through an IPO or a private sale to a third party.³³

Due to the uncertainties surrounding the innovation process,³⁴ the volatility of the environment in which start-up companies operate and the intangible nature of start-up assets,³⁵ investments in high-technology, start-up companies are inherently riskier than investments in more established companies in mature industries.³⁶ In light of the risks associated with financing innovation-intensive companies, a unique organizational pattern has evolved in the industry that allows venture capital firms to manage portfolios consisting of discrete investments in entrepreneurial enterprises, while minimizing some of the inherent risk of venture capital finance.³⁷

Institutional investors, such as public and corporate pension funds, university endowments, investment banks, insurance companies and bank

tech, require a great deal of capital in the months and years before they reach profitability.”).

32. GOMPERS & LERNER, *supra* note 18, at 5; see Manuel A. Utset, *Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital-Financed Firms*, 2002 WIS. L. REV. 45, 65 (discussing “staged financing” as a means to partially protect the venture capitalist); Jose M. Padilla, *What's Wrong with a Washout?: Fiduciary Duties of the Venture Capitalist Investor in a Washout Financing*, 1 HOUS. BUS. & TAX L.J. 269, 288 (2001) (highlighting the possible benefits of “washout” techniques in certain circumstances).

33. Utset, *supra* note 32, at 111.

34. See *id.* at 58 (concerning, among other things, the technical feasibility and market potential of the innovation and the possible emergence of new competition).

35. See *id.* (observing the intangibility in nature of assets of high-technology, start-up enterprises, for example, entrepreneur's human capital, patents, and trade secrets). Firms whose primary assets are intangible are riskier to finance than those with tangible assets because in the latter investors can recuperate some of their investment by selling tangible assets. *Id.*

36. *Id.*

37. See Robert M. Kossick, Jr. & Julian Fernandez Neckelmann, *Structuring Private Equity Transactions in Mexico*, 6 NAFTA: L. & BUS. REV. OF THE AM. 105, 111 (2000) (suggesting private equity investment can be a superior approach to portfolio investment). A fund's investments commonly take the form of convertible preferred stock that is either convertible into common stock or accompanied by warrants for the purchase of common stock. George G. Triantis, *Financial Contract Design in the World of Venture Capital*, 68 U. CHI. L. REV. 305, 312 (2001). Conversion is triggered by the occurrence of certain events such as the successful completion of an IPO. *Id.* at 317. While affording investors the benefit of a liquid security that potentially will trade on the public market at an appreciated value, convertible preferred stock also provides investors with protection against downside risk through redemption, repayment or liquidation preferences. See Richard J. Testa, *Massachusetts Business Lawyering: Venture Capital Financing*, § 13.9 (2003). Liquidation and redemption preferences enable investors to recapture some of the investment in the event the venture fails. *Id.* In the event of liquidation, the preferred stock usually has a preference over the common stock to the assets of the corporation. *Accord Cannon v. Denver Tramway Corp.*, 373 A.2d 580, 581-82 (Del. Ch. 1977). That preference, in most instances, equals the original purchase price of the convertible preferred issue plus accrued and unpaid dividends. *Id.*

holding companies, invest their money through financial intermediaries—limited partnerships typically called “funds”—in which these institutional investors serve as passive limited partners.³⁸ The limited partners often contribute up to ninety-nine percent of the capital of the fund.³⁹ As prescribed by the rules governing limited partnerships, limited partners do not assume an active role in the day-to-day management of the fund.⁴⁰ Accordingly, limited partners assume liability on any investment only to the extent of their capital contribution to the fund.⁴¹

Usually organized as a limited liability company of investment professionals, the general partner (“GP”) of the fund is responsible for the identification, management and harvest of the fund’s investments.⁴² Although the GP customarily contributes only one percent of the capital of the fund,⁴³ it retains almost complete control over the management of the fund.⁴⁴ The GP receives an annual fixed fee (often called a management fee) of between 1.5 and 3 % of the committed capital of the fund.⁴⁵ The GP’s compensation is primarily based on variable, performance-related fees.⁴⁶ The variable compensation, called the “carried interest” or “carry,” represents the GP’s right to receive a specified percentage, which typically is twenty percent of the profits realized by the limited partnership.⁴⁷ While

38. Gilson, *supra* note 29, at 1070. Limited partnerships have a defined, and contractually fixed, lifespan, often of ten years, which is renewable in one or two-year increments. See JOSH LERNER & PAUL GOMPERS, HARVARD BUS. SCH., A NOTE ON PRIVATE EQUITY PARTNERSHIP AGREEMENTS 2 (2d ed. 2001). The limited partnership is the prevalent organizational form in the venture capital industry in part because of the tax benefits provided by this legal form. Deborah A. DeMott, *Agency and the Unincorporated Firm: Reflections on Design on the Same Plane of Interest*, 54 WASH. & LEE L. REV. 595, 606 (1997). Income from limited partnerships is taxable only to the individual partners; it is not subject to partnership-level taxation. Sahlman, *supra* note 1, at 482. In addition, income from distributions of securities is recognized as taxable income at the time the underlying asset is sold, not at the time the partnership makes a distribution of securities to the limited partners. *Id.* at 489.

39. Rosenberg, *supra* note 31, at 366.

40. Gilson, *supra* note 29, at 1070.

41. Kossick, Jr. & Neckelmann, *supra* note 37, at 111.

42. Gilson, *supra* note 29, at 1071.

43. LERNER & GOMPERS, *supra* note 38, at 1.

44. See Gilson, *supra* note 29, at 1071 (discussing the issue of the emergence of the separation between ownership and control of the modern corporation as raised in ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932)).

45. See Gilson, *supra* note 29, at 1072 (characterizing the compensation as “skewed”); GOMPERS & LERNER, *supra* note 18, at 10, 70 (discussing committed capital, which is the amount of money investors commit to provide over the life of a fund). Less frequently, the management fee consists of a specified percentage of the fund’s assets or some combination or modification of both the committed capital and asset value formulae. *Id.* During the internet bubble, the management fee increased in some instances to as high as 3.5% of the committed capital of the fund. Rosenberg, *supra* note 24, at 420.

46. Gilson, *supra* note 29, at 1071-72.

47. *Id.* at 1072. During the peak of the internet bubble, the “carry” rose to as high as thirty percent. Rosenberg, *supra* note 24, at 420 n.7; *Highly Leveraged: A Gravity-Defying Pay Structure*, *ECONOMIST*, Nov. 27, 2004, at 8, 8 (reporting that the “general partners who

incentive-based compensation structures inure to the benefit of limited partners by motivating appropriate effort levels on the part of GPs, such incentive structures are also advantageous to GPs.⁴⁸ A GP's explicit acceptance of a "pay-for-performance" compensation scheme signals confidence in its ability to create value in an investment, thereby attracting more investors to existing funds, facilitating future fundraising efforts and enhancing its reputational value in the industry.⁴⁹

Many venture capital funds also have a professional fund manager who is neither a general nor a limited partner of the fund.⁵⁰ The fund manager—a separate (and often affiliated) entity usually organized as a limited liability company—provides investment guidance and other administrative services to the fund.⁵¹ In addition to general advisory services, the fund manager may be responsible to prospect and identify investment opportunities for the fund.⁵² Pursuant to a right of first refusal, the fund may have the opportunity to co-invest with the manager in an identified investment opportunity up to a predetermined percentage.⁵³ For its advisory and prospecting services, the fund pays the manager an annual management fee.⁵⁴ This fee often represents a specified percentage of the amounts the fund invests in an identified investment opportunity.⁵⁵

Both the liability limitations for limited partners and the incentive-based compensation structures (*i.e.*, the "carry") for GPs shift some of the risks associated with venture capital finance from limited partner investors to GPs.⁵⁶ In addition to the organizational infrastructure that provides for the shifting of risk internally within the fund, a number of mechanisms have evolved in the industry that permit funds to transfer and/or share risk with other funds or with the entrepreneurial companies they finance. For instance, a number of venture capital funds simultaneously may participate

manage private-equity funds are lavishly paid").

48. Gilson, *supra* note 29, at 1078.

49. See LERNER & GOMPERS, *supra* note 38, at 6.

50. See Woodrow W. Campbell, Jr. & Paul S. Bird, *Private Equity: Current Topics*, 1393 PRAC. L. INST. CORP. & PRAC. HANDBOOK SERIES 7, 19 (2003) (discussing the role of the manager of a private equity fund in the United States).

51. *Id.*

52. See *id.* at 15 ("[T]he professional fund manager has learned to be ruthlessly selective. He or she quickly picks from the flow of opportunities the very few that have high appeal, and then further eliminates all but the most compelling opportunities. By being so selective and disciplined, the fund manager has made a major contribution to innovation by focusing available resources behind the very best concepts and limiting the dissipation of money and energy on superficially attractive but low-probability outcomes.").

53. See Mitchell, *supra* note 5 and accompanying text.

54. Campbell, Jr. & Bird, *supra* note 50, at 19 (providing a sample investment fund manager's agreement).

55. See JAMES M. SCHELL, PRIVATE EQUITY FUNDS: BUSINESS STRUCTURES AND OPERATIONS, at App. E (2004) (providing a sample agreement).

56. Gilson, *supra* note 29, at 1078.

in an investment.⁵⁷ The syndication of an investment through the participation of several funds facilitates the selection of superior investments, provides more capital availability for the current and follow-on cash needs of an investment and enhances opportunities for diversification, all while leveraging the expertise of additional market participants.⁵⁸ Furthermore, unlike banks, which disburse borrowed money in a single tranche, funds typically mete out capital infusions in stages.⁵⁹ To receive a subsequent round of financing, the portfolio company generally must meet specified goals such as the completion of product development, the attainment of profitability or the pursuit of an IPO or other viable exit strategy.⁶⁰ By disbursing funds only when predetermined milestones have been achieved, staged financing provides investors with the flexibility to abandon underperforming projects or to increase their investments in viable projects by participating in subsequent rounds of financing.⁶¹

C. An Agency Theory of Venture Capital Investment

The organizational infrastructure of venture capital described above points to the salience of agency theory as a basis for understanding the nature of venture capital investment. Whenever one individual acts on behalf of another, a potential agency problem arises: the agent (the person acting on behalf of another) may have interests that are incongruous with those of its principal.⁶² In venture capital, there are a number of

57. *Id.* at 1073; GOMPERS, *supra* note 8, at 14.

58. GOMPERS & LERNER, *supra* note 18, at 187.

59. *See id.* at 139.

60. *Id.* at 142; Sahlman, *supra* note 1, at 482; *see* Shannon Wells Stevenson, *The Venture Capital Solution to the Problem of Close Corporation Shareholder Fiduciary Duties*, 51 DUKE L.J. 1139, 1173 (2001) (listing factors peculiar to venture capital that may account for a lack of litigation in the field). Apple Computer and Federal Express are examples of venture-funded companies that received staged financing. *See* GOMPERS & LERNER, *supra* note 18, at 142 (detailing the relation between venture capitalists' financial investments and the success of the firm at each periodic investment stage). Apple Computer received three rounds of financing. *Id.* Venture capitalists invested \$518,000 in January 1978 at a price of \$0.09 per share. *Id.* Due to initial successes, the company received an additional \$704,000 at a price of \$0.28 per share during the second round of financing. *Id.* In December 1980, investors made a final capital infusion of \$2.331 million at \$0.97 per share, which reflected further progress made by the young company and optimism regarding Apple Computer's prospects. *Id.* Federal Express also received three rounds of financing. Unlike Apple Computer, however, each round did not signal the increased success of the company. During the first round of financing in September 1973, venture capitalists invested \$12.25 million at a price per share of \$204.17. *Id.* By the time of the second round of financing in March 1974, the company's performance had fallen below expectations, and investors expressed their uncertainty over the company's prospects by investing only \$6.4 million at a price per share of \$7.34. *Id.* In September 1974, Federal Express received its final round of funding in the amount of \$3.88 million priced at \$0.63 per share. *Id.* By 1978, Federal Express's performance had improved, and it went public at \$6 per share. *Id.*

61. Gilson, *supra* note 29, at 1080.

62. Utset, *supra* note 32, at 55.

relationships that follow the agency paradigm, including the GP/limited partner, entrepreneur/fund and fund/manager relationships.

Inherent in any agency relationship are informational asymmetries between the principal and the agent. As monitoring costs—that is, informational costs—increase, an agent will have more opportunities to take actions that are detrimental to its principal.⁶³ For instance, as a result of its prospecting activities, a fund manager may procure significant informational advantages over the fund(s) it manages regarding existing or prospective investment opportunities. When a fund's informational disadvantage increases, and accordingly, its monitoring costs rise, the potential for managerial opportunism also increases. The Google hypothetical set forth in Part II presents an illustrative example of managerial opportunism in the context of venture capital investment.

Mitigating against the informational asymmetries between principals and agents and the potential opportunism arising therefrom is the reputational constraint mechanism. The following section considers the evolving nature of reputation as an enforcement mechanism in the venture capital industry and its proper role within a legal regime of damages.

D. The Reputational Constraint Mechanism

The importance of reputation arises from two sources: (1) the possibility of repeat transactions with current business associates and (2) the potential for the development of new business relationships as a result of market participants' exchanges of information.⁶⁴ Apart from the law's remedial framework for breaches of contract, the value of lost future transactions encourages parties to perform their contracts.⁶⁵ Although its effectiveness in the enforcement of contractual performance is not susceptible to empirical proof, reputation bears a strong relationship to a person's decision not to breach a contract.⁶⁶

Enhancing the potency of the reputational constraint mechanism is the uniquely cyclical nature of venture capital investment.⁶⁷ The venture

63. *Id.*

64. See Thomas S. Ulen, *The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies*, 83 MICH. L. REV. 341, 347 (1984) (claiming reputation is likely the most important “nonlegal market force”).

65. *Id.* at 347-48.

66. *Id.* at 347.

67. See Rosenberg, *supra* note 31, at 395 (contrasting the investment protection mechanisms of venture capital partnership investors, who rely almost exclusively on reputational constraints, with corporate shareholders, who leverage control through voting, buying and selling stock, and bringing derivative actions to enforce their rights); Triantis, *supra* note 37, at 320 (suggesting that because the time required to acquire requisite skills and track record limits the supply of venture capitalists, an increase in demand among investors would improve the bargaining power of venture capitalists and cause a significant short-run increase in their returns).

capital market consists of a predictable and regular cycle through which GPs and/or fund managers return to the same investors upon the completion of a prior round of investment.⁶⁸ Characterized by Black and Gilson as “an implicit contract in which capital providers are expected to reinvest in future limited partnerships sponsored by successful venture capital funds,”⁶⁹ this agreement forms the basis for the cyclicity of venture capital investment.⁷⁰ The prospect of renewing existing relationships thus promotes bilateral adherence to the reputational constraint mechanism.⁷¹

Further strengthening the efficacy of reputation as an enforcement mechanism is the industry's concentration of capital and stratification of managerial talent.⁷² The concentration of capital in the hands of relatively few investors incentivizes both GPs and fund managers to perform their contracts to obtain financing for future investments.⁷³ Similarly, the potential to cultivate relationships with the industry's managerial talent and thereby participate in the industry's meritorious enterprises promotes investor adherence to the reputational constraint mechanism.⁷⁴

These attributes (*i.e.*, cyclicity of investment, concentration of capital

68. See Rosenberg, *supra* note 24, at 424 (explaining that the desire to continue the relationship encourages GPs and investors to act in good faith and avoid extreme measures, such as litigation).

69. Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 256 (1998).

70. See Gilson, *supra* note 29, at 1071 (explaining the common practice where GPs begin soliciting investors for a new fund by the mid-point of the existing fund's contractually fixed term); see also Rosenberg, *supra* note 31, at 397 (noting that “as the venture capitalists gain experience, initially at some cost to the investors, the value of their services to those same investors increases, making them more likely to join a future limited partnership”); Triantis, *supra* note 37, at 320 (observing that the venture capital sector is “significantly segmented by the size, industry focus, location, and reputation of venture capitalists”).

71. See Rosenberg, *supra* note 24, at 425 (“Even though the investors and limited partners are only legally committed to each other for the duration of the current fund, the success of both parties' long-term commitment to investment in venture capital depends on their having the confidence that the relationship will in fact continue for years, through the creation of new venture capital limited partnerships involving the same parties.”).

72. See Rosenberg, *supra* note 31, at 395 (explaining that a successful venture capital firm is “plainly one to which investors return again and again following the creation and subsequent profitable liquidation of a limited partnership”); Triantis, *supra* note 37, at 320 (stating that VCs are compensated through both their contractual share of portfolio profits and the nonmonetary private benefits extracted from the partnership).

73. See Rosenberg, *supra* note 31, at 395 (suggesting that the “short life of limited partnerships virtually guarantees that the venture capitalists will undergo a ‘periodic review’ at the hands of their current investors who are, inevitably, potential future investors as well”); see also Triantis, *supra* note 37, at 315 (stating that “the relationship of the parties and the intermediaries' concern with their reputations are crucial constraints against opportunistic behavior”).

74. See Rosenberg, *supra* note 24, at 424-25 (explaining how highly successful venture capitalists are able to dictate the terms of the limited partnership agreements governing their relationships with investors, retain virtually all of the decision-making power, and insist on increasingly better terms of remuneration for themselves).

and stratification of management talent) historically have made litigation a rare occurrence in the venture capital industry.⁷⁵ Recent anecdotal evidence, however, points to a trend toward an increase in litigation in the industry.⁷⁶ Beyond the obvious incentives for litigation arising out of the poor investment returns of recent years, the gradual fragmentation of the venture capital market resulting from the participation of an increasing number of entrepreneurs, investors and managers has diminished the importance of relationships, and accordingly, the efficacy of reputation both as an enforcement mechanism and as a constraint to litigation.⁷⁷

As the market continues to mature, more litigation is inevitable.⁷⁸ In light of this evolving legal landscape, the resolution of the damages issue raised in this Article is of particular salience. Part II sets forth a more detailed account of the Google hypothetical and is followed by an analysis of the legal frameworks of several remedial theories as well as a consideration of their applicability to the breach of the Fund's right of first refusal.

II. THE GOOGLE HYPOTHETICAL

Suppose that, in 1998, the Fund and the Manager entered into a non-exclusive agreement pursuant to which the Manager was required to present to the Fund all investment opportunities the Manager identified during a two-year period (1998-99). The Fund, in turn, had a right of first refusal on those investments identified by the Manager during the stated term of the contract.⁷⁹ For each investment opportunity, the Fund's right of first refusal entitled it to participate in such an opportunity up to fifty

75. See Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 571 (1991) (stating that sophisticated investors, such as those who invest in venture capital partnerships or established companies, do not generally sue if things turn out badly unless there is strong evidence of fraud).

76. See Noram Alster, *What's that Rumble in Venture Capital Funds*, N.Y. TIMES, Mar. 3, 2002, § 3, at 4 (pointing to poor performance, high management fees, and a desire to recover losses as factors creating tension between GPs and investors after a period of strong returns and little friction during the 1980s and 1990s); Gary Rivlin, *The Founders of Web Site Accuse Backers of Cheating Them*, N.Y. TIMES, Jan. 26, 2005, at C15 (chronicling a case filed in January 2005 in the Superior Court of California involving a dispute between a group of investors and its venture capital sponsors).

77. See Alster, *supra* note 76, at §§ 3, 4 ("An outbreak of litigation in this relatively closed world is one clear sign of investor frustration over the tens of billions of dollars that have been committed but not put to use.").

78. See Robert Chow, *Holy Grail Proves Elusive for VCs*, FIN. TIMES Mar. 26, 2002, at 26 (chronicling reports of failed venture capital investments, uncommitted fund capital, and management agreement disputes); Beth Healy, *Threat of Lawsuits Has Firms Seeking Insurance Coverage*, BOSTON GLOBE, Aug. 26, 2002, at C2 (quoting Carl Metzger, who stated "[t]he new litigation landscape that's out there for VCs is not just a function of the economic environment, but a function of the growth of the industry.>").

79. See *supra* note 5 and accompanying text (defining the right of first refusal as the right to participate in any investment opportunity identified by the Manager in advance of all other potential investors and on predetermined terms).

percent of the amounts that the Manager elected to invest in the opportunity. In return for the Manager's prospecting services, the Fund would pay two percent of any amounts the Fund invested in an investment opportunity as a fee to the Manager.

Suppose further that in February 1999, the Manager identified an investment opportunity in Google, a privately-held search engine company formed in 1998 by two Stanford University students.⁸⁰ After evaluating the opportunity, in June 1999, the Manager decided to invest \$5 million in Google, reflecting an eight percent ownership stake in the company.⁸¹ In breach of the Fund's right of first refusal, the Manager failed to present to the Fund the opportunity to co-invest in fifty percent of the Manager's \$5 million investment (or \$2.5 million, representing a four percent ownership interest in Google).⁸²

Recognizing Google's potential for success, the Manager invested an additional \$7.6 million in December 2000,⁸³ which as of December 2000, represented an additional 1.5 % ownership stake.⁸⁴ At that time, the Manager's prior \$5 million investment, or eight percent ownership interest, had increased in value to \$40.534 million (an approximately 800% increase).⁸⁵ Had the Manager presented to the Fund the Google investment

80. See Press Release, Google Inc., Google Receives \$25 Million in Equity Funding (June 7, 1999) (on file with the American University Law Review) (providing the basis for this hypothetical, where Google received \$25 million in equity financing from a group of investors led by Sequoia Capital and Kleiner Perkins Caufield & Byers in June 1999); see also Verne Kopytoff & Dan Fost, *For Early Googlers, Key Word is \$\$\$: Founders, Backers Could Reap Billions When Company Goes Public*, S.F. CHRON., Apr. 29, 2004, at A1, A14 (estimating that Sequoia Capital and Kleiner Perkin Caufield & Byers' \$25 million investment represented a forty percent ownership share in Google).

81. See *infra* note 83 (supplying this hypothetical's basis, which assumes that Sequoia Capital and Kleiner Perkins Caufield & Byers syndicated their \$25 million investment by taking twenty percent of the syndicate's investment in Google (\$5 million representing an eight percent ownership interest in Google)).

82. See *infra* notes 83-84 (providing the basis for this hypothetical, which assumes that under the co-investment agreement, the Manager was required to present to the Fund fifty percent of any investment it made in an opportunity the Manager identified (fifty percent of the Manager's \$5 million investment in Google, representing an eight percent ownership interest in the company, is \$2.5 million, reflecting a four percent ownership interest in Google)).

83. See Dan Primack, *PE Week Wire*, PRIVATE EQUITY WK., Aug. 20, 2004, available at <http://www.privateequityweek.com/pew/freearticles/1070550169239.html> (indicating that Sequoia Capital and Kleiner Perkins Caufield & Byers invested an additional \$15.18 million in Google in late 2000 at a post-money valuation of approximately \$445 million and representing approximately a three percent ownership interest in Google).

84. See *id.* (applying the additional \$15.18 million investment to the hypothetical numbers (\$7.6 million) reduces the investment by fifty percent reflecting a 1.5% ownership interest; according to the hypothetical, the Manager's December 2000 investment fell outside the coverage period of the co-investment agreement (1998-99), and as a result, the Manager had no contractual obligation to provide the Fund with an opportunity to participate in this latter investment).

85. See *supra* notes 83-85 (deriving the December 2000 investment value given that 1.5% of Google was worth \$7.6 million in December 2000, eight percent of Google was worth \$40.534 million, and four percent was worth \$20.267 million at the time).

opportunity—as it was contractually obligated to do in June 1999—the Fund's allocable \$2.5 million investment, or four percent ownership interest, would have been worth \$20.267 million by December 2000.⁸⁶

From 2000 to 2004, Google experienced tremendous success.⁸⁷ On April 29, 2004, Google announced that it had filed a registration statement with the SEC for a proposed IPO of its Class A common stock.⁸⁸ Subsequently, on August 18, 2004, Google's IPO was priced at \$85/share, and 19.6 million shares were issued, which represented 7.23% of the company.⁸⁹ Pursuant to this valuation, as of August 18, 2004, the Manager's eight percent ownership interest had risen in value to \$1.848 billion (an approximately 360,000% increase), while the Fund's allocable four percent ownership interest would have been worth \$924 million (an approximately 180,000% increase).⁹⁰

Google went public on August 19, 2004.⁹¹ Its closing stock price on the first day of trading was \$100.34/share.⁹² The following chart sets forth

86. See *supra* notes 83-85 and accompanying text (calculating the valuation of the Fund's potential investment if Manager had adhered to the traditional reputational constraint mechanism).

87. See Google Inc., Google Corporate Information: Google History, <http://www.google.com/corporate/history.html> (last visited Oct. 2, 2005) (chronicling Google's expansion into new services and technologies, which included the Google Directory, global partnerships, wireless search capability, Google Image Search, Google Labs, Google News, Froogle, Blogger and Gmail).

88. Press Release, Google Inc., Google Inc. Files Registration with the SEC for an Initial Public Offering (Apr. 29, 2004), available at http://www.google.com/press/pressrel/reg_statement.html.

89. Google Prospectus, *supra* note 2; Press Release, Google Inc., Google Inc. Prices Initial Public Offering of Class A Common Stock (Aug. 18, 2004), available at <http://www.google.com/press/pressrel/ipo.html>; see Press Release, Google Inc., Google Inc. Requests Effectiveness of IPO Registration Statement (Aug. 18, 2004), available at http://www.google.com/press/pressrel/reg2_statement.html (announcing decision to lower both the offering price and the issuance's number of shares to 19.7 million shares (of its 271.2 million shares outstanding)); see also Matthew Fordahl, *Google Price Set at \$85, at Low End of Company's Expectations*, S.F. GATE.COM (Aug. 18, 2004), available at <http://www.sfgate.com/cgi-bin/article.cgi?file=/news/archive/2004/08/18/financial2112EDT0223.DTL&type=business> (explaining that the \$85 price “values the world's most popular search engine at \$23.1 billion”). Google initially planned to issue 25.7 million shares at a price per share of between \$108 and \$135. Google's market capitalization at the time of the IPO is calculated by multiplying the number of outstanding shares by the share offering price (271,219,243 shares x \$85/share), which equals \$23.1 billion. From the IPO, Google raised \$1.674 billion (price per share (\$85) multiplied by the number of shares issued (19,695,052)).

90. See *supra* note 89 (calculating the amount of capital raised in the IPO, given that 7.23% of Google was worth \$1.674 billion at the time of the IPO, eight percent of Google was worth \$1.848 billion and four percent of the company was worth \$924 million).

91. See Gary Rivlin, *Unorthodoxy Pushed Aside, Google Opens with Run-Up*, N.Y. TIMES, Aug. 20, 2004, at C1 (reporting on Google's first day of trading where Google stock was bought and sold at a rapid rate, which Google had tried to avoid by using an online auction to attract bidders who would buy the stock as a long-term investment).

92. See *id.* (reporting that Google's price at the end of its first day of trading was eighteen percent higher than its release price, which gave Google a market valuation of more than \$27 billion).

Google's stock price on various dates from the date of its IPO to the date of the Fund's lawsuit.

Figure 2.1

As indicated by Figure 2.1, Google's stock price continued to rise in the wake of its IPO, reaching \$190.64/share on October 31, 2004.⁹³ On that date, the Manager sold its investment in Google and made a profit on the sale of approximately \$2 billion. Upon learning of the sale, the Fund sued for breach of the right of first refusal on October 31, 2004 and sought damages of approximately \$2 billion or, in the alternative, specific performance of its contract with the Manager.⁹⁴

93. See Andrei Postelnicu, *Blue-Chips Hold Steady With All Eyes on Rates*, FIN. TIMES, Nov. 11, 2004, at 30 (reporting that Google's stock price decreased slightly based on news that Microsoft planned to preview a competing search service).

94. The Fund calculated its damages by valuing what its investment in Google would have been worth on October 31, 2004. Based on the IPO allocations, 10,843,706 shares represented a four percent ownership stake in Google. As of October 31, 2004, Google's stock price was \$190.64/share. Thus, 10,843,706 shares (four percent of Google's stock) multiplied by \$190.64 (the price/share) less \$2.5 million (the cost of the Fund's investment in Google had it been permitted to invest in Google) equals \$2,064,744,111.84.

III. POSSIBLE REMEDIES FOR BREACHES OF RIGHTS OF FIRST REFUSAL

A. *Conversion Theory*

The first (and potentially most lucrative) theory of recovery for the Fund lies in conversion. The modern action for the tort of conversion descended from the common law action of trover.⁹⁵ Traditionally based on the theory that a finder of lost goods has a duty to return them to their rightful owner, trover was eventually extended to cases of dispossession, or of withholding possession, by others than finders of lost goods.⁹⁶ Trover became a universal remedy for deprivations of chattel (personal property), whether by wrongful taking, wrongful detention, wrongful disposal or other interference with the chattel.⁹⁷ The modern-day definition of conversion imposes a duty on individuals not to engage in the “unauthorized and wrongful exercise of dominion and control over another's personal property.”⁹⁸ While the tort historically did not encompass intangible personal property, courts have expanded the cause of action to apply to certain types of intangible property, including stocks and bonds.⁹⁹

For contracts involving stocks and bonds, courts endorsing the use of conversion apply no fewer than seven methods for calculating damages.¹⁰⁰

95. See RESTATEMENT (SECOND) OF TORTS § 222A (1965) (stating that “conversion is an intentional exercise of dominion or control over a chattel which so seriously interferes with the right of another to control it that the actor may justly be required to pay the other the full value of the chattel”).

96. See *id.* (explaining that the fiction of losing and finding persisted until comparatively recent times in many jurisdictions in the pleading of the action).

97. See *id.* (explaining that because of its use as a universal remedy, conversion was not clearly distinguished from the action of trespass).

98. *Phansalkar v. Andersen Weinroth & Co.*, 175 F. Supp. 2d 635, 639 (S.D.N.Y. 2001) (quoting *Pioneer Commercial Funding Corp. v. United Airlines, Inc.*, 122 B.R. 871, 883 (Bankr. S.D.N.Y. 1991)).

99. See *id.* (quoting *In re Chateaugay Corp.*, 156 B.R. 391, 400 (Bankr. S.D.N.Y. 1993)) (confirming that New York has “extended the tort of conversion to intangible property rights that are ‘merged in, or identified with, some document’ or ‘relate to specifically identifiable money.’”). See generally W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 15, at 90-92 (5th ed. 1984) (chronicling the expansion of the theory of conversion, which has stopped short of finding conversion of an ordinary debt, the goodwill of a business, an idea, or “any species of personal property which is the subject of private ownership,” despite the lack of a valid or essential reason for this limitation).

100. See Royce de R. Barondes, *An Alternative Paradigm for Valuing Breach of Registration Rights and Loss of Liquidity*, 39 U. RICH. L. REV. 627, 636-39 (2005) (identifying the seven different measures as: (1) the value of the stock at the time of the conversion; (2) the highest value of the stock from the time of the conversion to a reasonable period of time thereafter; (3) the highest value of the stock between the time of the conversion and a reasonable time after the owner's notice of the conversion; (4) the highest value of the stock from the time the owner has notice of the conversion to a reasonable period thereafter; (5) the higher of the value of the stock at the time of the conversion and the highest value of the stock from the time the owner has notice of the conversion to a reasonable period of time thereafter; (6) the highest value of the stock from the time of the conversion until the time of the lawsuit; and (7) the highest value of the stock from the time of the conversion until the time of the trial or the time a verdict is issued).

A majority of courts, including the U.S. Supreme Court in *Galigher v. Jones*, has measured conversion damages by taking the highest value of the stock between the date of the conversion and a reasonable period of time after the owner's notice of the conversion.¹⁰¹ The proposition underlying conversion theory is that the breaching party should assume the risk of market fluctuation until the injured party can enter the market and replace the converted shares.¹⁰² Although the *Galigher* Court did not require the injured party actually to reenter the market, it discussed market reentry only to establish the outer time limit of a reasonable period during which "the highest intermediate value" of the lost stock could be ascertained.¹⁰³ In *Galigher*, a case involving a broker's failure to purchase shares of stock at his customer's instruction as well as the broker's unauthorized sale of other shares held by his customer, the Supreme Court reasoned that using the conversion measurement of damages in cases involving stock (a good with oscillating market value) would allow a plaintiff to recover profits possibly lost as a result of the conversion.¹⁰⁴

Courts have not developed consistent rules governing what constitutes a "reasonable period" of time after the injured party's notice of the conversion.¹⁰⁵ However, as the *Galigher* Court emphasized, courts have attempted to define a "reasonable period" as the time frame during which the plaintiff could have accomplished a commercially reasonable substitute transaction.¹⁰⁶ In attempting to resolve this inquiry, courts consider a number of factors, including the amount of securities to be purchased by

101. See *Galigher v. Jones*, 129 U.S. 193, 200 (1889) ("[T]he measure of damages . . . is the highest intermediate value reached by the stock between the time of the wrongful act complained of and a reasonable time thereafter . . .").

102. See *id.* (explaining the measure of damages to allow "the party injured to place himself in the position he would have been in had not his rights been violated").

103. *Id.*; see *Schultz v. Commodity Futures Trading Comm'n*, 716 F.2d 136, 140 (2d Cir. 1983) (citing *Galigher*, 129 U.S. at 201) (explaining that in a volatile market allowing the injured party "merely the value of the stock at the time of conversion would provide an inadequate and unjust remedy"); see also *Scully v. US WATS, Inc.*, 238 F.3d 497, 514 (3d Cir. 2001) (quoting *Schultz*, 716 F.2d at 140) (noting that requiring actual reentry into the market would increase the risk to plaintiff because such a rule does not account for the possibility of unfavorable market conditions, which "would frustrate the rule which seeks to make an investor whole"). But see 11 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5117 (perm. ed., rev. vol. 2003) ("The general rule for conversion damages is that the value of the property is to be determined as of the date of the conversion.").

104. See *Galigher*, 129 U.S. at 200 ("The real injury sustained by the principal consists . . . in the sale of [the stock] at an unfavorable time, and for an unfavorable price.").

105. See *Schultz*, 716 F.2d at 140 (explaining that "what constitutes a reasonable period between the act complained of and the time when reentry into the market would be both warranted and possible will vary from case to case").

106. See *Galigher*, 129 U.S. at 200 (distinguishing stocks, for which the market is volatile, from other goods, which are "generally supposed to have a fixed market value at which they can be replaced at any time"); de R. Barondes, *supra* note 100, at 648 (stating that "[t]he courts have not developed firm rules governing what constitutes a 'reasonable period.'").

the plaintiff and the liquidity (or illiquidity) of the relevant market.¹⁰⁷ Depending on the factual circumstances, courts have found that ten days, one month, two months or more constituted a “reasonable period.”¹⁰⁸

Even small changes in the court's selection of a “reasonable period” of time after the owner's receipt of notice may result in vastly different damages outcomes, particularly in cases involving assets with fluctuating values.¹⁰⁹ Applying the *Galigher* measure of damages, the following chart sets forth a number of possible damages outcomes in the Google hypothetical on various dates from the date of the breach to the date of the lawsuit. Based on the court's assessment of a “reasonable period” of time following the Fund's receipt of notice of the conversion, these damages could range from \$0 to \$2,064,744,111.

Figure 3.1
Damages Calculations: Conversion

<i>Description</i>	<i>Calculation</i>	<i>Total</i>
June 30, 1999—Date of Breach (Date of First Investment by Manager)	\$2.5 million (4% ownership stake in Google) less \$2.5 million	\$0
December 31, 2000—Date of Second Investment by Manager	\$20.267 million (4% ownership stake in Google) less \$2.5 million	\$17,767,000
August 19, 2004—Google Traded	10,843,706 shares (4% ownership stake in	\$1,291,804,748

107. See de R. Barondes, *supra* note 100, at 648 (“If the reasonable period is designed to reflect the time period in which one could make a commercially reasonable sale, that time period would be based on a number of factors, including the amount of securities to be sold and the liquidity of the market . . .”).

108. See *Commonwealth Assocs. v. Palomar Med. Techs. (Palomar)*, 982 F. Supp. 205, 211-12 (S.D.N.Y. 1997) (indicating that where the availability of a market has not been proven, a year or more may be a reasonable time period under the highest intermediate value test); *Madison Fund, Inc. v. Charter Co.*, 427 F. Supp. 597, 610 (S.D.N.Y. 1977) (concluding that two months was a reasonable period); *TheraTX, Inc. v. Duncan*, 775 A.2d 1019, 1023 (Del. 2001) (affirming that ten days can constitute a reasonable period under the highest intermediate value test).

109. de R. Barondes, *supra* note 100, at 648.

Publicly	Google) (\$100.34/share)less \$2.5 million	
September 20, 2004— 30 Days After Google Goes Public	10,843,706 shares (4% ownership stake in Google) (\$119.36/share)less \$2.5 million	\$1,291,804,748
October 31, 2004— Date of the Fund's Lawsuit	10,843,706 shares (4% ownership stake in Google) (\$190.64/share)less \$2.5 million	\$2,064,744,111

Before deciding which, if any, of these damages outcomes is appropriate for the breach of the Fund's right of first refusal, this Article next examines the legal framework of a cause of action in conversion to determine whether its application is warranted under the factual circumstances of the Google hypothetical.

1. *The legal framework of conversion*

a. *Establishing a cause of action for conversion*

To establish a cause of action in conversion, plaintiffs must prove (1) their “legal ownership or an immediate, superior possessory right of possession to a specific identifiable thing” that is merged in, or identified with, some document, or relates to specifically identifiable money and (2) that the defendant wrongfully assumed unauthorized control and dominion over the property in question.¹¹⁰

Proving the first element of a cause of action in conversion has been the subject of some legal debate. For example, in *Weiss v. Leewards Creative Crafts, Inc.*, Kenneth M. Weiss, the plaintiff, alleged that the defendants—Leewards (the issuing corporation), its selling stockholders, underwriters and individual directors—converted Leewards stock by not delivering 1000 shares of Leewards stock that Weiss had agreed to purchase at a future public offering.¹¹¹ The Leewards stock was not delivered because the stock issuance was cancelled.¹¹² Even assuming that Weiss had some cognizable

110. *Phansalkar v. Andersen Weinroth & Co.*, 175 F. Supp. 2d 635, 639 (S.D.N.Y. 2001); *Calabrese Found. v. Inv. Advisors*, 831 F. Supp. 1507, 1515 (D. Colo. 1993); *Weiss v. Leewards Creative Crafts, Inc. (Leewards)*, No. 12,384, 1993 Del. Ch. LEXIS 73, at *16 (Del. Ch. Apr. 29, 1993).

111. *Leewards*, 1993 Del. Ch. LEXIS 73, at *3, *4.

112. *Id.*

property right in Leewards stock, the Delaware Court of Chancery found that Weiss had failed to demonstrate his right to possess the Leewards stock as a matter of law.¹¹³ In reaching this conclusion, the Court pointed to Leewards' final prospectus, which unambiguously stated that the purchase of the company's stock was "conditionally sold on a 'when-issued' basis."¹¹⁴ The Court determined that because the stock was never issued, Weiss was precluded from claiming a superior, possessory interest in the stock.¹¹⁵

The *Leewards* analysis calls into question the Fund's ability to prove either of the requisite elements of a cause of action in conversion. Unlike Weiss who potentially had a cognizable ownership interest in Leewards stock, the Fund had never purchased, or even attempted to purchase, Google stock. Thus, the Fund's interest in Google was even more attenuated than Weiss's interest in Leewards. The Fund's failure to establish an ownership or a superior, possessory interest in Google stock would also indicate that the defendant Manager failed to exercise the requisite "unauthorized and wrongful dominion or control" over property that the Fund owned or possessed.¹¹⁶

The preceding analysis regarding the conversion of Google stock fails to contemplate the potential for the Fund to bring a claim for the conversion of the *opportunity* to invest in Google. The Fund might argue that had the Manager not converted the *opportunity* to invest in Google by breaching the right of first refusal, the Fund would have purchased Google stock, and accordingly, proven the requisite ownership and possession elements of a cause of action in conversion. While, on its face, this argument makes good sense, two significant limitations undermine its persuasive value. First, considering that the Fund did not provide any advanced consideration for the right of first refusal, a substantial question would arise as to whether or not the Fund even owned or possessed the "converted" opportunity to invest in Google.¹¹⁷ Second, even assuming that the Fund could prove an ownership or possessory interest in the opportunity, courts typically have not recognized conversion claims for the withholding or dispossession of

113. *Id.* at *17.

114. *Id.* at *7.

115. *Id.*; see *Simon v. Electrospace (Electrospace)*, 269 N.E.2d 21, 26 (N.Y. 1971) (stating in dictum, consistent with the *Leewards* court, that a plaintiff does not become the owner of stock just because the defendant breached its contract to deliver shares to the plaintiff).

116. *Phansalkar v. Andersen Weinroth & Co.*, 175 F. Supp. 2d 635, 639 (S.D.N.Y. 2001) (quoting *Pioneer Commercial Funding Corp. v. United Airlines, Inc.*, 122 B.R. 871, 833 (Bankr. S.D.N.Y. 1991)).

117. The fee paid by the Fund to the Manager was based solely on the amounts invested by the Fund in identified opportunities. The contractual fee arrangement necessarily implied that the Fund's payment of the fee would take place *after* the investment had been made.

“indefinite, intangible, and incorporeal species of property” such as opportunities.¹¹⁸

b. Conversion as a remedy in breach of contract cases

Apart from the Fund's failure to prove the legal elements of a cause of action in conversion, courts often do not permit tort causes of action that arise from breaches of contractual duties.¹¹⁹ In fact, several courts have ruled that a cause of action in conversion is not available for non-performance of an agreement.¹²⁰ For example, in *Peters Griffin Woodward, Inc. v. WCSC, Inc.*, the plaintiff, Peters Griffin Woodward, Inc., had contracted with the defendant, WCSC, Inc., to be its national sales representative in arranging the sale of television advertisement time.¹²¹ When the defendant entered into a new agreement with MMT Sales, Inc. in violation of its contract with the plaintiff, the plaintiff sued both for breach of contract and conversion of commissions totaling \$15,924.09 that allegedly had been wrongfully delivered to MMT Sales, Inc.¹²² The New York Appellate Division dismissed the conversion cause of action because it was derived from the plaintiff's breach of contract claim.¹²³

Similarly, in *Bridgestone/Firestone, Inc. v. Recovery Credit Services, Inc.*,¹²⁴ the Second Circuit considered whether a cause of action for fraud is

118. *Phansalkar*, 175 F. Supp. 2d at 639 (quoting *Matzan v. Eastman Kodak Co.*, 521 N.Y.S.2d 917, 918 (App. Div. 1987)); see also *Spiegel v. Quality Bakers of Am. Coop., Inc.*, No. 91 Civ. 5702, 1992 U.S. Dist. LEXIS 17194, at *23 (S.D.N.Y. Nov. 10, 1992) (holding that a cause of action for conversion does not exist to remedy one party's cancellation of a licensing agreement); *Ippolito v. Lennon*, 542 N.Y.S.2d 3, 6 (App. Div. 1989) (finding that New York “does not generally recognize a cause of action for conversion of intangible property” and, on that basis, holding that conversion did not apply to a musician's intangible property interest in a concert performance). Given that damages for the loss of something as nebulous as an opportunity would be particularly difficult to quantify, courts likely are disinclined to award damages for the conversion of an opportunity.

119. See *Lazar v. Rykoff-Sexton, Inc.*, 909 P.2d 981, 991 (Cal. 1996) (allowing a claim for fraudulent inducement of an unwritten employment contract, not breach of contract); *Juran v. Bron*, No. 16464, 2000 Del. Ch. Lexis 143, at *18 (Del. Ch. Oct. 6, 2000) (stating that there is no cause of action for fraud where the wrongful conduct is actually breach of an employment contract).

120. See *Matzan*, 521 N.Y.S.2d at 918 (denying claim of conversion for nonperformance of contract); see also *Cavallo v. Am. Skandia Life Assurance Corp.*, No. 94 Civ. 2908, 1997 WL 251538, at *15 (S.D.N.Y. May 13, 1997) (quoting *Kubin v. Miller*, 801 F. Supp. 1101, 1118 (S.D.N.Y. 1992)) (“[Conversion] may not lie for simple non-performance under an alleged agreement. In order to maintain a conversion claim, plaintiff must set forth additional allegations of wrongdoing.”).

121. *Peters Griffin Woodward, Inc. v. WCSC, Inc.*, 452 N.Y.S.2d 599, 600 (App. Div. 1982).

122. *Id.*

123. *Id.*; see *Matzan*, 521 N.Y.S.2d at 918 (emphasizing that because plaintiff's claim for non-performance was under an alleged agreement, his remedy was to sue for breach of contract only; to bring a conversion claim, plaintiff had to make additional allegations of wrongdoing).

124. 98 F.3d 13 (2d Cir. 1996).

available when it is derived from an alleged breach of a contractual duty.¹²⁵ Bridgestone/Firestone (“BFI”), the plaintiff, had contracted with various agencies to collect delinquencies on credit card accounts.¹²⁶ When the agencies failed to remit those amounts to BFI, BFI brought an action alleging fraud and breach of contract.¹²⁷ The Second Circuit dismissed the cause of action for fraud because it concluded that BFI did not (1) demonstrate the existence of a legal duty separate from the collection agencies’ duty to perform under the contract; (2) prove a fraudulent misrepresentation collateral or extraneous to the contract; or (3) plead special damages caused by the misrepresentation that were unrecoverable as contract remedies.¹²⁸

Upon analysis, the holdings in both *Peters Griffin Woodward* and *Bridgestone/Firestone* are consistent with the basic precepts of contract law. A contract imposes duties upon the contracting parties for the exchange of goods and services.¹²⁹ That contract represents the entire relationship between the parties and all reasonable expectations flowing therefrom.¹³⁰ Beyond those duties referenced and implied in the contract (e.g., good faith and fair dealing), there are no independent or separate duties upon which to base a tort claim.¹³¹ Therefore, tort claims stemming from duties contained within a contract go beyond the reasonable expectations the parties had at the time of contract.¹³² Applying this logic,

125. *Id.* at 14.

126. *Id.* at 14-15.

127. *Id.*

128. *Id.* at 20; see also *Papa's-June Music, Inc. v. McLean*, 921 F. Supp. 1154, 1162 (S.D.N.Y. 1996) (dismissing fraud claim where it is not sufficiently distinct from breach of contract claim); *McKernin v. Fanny Farmer Candy Shops, Inc.*, 574 N.Y.S.2d 58, 59 (App. Div. 1991) (holding that a cause of action for fraud does not lie where the fraud claim stems from an alleged breach of contract and the supporting allegations do not concern misrepresentations that are collateral or extraneous to such contract).

129. E. ALLAN FARNSWORTH, *CONTRACTS* § 1.1, at 4 (2d ed. 1990).

130. See U.C.C. § 1-201(12) (2005) (defining a contract as the “total legal obligation which results from the parties’ agreement”).

131. See *Bridgestone/Firestone, Inc. v. Recovery Credit Servs., Inc.*, 98 F.3d 13, 20 (2d Cir. 1996) (stating that to maintain a claim of fraud, plaintiff must “demonstrate a legal duty separate from the duty to perform under the contract” or “demonstrate a fraudulent misrepresentation collateral or extraneous to the contract”).

132. See *Lazar v. Rykoff-Sexton, Inc.*, 909 P.2d 981, 991 (Cal. 1996) (holding that a tort remedy does not exist for breach of an employment contract); see also *Commonwealth Assocs. v. Palomar Med. Techs. (Palomar)*, 982 F. Supp. 205, 208 (S.D.N.Y. 1997) (awarding conversion damages for defendant’s breach of an agreement to register warrants and issue the underlying shares to the plaintiff).

The *Palomar* case is inconsistent with both the *Bridgestone/Firestone* and *Peters Griffin Woodward* line of cases for a number of reasons. First, plaintiff’s claim for conversion damages in *Palomar* arose out of defendant’s breach of its contractual duty to register the warrants, issue the shares and assign them to the plaintiff pursuant to a contractual arrangement between the parties. *Id.* Second, by not registering the warrants or issuing the shares to the plaintiff, the defendant did not exercise unlawful dominion or control over stock which the plaintiff *owned* or in which the plaintiff had a *possessory* interest. Nonetheless, the *Palomar* Court held that the appropriate recovery would be the greater of

the California Supreme Court in *Lazar v. Rykoff-Sexton, Inc.* noted its “consistent refusal to validate tort remedies for breach of contract.”¹³³

The Fund's failure to satisfy the legal elements of a cause of action in conversion, along with courts' reluctance to recognize tort claims arising out of breaches of contract, precludes the availability of any of the conversion damages set forth in Figure 3.1. Under the factual circumstances of the Google hypothetical, the majority of courts instead would apply more commonly accepted and legally supportable breach of contract principles. The following section begins with a discussion of the taxonomy of interests protected by contract law's remedial framework, followed by an analysis of the two prevailing breach of contract remedial regimes—specific performance and expectation damages.

B. Contract Law's Remedial Framework: The Protection of the Expectation, Reliance and Restitution Interests Through Specific and Substitutional Relief

Contract law's remedial framework focuses on three distinct interests.¹³⁴ The first, the expectation interest, protects the expected value the contract would have had to the aggrieved party had the contract not been breached.¹³⁵ This interest protects the non-breaching party's expectation of

the stock's value at the time of the conversion, or its highest intermediate value between notice of the conversion and a reasonable time thereafter. *Id.* at 210. *But see* *Hermanowski v. Acton Corp.*, 580 F. Supp. 140, 145 (E.D.N.Y. 1983) (holding that the measure of damages for breach of a stock option agreement is the difference between the option price and the market value of the stock on the date of the breach).

The facts of the *Palomar* case differ from the Google hypothetical. In particular, the defendant in *Palomar* continued to pay the financial consultation costs to the plaintiff. It was based on this mitigating fact that the Court found that the plaintiff was justified in assuming that the defendant would honor its obligation. *Palomar*, 982 F. Supp. at 211. In the Google hypothetical, the Fund never paid any consideration for the opportunity to invest in Google and, therefore, had no reason to rely on the Manager's presentation of the Google opportunity.

133. *Lazar*, 909 P.2d at 991; *see also* *Hunter v. Up-Right, Inc.*, 864 P.2d 88, 89 (Cal. 1993) (holding that a “wrongful termination of employment ordinarily does not give rise to a cause of action for fraud or deceit, even if some misrepresentation is made in the course of the employee's dismissal.”); *Foley v. Interactive Data Corp.*, 765 P.2d 373, 380 (Cal. 1988) (declining to expand availability of tort remedies for breach of contract). In *Hunter*, Charles Hunter (the plaintiff) sued his former employer, Up-Right, Inc., for fraud. Hunter alleged that Up-Right had induced him to resign by falsely claiming that it was going to discontinue his position. *Hunter*, 864 P.2d at 89. The Court precluded a recovery for fraud because “the result of Up-Right's misrepresentation [was] indistinguishable from an ordinary constructive wrongful termination.” *Id.* at 93. Thus, the Court premised its ruling on the theory that tort recovery is available only if the plaintiff can establish the existence of fraud separate from the termination of the employment contract. *Id.* at 94.

134. *See* Avery Katz, *Reflections on Fuller and Perdue's The Reliance Interest in Contract Damages: A Positive Economic Framework*, 21 U. MICH. J.L. REFORM 541, 542-45 (1988) (suggesting a model of analyzing contract law's remedial framework using a backward- and forward-looking, and promisee- and promisor-based approach, in which a fourth interest would exist).

135. *See* RESTATEMENT (SECOND) OF CONTRACTS § 347 cmt. b (1981) (“Where the

profit by awarding to such party the “benefit of the bargain.”¹³⁶

The second interest that the remedial framework protects is the reliance interest.¹³⁷ The reliance principle holds that damages should place the plaintiff in the position it would have occupied had the contract never been made.¹³⁸ The reliance interest includes both the costs that the injured party has borne in performance, or in preparation for performance, of the contract, and incidental costs incurred in preparation for collateral transactions.¹³⁹ Unlike expectation damages, reliance damages do not account for the non-breaching party's lost profits as a result of the breach.¹⁴⁰

injured party's expected advantage consists largely or exclusively of the realization of profit, it may be possible to express this loss in value in terms of money with some assurance.”)

136. *See id.* § 347 (defining expectation damages as: “(a) the loss in value to [the injured party] of the other party's performance caused by its failure or deficiency, plus (b) any other loss, including incidental or consequential loss, caused by the breach, less (c) any cost or other loss that [the injured party] has avoided by not having to perform”); FARNSWORTH, *supra* note 129, § 12.1, at 149-50 (distinguishing the two types of reliance interest: essential reliance, which is reliance that “consists of preparation for and performance under the contract in question”; and incidental reliance, which “consists of preparations for collateral transactions that a party plans to carry out when the contract in question is performed”); W. David Slawson, *Why Expectation Damages for Breach of Contract Must be the Norm: A Refutation of the Fuller and Perdue “Three Interests” Thesis*, 81 NEB. L. REV. 839, 848 (2003) (explaining that the rationale behind expectation damages is to give the injured party (1) the value of his bargain in every case, and (2) the value of his property in the contract).

137. *See generally* 3 FARNSWORTH, *supra* note 129, § 12.1, at 149-50 (providing overview and examples of reliance interest).

138. *Id.* at 149; Katz, *supra* note 134, at 543.

139. *See* 3 FARNSWORTH, *supra* note 129, § 12.1, at 149-50 (distinguishing reliance in preparation of contract performance and reliance in preparation for collateral transactions); *see also* L.L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages*, 46 YALE L.J. 52, 78 (1936) (explaining the differences between natural expenses, or incidental reliance, and necessary expenses, or essential reliance).

140. 3 FARNSWORTH, *supra* note 129, § 12.1, at 150. *But see* Booker v. Ralston Purina Co., 699 F.2d 334, 336 (6th Cir. 1983) (finding no merit in the argument “that we allow damages based on some concept of foregone opportunity”); RESTATEMENT (SECOND) OF CONTRACTS § 347 cmt. b (noting that lost profits “may be precluded by the limitation of certainty” when calculating expectation damages).

A court applying the principles of reliance interest in the Google hypothetical would likely find that the Fund was not injured by the breach of contract, because the Fund bore no costs in performance, or in preparation for performance, of its contract with the Manager. According to the contract, the Fund was not required to pay the Manager any advanced consideration for the identification of investment opportunities, and thereby avoided any costs in preparation for performance. Instead, the Fund was required to pay the Manager a fee of two percent of any amount the Fund invested in an opportunity identified by the Manager. The Fund's payment of the two percent fee necessarily would take place *after* the Fund co-invested with the Manager in an investment opportunity. Apart from the fund's failure to incur costs in preparation for performance, the Fund bore no costs in actual performance of the contract.

Despite its failure to incur costs in connection with the contract, the Fund could argue that, in reliance on the contract, it forewent opportunities to enter into contracts with other managers. This argument likely would not withstand scrutiny for two reasons. First, the Fund had no reasonable basis for relying on the Manager given the non-exclusive nature of their contractual agreement. Second, even to the extent parties rely on each other to the exclusion of other contracting opportunities, courts typically do not award reliance damages in connection with foregone opportunities to enter into other contracts. *See* 3 FARNSWORTH,

The third, and final, interest protected by contract law's remedial framework is the restitution interest.¹⁴¹ While both the expectation and reliance interests focus on placing the non-breaching party at some level of pre-contractual welfare, the restitution interest attempts to place the breaching party in its pre-contractual position by having the breaching party disgorge whatever benefit it received from the breach.¹⁴² Thus, the goal of restitution damages is to prevent the breaching party's unjust enrichment.¹⁴³ As such, this measure of recovery is based on the defendant's gain rather than the plaintiff's loss.¹⁴⁴ The restitution interest includes neither the injured party's lost profits nor its expenditures, essential or incidental, in reliance on the contracted performance.¹⁴⁵

Several normative arguments dominate the debate over the propriety of expectation, reliance and restitutionary damages for breaches of contract. Although an exploration of these normative arguments is beyond the scope of this Article, the arguments generally reflect concerns over, *inter alia*, efficiency, the achievement of full compensation, proof of loss, morality and the desirability of a fault-based damages regime.¹⁴⁶ Notwithstanding the normative debate, the doctrinal focus reflected in the case law has been on protecting an injured party's expectation interest, particularly in the context of commercial bargains.¹⁴⁷

supra note 129, § 12.1, at 150 (explaining that courts are unwilling to expand reliance interest to include lost investment opportunities due to the unreliable and predictive nature of the damage calculation).

141. 3 FARNSWORTH, *supra* note 129, § 12.1, at 150-51.

142. *Id.*

143. *Id.* See generally Douglas Laycock, *The Scope and Significance of Restitution*, 67 TEX. L. REV. 1277, 1278 (1989) (offering a conceptual and practical overview of restitution damages).

144. Laycock, *supra* note 143, at 1279.

145. 3 FARNSWORTH, *supra* note 129, § 12.1, at 151. In the Google hypothetical, in not paying any advanced consideration to the Manager for the identification of investment opportunities, the Fund did not confer a benefit on the Manager that must be disgorged.

146. See generally George M. Cohen, *Finding Fault with Wonnell's "Two Contractual Wrongs"*, 38 SAN DIEGO L. REV. 137, 167 (2001) (discussing moral implications of expectation and reliance damages and providing a theoretical justification for a fault-based damages regime); Fuller & Perdue, Jr., *supra* note 139, at 60 (explaining how the reliance measure provides as great a recovery as the expectation measure when lost opportunities are taken into account); Laycock, *supra* note 143, at 1293 (arguing for the practical significance of the restitution remedy "when unjust enrichment is the only basis of substantive liability, when defendant's gain exceeds plaintiff's provable loss, or when plaintiff desires the property in kind or its proceeds"); Slawson, *supra* note 136, at 862 (arguing that the expectation measure meets the needs of a modern market economy); Ulen, *supra* note 64, at 363 (maintaining that from an efficiency standpoint expectation damages are viewed as superior to other measures of damages).

147. Scholars have explained this doctrinal focus on several theoretical grounds. Among the theoretical arguments offered in support of the desirability of the expectancy interest over the reliance and restitution interests as a damages measurement are the expectancy interest's achievement of contract law's goal of full compensation, its strong theoretical justification for a fault-based damages regime and its superiority from an efficiency standpoint. See, e.g., Cohen, *supra* note 146, at 151 (explaining why expectation damages

Contract law acknowledges two judicial methods for the protection of the expectation interest. The breaching party must either perform under the terms of the contract or pay money damages, thereby enabling the injured party to purchase a substitute performance or replace lost gains that performance would have rendered.¹⁴⁸ These judicial remedies can be classified as “specific” or “substitutional,” respectively.¹⁴⁹

C. *Specific Performance—Specific Relief*

1. *The legal framework of specific performance—The “adequacy test”*

The doctrine of specific performance “reflect[s] the principle . . . that the law should compel parties specifically to perform their contractual obligations.”¹⁵⁰ An award of specific performance is intended to protect the non-breaching party's expectation interest by putting the non-breaching party in the position it would have occupied had the contract not been breached.¹⁵¹ Courts award specific performance on a discretionary basis and only in extraordinary circumstances.¹⁵² As the late E. Allan Farnsworth stated, “[o]ur system of contract remedies is not directed at *compulsion of promisors to prevent breach*; it is aimed, instead, at *relief to*

are superior to reliance damages in deterring opportunistic contract breaches); Katz, *supra* note 134, at 543 (noting continued dominance of expectation interest in commercial transactions); Slawson, *supra* note 136, at 862 (arguing that the expectation interest is the only acceptable means of measuring damages from an institutional perspective); Ulen, *supra* note 64, at 362 (discussing how expectation interest may lessen informational asymmetries between contracting parties). Although each of the reliance, restitution and expectation interests serves a distinct remedial purpose, the remedial outcome under any of them (under the same set of facts) often is the same. See Katz, *supra* note 134, at 542 (explaining how the economic relationships of the competing damage principles “can be used, under the appropriate circumstances, as an approximate measure for the others”).

148. Deepa Varadarajan, Note, *Tortious Interference and the Law of Contract: The Case for Specific Performance Revisited*, 111 YALE L.J. 735, 737 (2001).

149. See 3 FARNSWORTH, *supra* note 129, § 12.2, at 152 (distinguishing between substitutional relief, which gives the injured party a replacement for the contracted performance in the form of money damages, and specific relief, which gives the injured party the exact performance that was promised under the contract).

150. John M. Catalano, *More Fiction than Fact: The Perceived Differences in the Application of Specific Performance under the United Nations Convention on Contracts for the International Sale of Goods*, 71 TUL. L. REV. 1807, 1818 (1997) (quoting JOHN O. HONNOLD, UNIFORM LAW FOR INTENTIONAL SALES UNDER THE 1980 UNITED NATIONS CONVENTION 300 (1987) and discussing the interpretation of the Convention in light of its underlying principles and its legislative history).

151. RESTATEMENT (SECOND) OF CONTRACTS § 357 cmt. a (1981); see 3 FARNSWORTH, *supra* note 129, § 12.4, at 158 (“specific relief is plainly better suited to the objective of putting the promisee in the position in which it would have been had the promise been performed”).

152. See RESTATEMENT (SECOND) OF CONTRACTS § 371 cmt. a (noting that specific performance is seldomly granted). The common law courts generally did not grant specific relief in breach of contract cases. 3 FARNSWORTH, *supra* note 129, § 12.4, at 158. At common law, the usual form of relief was substitutional in the form of an award of monetary damages. *Id.*

promisees to redress breach."¹⁵³

Derived from a court's powers in equity, specific performance is available to an injured party when money damages cannot compensate such party for the loss resulting from the breach.¹⁵⁴ In determining whether money damages are adequate, a court will consider: (1) the difficulty of proving monetary damages with reasonable certainty; (2) the difficulty of arranging a substitute performance by means of an award of monetary damages; and (3) the likelihood that the breaching party will fail to pay monetary damages to the injured party.¹⁵⁵ These three inquiries comprise the "adequacy test" and inform the analysis of the applicability of specific performance in the Google hypothetical.¹⁵⁶

The substitutability inquiry is particularly noteworthy because it comprises the primary consideration of the "adequacy test." This inquiry considers whether the procurement of a substitute performance through an award of monetary damages is commercially practicable.¹⁵⁷ In those instances where the arrangement of a substitute transaction is impracticable, courts typically award specific performance. Most courts consider obtaining a replacement performance for a transaction involving a "unique" good to be impracticable.¹⁵⁸ "Unique" means that a court cannot obtain, at a reasonable cost, sufficient information about reasonable substitute transactions to calculate an appropriate award of damages without imposing an excessively high risk of under-compensation on the injured party.¹⁵⁹ The case law identifies the paradigmatic "unique" goods

153. 3 FARNSWORTH, *supra* note 129, § 12.1, at 146-47.

154. *See, e.g.,* Am. Brands, Inc. v. Playgirl, Inc., 498 F.2d 947, 950 (2d Cir. 1974) (affirming denial of specific relief because plaintiff failed to establish that "it cannot be made whole by monetary relief"); RESTATEMENT (SECOND) OF CONTRACTS § 359 cmt. a (advising the denial of equitable relief when monetary damages are sufficient).

155. RESTATEMENT (SECOND) OF CONTRACTS § 360.

156. *See* 3 FARNSWORTH, *supra* note 129, § 12.6, at 167-76 (noting historical development of the adequacy test and discussing contemporary application of the three-part judicial inquiry).

157. *See* RESTATEMENT (SECOND) OF CONTRACTS § 360 cmt. c ("If the injured party can readily procure by the use of money a suitable substitute for the promised performance, the damage remedy is ordinarily adequate."); Subha Narasimhan, *Modification: The Self-Help Specific Performance Remedy*, 97 YALE L.J. 61, 71 (1987) (explaining that monetary damages are inadequate if the contract goods cannot be purchased in a substitute transaction); *see also* Paul G. Mahoney, *Contract Remedies and Options Pricing*, 24 J. LEGAL STUD. 139, 154 (1995) (noting that specific performance will likely be granted if the market for the contract good is "sporadic" or "inefficient"). The availability of a substitute transaction also affords a basis for proving monetary damages with reasonable certainty, thereby obviating the inquiry with respect to the first prong of the "adequacy test." RESTATEMENT (SECOND) OF CONTRACTS § 360 cmt. c.

158. *See id.* (noting that it may be "impracticable" to purchase a substitute of a unique good); Mahoney, *supra* note 157, at 154 (arguing that the specific performance is necessary in cases of unique goods because the market for such items is thin or largely speculative); Narasimhan, *supra* note 157, at 71 (explaining that money damages are inadequate for unique goods because the injured parties cannot obtain the goods elsewhere).

159. *See* RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 132 (5th ed., 1998) ("it is

as real property and certain items of personal property, such as heirlooms, race horses, antiques and works of art.¹⁶⁰ Because the market for these items is “thin, sporadic, and inefficient, which is a substantial departure from the assumption of marketability” underlying substitutional relief theory, the non-breaching party's inability to acquire a substitute performance, or “cover,” in cases involving “unique” goods indicates the aptness of an award of specific performance.¹⁶¹

2. *The application of specific performance to stock cases*

The Restatement (Second) of Contracts states that transfers of shares of stock in a corporation may qualify for specific relief if the shares are not publicly-traded or otherwise available.¹⁶² The Restatement's interpretation of specific performance considers the inability of a party to arrange a readily-ascertainable proxy for non-publicly traded stock as evidence of the propriety of specific relief.¹⁶³ Consistent with the Restatement's view, courts have specifically enforced contracts where the breaching party failed to deliver securities that were not publicly-traded.¹⁶⁴ For instance, in *Dominick v. Vassar*,¹⁶⁵ two co-equal owners of stock in a closely-held corporation, E.L. Dominick, Jr. (“Dominick”) and John Vassar (“Vassar”),

possible to obtain injunctive relief upon a showing that your damages remedy would be inadequate, for example because your damages cannot be computed with reasonable accuracy”); see also Anthony T. Kronman, *Specific Performance*, 45 U. CHI. L. REV. 351, 363-64 (1978) (arguing that if a good lacks a well-developed market from which the court can reliably calculate damages, there is a substantial risk that the court will undercompensate the injured party). U.C.C. § 2-716(1) permits specific performance where goods are unique or in “other proper circumstances.” U.C.C. § 2-716 (2000). Comments to the U.C.C. note that the “inability to cover is strong evidence of other proper circumstances.” *Id.* (quotation omitted).

160. Mahoney, *supra* note 157, at 154; see 3 SAMUEL WILLISTON, WILLISTON ON SALES § 25-46, at 698 (5th ed. 1994) (discussing cases relating to disputes over artworks, heirlooms and vessels).

161. Mahoney, *supra* note 157, at 154; see U.C.C. § 2-716, cmt. 2 (recommending specific performance when the buyer is unable to cover); RESTATEMENT (SECOND) OF CONTRACTS § 360 (arguing that the damage remedy is inadequate for unique goods); Narasimhan, *supra* note 157, at 71 (noting that courts traditionally inquire about a good's uniqueness in determining the availability of a substitute market transaction).

162. See RESTATEMENT (SECOND) OF CONTRACTS § 360 cmt. c (noting that damages may be inadequate when “[s]hares of stock in a corporation may not be obtainable elsewhere”).

163. See *id.* (“If goods are unique in kind, quality or personal association, the purchase of an equivalent elsewhere may be impracticable, and the buyer's inability to cover is strong evidence of the propriety of granting specific performance.” (quoting U.C.C. § 2-716, cmt. 2 (2000))).

164. See *Brown v. Knox*, 361 N.W.2d 540, 543 (Neb. 1985) (“[C]ontracts for acquisition of shares of a closely held family corporation, which stock is not obtainable in the open market, are proper subjects for specific performance.”); *Chadwell v. English*, 652 P.2d 310, 314 (Okla. 1982) (affirming decision to grant specific performance of a contract to sell stock that “existed in extremely low volume, was not traded in a ready market, and was seldom exchanged”).

165. 367 S.E.2d 487 (Va. 1988).

entered into a stock option purchase agreement.¹⁶⁶ The parties agreed that the surviving stockholder would have the right to purchase the decedent stockholder's shares at book value within ninety days of the decedent stockholder's death.¹⁶⁷ When Vassar died, his wife refused to tender his shares to Dominick.¹⁶⁸ Noting that "the stock [was] not readily purchasable in the market and its pecuniary value [was] uncertain and not easily ascertainable,"¹⁶⁹ the Court specifically enforced the share purchase agreement by ordering Vassar's wife to tender Vassar's stock in the closely-held corporation to Dominick.¹⁷⁰

Similarly, in *Medcom Holding Co. v. Baxter Travenol Laboratories*,¹⁷¹ a dispute originated out of a stock purchase agreement between Medcom Holding Co. ("Holding") and Baxter Travenol Laboratories ("Baxter"), in which Holding agreed to purchase all of the stock in Baxter's subsidiary, Medcom.¹⁷² The stock purchase agreement listed Medcom's assets, including a \$10,000 investment in Entertainment Partners, Inc. ("EPI").¹⁷³ Baxter failed to convey any of the EPI stock to Holding at the closing.¹⁷⁴ The Seventh Circuit contemplated whether specific performance would be an appropriate remedy for Baxter's breach of the agreement regarding EPI.¹⁷⁵ Emphasizing that EPI's stock was not publicly-traded, the Court specifically enforced the contract and ordered the stock's delivery "on the ground that valuation is imprecise without an active market for the stock."¹⁷⁶

In light of the non-public nature of stock in venture-financed companies, both the Restatement's discussion of specific performance and the *Vassar/Medcom* cases point to the potential availability of specific relief in the Google hypothetical. The following section sets forth the theoretical framework of specific performance and considers the remedy's application to the facts of the Google hypothetical.

3. *The application of specific performance to the Google hypothetical*

Notwithstanding the legal limitations reflected in the "adequacy test," a

166. *Id.* at 488.

167. *Id.*

168. *Id.* at 488-89.

169. *Id.* at 489-90 (quoting *Fanney v. Inv. Corp.*, 107 S.E.2d 414, 421 (Va. 1959)).

170. *Id.* at 490.

171. 984 F.2d 223 (7th Cir. 1993).

172. *Id.* at 225.

173. *Id.* at 225-26.

174. *Id.* at 226.

175. *See id.* at 227 (noting that "[u]nlike contract construction," specific performance is an equitable determination that will be reversed only for abuse of discretion).

176. *Id.* at 227; *see also* *Owen v. Merts*, 405 S.W.2d 273, 279-80 (Ark. 1966) (holding that appellants were entitled to specific performance of contract for shares of stock because shares were unique and not available on the market).

delay in litigation may limit specific performance's availability, even if the market for the good in question is scarce.¹⁷⁷ Theoretical considerations mitigate against the application of specific relief when there has been a delay in litigation (*i.e.*, the remedial course of action sought is no longer congruous with the circumstances as they existed at the time of the breach).¹⁷⁸ Hypothetically, suppose that two parties (Party A and Party B) entered into a contract pursuant to which Party A agreed to present to Party B the option to purchase tickets for the Yankees/Braves World Series games in 1999. If Party A failed to present to Party B that option and Party B sued *after* the completion of the World Series games, it would be impossible for a court to compel Party A to specifically perform the contract.¹⁷⁹ As noted above, the goal of specific performance is to protect a non-breaching party's expectation interest by tendering to that party the exact performance promised in the contract.¹⁸⁰ The World Series example indicates that a lapse of time may result in a court's inability to compel the promisor's delivery of the contracted performance, and failure to protect the promisee's expectancy interest.¹⁸¹

177. *See Bander v. Grossman*, 611 N.Y.S.2d 985, 990 (App. Div. 1994) (“[W]ith a greater delay, where a defendant has changed position or taken any economic risk, the court may conclude that ‘the plaintiff will lose nothing but an unanticipated opportunity to gather a windfall.’” (citing *Concert Radio v. GAF Corp.*, 488 N.Y.S.2d 696, 700 (App. Div. 1985))).

178. *See In re J.P. Morgan Chase & Co. Shareholder Litig.*, No. 531-N, 2005 WL 1076069, at *12 (Del. Ch. Apr. 29, 2005) (noting that because plaintiffs failed to act promptly to preserve equitable remedies “the ‘eggs’ have been irretrievably ‘scrambled’ and there is no possibility of effective equitable relief”).

179. *See Bander*, 611 N.Y.S.2d at 990 (“With the passage of time, specific performance becomes disfavored [B]ecause goods are subject to a rapid change in condition, or the cost of maintenance of the goods is important, time may be found to have been of the essence, and even a month’s delay may defeat specific performance” (citing *Ziebarth v. Kalenze*, 238 N.W.2d 261 (N.D. 1976); *Putnam Ranches, Inc. v. Corkle*, 203 N.W.2d 502 (Neb. 1973))).

180. *See* RESTATEMENT (SECOND) OF CONTRACTS § 359(1) (1981) (noting that specific performance is appropriate when money damages would be inadequate to protect the “expectation interest of the injured party”).

181. The Fund’s delay in bringing suit made specific performance an unsuitable remedy for the Manager’s breach because of the availability of an ascertainable market replacement for the Fund’s diverted Google shares at the time of the hypothetical litigation. Assuming that the Fund had brought suit when the Google shares remained privately-held, a stronger argument could be made for an award of specific performance. This is because monetary damages might not enable the Fund to readily purchase substitute Google shares on the market. However, the longer the elapsed period of time between the lawsuit and the breach, the less likely courts are to award specific performance, even if the market for the goods is scarce. *See Narasimhan, supra* note 157, at 69 (“The option of suing for specific performance is thus untenable where there is a significant delay in litigation.”). The concern is that parties, like the Fund, would unfairly receive windfalls.

For example, in December 2000, when the Manager made a second investment in Google, the Fund’s four percent allocable ownership interest (\$2.5 million) in Google would have been worth \$20.267 million. If a court had awarded specific performance to the Fund in December 2000, the Fund would have received \$20.267 million worth of Google shares in exchange for a contract price of \$2.5 million. Additionally, if a court had awarded specific

The Google hypothetical illustrates both the legal and theoretical inaptness of specific relief where there has been a delay in litigation. From a legal standpoint, by the time of the Fund's lawsuit, Google's shares were traded publicly.¹⁸² Therefore, unlike the stock at issue in *Vassar* and *Medcom*, the Google stock failed to meet the "uniqueness" requirement for specific performance set forth in the "adequacy test."¹⁸³ Consistent with the Restatement's discussion of specific performance, the availability of Google shares on the public market at the time of the Fund's lawsuit indicates the commercial practicability of a substitute transaction.¹⁸⁴

Even assuming *arguendo* that the Fund could argue for the commercial impracticability of a market substitute on the basis of the difficulty of acquiring a full four percent ownership interest in the company when only 7.23% of Google's shares had been issued as part of the IPO, the Manager's inability to deliver the contracted performance to the Fund points to the theoretical inaptness of specific relief in the Google hypothetical.¹⁸⁵ The Manager was contractually obligated to present to the Fund the opportunity

performance immediately before the IPO, the Fund would have received \$924 million worth of Google shares in exchange for its \$2.5 million investment. These windfalls suggest that specific performance should only be available for a short period after the breach when the contract price of the investment still closely approximates the market value of the investment. *See* *Scully v. US WATS, Inc.*, 238 F.3d 497, 509 (3d Cir. 2001) (noting that if stock valuation was based on a time period significantly after the breach, the injured party would possess "the benefit of hindsight"); *Tamari v. Bache & Co.*, 838 F.2d 904, 907 (7th Cir. 1988) (arguing against damage measures that allow injured parties to calculate lost profits on the basis of a high stock value that occurred after the date of breach); *see also* *Miller v. Bloomberg*, 466 N.E.2d 1342, 1348 (Ill. App. Ct. 1984) (denying specific performance where property had appreciated during two-and-one-half-year delay); *Hawks v. Sparks*, 133 S.E.2d 536, 540 (Va. 1963) (denying specific performance where property had appreciated during five-year delay).

182. *See* Google Prospectus, *supra* note 2, at 2 (outlining Google's initial public offering on August 18, 2004).

183. *See* *Lucente v. Int'l Bus. Mach. Corp.*, 310 F.3d 243, 262-63 (2d Cir. 2002) (dismissing plaintiffs' specific performance argument for IBM stock options on the grounds that "[t]here is simply no reason why, assuming a jury finds IBM liable for breach of contract, money damages would not adequately compensate Lucente"); *see also* *Simon v. Electrospace (Electrospace)*, 269 N.E.2d 21, 26 (N.Y. 1971) (noting that specific performance is not appropriate where the claim involves publicly-traded stock).

184. *See* RESTATEMENT (SECOND) OF CONTRACTS § 360 cmt. c ("Entering into a substitute transaction is generally a more efficient way to prevent injury than is a suit for specific performance . . ."). The availability of a substitute transaction also affords a basis for proving monetary damages with reasonable certainty and thereby diminishes the relevance of the remedy of specific performance. *Id.*

185. The Fund might argue that although some Google shares were technically available on the market as of the date of its IPO, the Google shares were not practically available to the Fund (or any other investor) to the extent of the four percent block needed by the Fund to acquire the number of shares that had been withheld from the Fund by the Manager. The Fund might also argue that it would have been exceedingly difficult, if not impossible, for any investor to acquire the four percent ownership interest, especially since Google issued 19.6 million shares as part of its IPO and those shares represented only approximately 7.23% of the company. Google Prospectus, *supra* note 2, at 2. In other words, the Fund would have had to purchase fifty-five percent of the shares that were issued as part of the IPO in order to acquire a four percent ownership interest.

to invest in Google, a nascent company seeking venture capital investors in 1999. That opportunity, which only existed in 1999, could not be replicated by a court in 2004 given Google's dramatic growth in the intervening period.¹⁸⁶ The passage of more than five years between the date of the breach and the date of the lawsuit simply eliminates any possibility of reproducing the facts and circumstances surrounding the 1999 Google investment opportunity.¹⁸⁷

In summary, the legal limitations of the “adequacy test,” as well as the theoretical framework of specific performance, point to the impropriety of specific relief under the facts of the Google hypothetical. The following section discusses substitutional relief theory and considers its application to the Google hypothetical.

D. *Expectation Damages—Substitutional Relief*

Rather than compelling parties to perform their contracts, the remedial framework of contract law historically has been directed at providing substitutional relief to non-breaching parties through an award of monetary damages.¹⁸⁸ Underlying the historic preference for substitutional relief is the rationale that the system of free enterprise and the market economy enable an injured party to procure a substitute transaction through an award of monetary damages.¹⁸⁹

1. *The legal framework for expectation damages*

The rule of law for calculating expectation damages is well-settled. That rule was explained by the New York Court of Appeals in *Simon v. Electrospace*.¹⁹⁰ The Court held that “[t]he proper measure of damages for breach of contract is determined by the loss sustained or gain prevented *at the time and place of breach*.”¹⁹¹ Applying that rule of law to breaches of stock or stock option agreements, the *Electrospace* Court calculated

186. Granting specific performance now would be like ordering a casino to pay out a roulette bet after the roulette wheel stopped spinning, because the casino had denied a gambler an opportunity to bet and the gambler claims he would have bet on the winning number or color.

187. As evidenced by the remarkable ascent in the value of Google after the Manager's initial venture capital investment, the same opportunity to invest \$2.5 million in exchange for a four percent ownership interest in Google no longer existed. In fact, a four percent ownership interest in Google at the time of the Fund's lawsuit was worth approximately \$2 billion. This limitation is in addition to the fact that the Manager had already sold the Google investment when the Fund sued, thereby precluding it from turning over fifty percent of its shares to the Fund.

188. See 3 FARNSWORTH, *supra* note 129, § 12.1, at 146-47 (discussing why contract law focuses on redressing breaches rather than preventing breaches).

189. See *id.* § 12.4, at 160-61 (noting that market proponents encouraged the development of the adequacy test).

190. 269 N.E.2d 21 (N.Y. 1971).

191. *Id.* at 26 (emphasis added) (citation omitted).

damages by taking the difference between the contract (or option) price of the stock and the market value of the stock on the date of the breach.¹⁹² Although the *Electrospace* case involved a breach of a contract to pay a commission to a finder of business opportunities, the Court explicitly noted that the expectancy formula for damages applied to breaches of contract involving the non-delivery of shares of stock.¹⁹³

A number of courts have applied the expectancy formula for damages in cases involving breaches of stock or stock option agreements.¹⁹⁴ Of particular note in this regard is the Third Circuit's decision in *Scully v. US WATS, Inc.*¹⁹⁵ In *Scully*, US WATS, Inc., a telecommunications carrier, granted Mark Scully, its president and chief operations officer, the option to purchase 850,000 shares of restricted company stock vesting over a two-year period.¹⁹⁶ The restriction provided that upon exercise of the option, Scully could not transfer the stock for a period of up to one year from the date of exercise.¹⁹⁷ When Scully attempted to exercise the option, US WATS, Inc. refused to honor his request.¹⁹⁸ Although Scully argued that his damages should be calculated from the expiration of the applicable restricted periods of the shares, the Third Circuit instead followed the *Electrospace* Court by measuring Scully's damages from the date of the breach (*i.e.*, when Scully attempted to exercise his stock option).¹⁹⁹ According to the *Scully* Court, using any other measurement would unfairly

192. *Id.* at 26-27; *see also* *Scully v. US WATS, Inc.*, 238 F.3d 497, 510 (3d Cir. 2001) (comparing the *Electrospace* court's contract theory of damage with a conversion theory of damage); 3 FARNSWORTH, *supra* note 129, § 12.12, at 227-31 (discussing market price formulas).

193. *Electrospace*, 269 N.E.2d at 26.

194. *See* *Oscar Gruss & Son, Inc. v. Hollander*, 337 F.3d 186, 196-97 (2d Cir. 2002) (rejecting the use of the conversion measure of damages in breach of contract cases and holding that damages for breaches of contract should place the plaintiff in the same position he would have occupied had the contract been performed); *Lucente v. Int'l Bus. Mach. Corp.*, 310 F.3d 243, 262-63 (2d Cir. 2002) (holding that the district court "ignored binding precedent" by calculating damages under a conversion measure rather than the breach of contract measure); *Hermanowski v. Acton Corp.*, 729 F.2d 921, 922 (2d Cir. 1984) (affirming that damages in a breach of contract action involving stock options should be measured as of the date of the breach); *Boyce v. Soundview Tech. Group, Inc.*, No. 03-2159, 2004 U.S. Dist. LEXIS 20635, at *4 (S.D.N.Y. Oct. 13, 2004) (stating that in a breach of contract action, damages should be calculated from the date of the breach); *Aroneck v. Atkin*, 456 N.Y.S.2d 558, 559 (App. Div. 1982) ("[D]amages for defendants' breach of contract to purchase plaintiffs' stock . . . [are computed] by ascertaining the difference between the agreed price of the shares and the fair market value at the time of the breach . . ."); *see also* *Arlington State Bank v. Colvin*, 545 N.E.2d 572, 575 (Ind. Ct. App. 1989) (holding that the measure of damages for a vendor's failure to convey land in breach of a right of first refusal is the difference between the contract price and the market value of the land at the time of the breach).

195. *Scully*, 238 F.3d 497.

196. *Id.* at 503.

197. *Id.*

198. *Id.* at 504.

199. *Id.* at 508.

give a party the benefit of hindsight and the ability to monitor the fluctuations of the market to then “cherry-pick” a date yielding the most advantageous damages outcome.²⁰⁰ The Court further explained its holding by noting that while Scully's stock option reduced his risk of loss and increased his opportunity for profit, it neither eliminated all risk, nor guaranteed a profit.²⁰¹ Accordingly, the Court refused to grant to Scully, on an *ex post* basis, an investment free of any risk of market downturn.²⁰² By measuring Scully's damages from the date of the breach, the *Scully* Court expressed a distinct preference for the *ex ante* calculation of damages in breach of contract cases.²⁰³

The application of the expectancy formula of damages to the Google hypothetical requires the determination of both the “contract price” and the “market value” of the Google stock on the date of the breach (June 1999). The following sections address: (1) the meaning of these terms in the context of venture capital investment and (2) their specific application to the Google hypothetical.

2. *Calculating expectation damages*

The contract price of stock typically is explicitly set forth in the parties' agreement, and as such, is easily identifiable.²⁰⁴ The determination of market value, on the other hand, requires a more sophisticated analysis. As a general proposition, fair market value is the price at which property would change hands in a transaction between a willing buyer and a willing seller, neither being forced to buy or sell and both having a reasonable knowledge of relevant facts.²⁰⁵

200. *See id.* at 509 (noting that with the benefit of hindsight the plaintiff could place himself in a better position than if no breach of contract had occurred); *see also* Tamari v. Bache & Co., 838 F.2d 904, 907 (7th Cir. 1988) (arguing that the conversion measure of damages “is a generous—maybe too generous—measure of damages; it assumes that the customer would have had the clairvoyance to sell when the stock hit its peak during the relevant period, and by so assuming systematically overcompensates defrauded investors”). In the *Scully* Appellee/Cross Appellant's Principal Brief, Scully argued that while measuring damages from the date he proposed did in fact result in a higher award to him, if the stock had fallen during the restricted period, he would have received a lower damages award. Appellee/Cross Appellant's Principal Brief at 25, *Scully v. US WATS, Inc.*, 238 F.3d 497 (3d Cir. 2001) (Nos. 99-1590, 99-1653), *available at* 2000 WL 34004909. Scully argued that measuring damages as of the end of the restricted periods of the shares did not result in any windfall to him. *Id.* It merely compensated him for what he actually lost by acknowledging what occurred to the value of the stock during the interim period. *Id.*

201. *Scully*, 238 F.3d at 513.

202. *Id.*

203. *See id.* at 512 (noting that Scully's request to determine damages at the expiration of the restricted holding period is “contrary to the general rule that damages for a breach of contract are determined on the breach date”).

204. *See id.* at 508 (using the stock option's exercise price as the contract price).

205. *United States v. Cartwright*, 411 U.S. 546, 551 (1973); *Arc Realty Co. v. Comm'r*, 295 F.2d 98, 103 (8th Cir. 1961) (“The question of ‘fair market value,’ [is] defined [as] ‘the price at which property would change hands in a transaction between a willing buyer and a

Courts have employed this analysis of market value in resolving valuation issues for complex merger and tax disputes.²⁰⁶ Unlike publicly-traded stock whose trading price serves as a readily-ascertainable proxy for its market value, no such proxy for market value is available for privately-held stock, including stock in venture-financed companies.²⁰⁷ Applying the valuation analysis described above, the Southern District of New York, in *Boyce v. Soundview Tech. Group, Inc.*,²⁰⁸ instructed the jury on how to determine the market value of the plaintiff's stock options on the date of the breach.²⁰⁹ The Court stated that "the sale price for the same asset, sold close to the time of the asset being valued, if it is the result of arm's length negotiations, is the best evidence of fair market value."²¹⁰ The Court promulgated this standard because the stock at issue was in a private company, was not actively traded on any exchange and had no readily-available proxy for its market value.²¹¹

Venture capital companies may be valued based on their business plan and their ability to translate that plan into future growth in earnings and revenues.²¹² Admittedly, this is a vague methodology on which to base a valuation,²¹³ and "[t]here is no single formula universally applicable in

willing seller, neither being under compulsion to buy nor to sell and both being informed" (quoting *O'Malley v. Ames*, 197 F.2d 256, 257 (8th Cir. 1952)).

206. See, e.g., *Krapf v. United States*, 17 Cl. Ct. 750, 759 (Cl. Ct. 1989) (determining the fair market value of a minority interest of a common stock gifted to the University of Delaware as the price agreed upon by a knowledgeable and reasonable buyer and seller under no obligation to buy or sell), *rev'd*, 977 F.2d 1454 (Fed. Cir. 1992); *Gatlin v. Comm'r*, 44 T.C.M. (CCH) 945, 951 (T.C. 1982) (evaluating the fair market value of unlisted stock contributed to charity as the price at which it would exchange hands between a reasonable buyer and seller); *Van de Walle v. Unimation*, No. 7046, 1991 Del. Ch. LEXIS 27, at *15 (Del. Ch. Mar. 6, 1991) (explaining that fairness of merger price resulted from arms-length bargaining).

207. See, e.g., *Schonfeld v. Hilliard*, 218 F.3d 164, 178 (2d Cir. 2000) (finding that the lack of proxy for market value in privately-held stock leads to the hypothetical market standard of knowledgeable exchange between willing hands); *Boyce v. Soundview Tech. Group, Inc.*, No. 03-2159, 2004 U.S. Dist. LEXIS 20635, at *7-8 (S.D.N.Y. Oct. 13, 2004) (noting the difficulty in valuing stock if the shares are in a private company and not actively traded on any exchange).

208. *Boyce*, 2004 U.S. Dist. LEXIS 20635.

209. *Id.* at *8.

210. *Id.* at *7; see *Suitum v. Tahoe Reg'l Planning Agency*, 520 U.S. 725, 741-42 (1997) (finding that the sale price for the subject asset, if negotiated by the parties at arm's length, was the "best evidence" of its market value).

211. *Boyce*, 2004 U.S. Dist. LEXIS 20635, at *8.

212. See *Krapf v. United States*, 17 Cl. Ct. 750, 764-66 (Cl. Ct. 1989) (stating that start-up companies "usually have not experienced earnings, have not the capacity to pay dividends . . . or have a negative asset or book value in the valuation years" and "[p]otential earnings or performance of the corporation cannot be estimated without understanding the economic and organizational foundation upon which the corporation is built"); see also *Gatlin v. Comm'r*, 44 T.C.M. (CCH) 945, 951 (T.C. 1982) (holding that the value of a venture capital company is based on its concept and its ability to grow in earnings and revenues).

213. See *Krapf*, 17 Cl. Ct. at 766 ("Valuation of a venture capital corporation is a fact-intensive study of the conditions and circumstances of the corporation at the valuation

determining such value” for a venture capital company.²¹⁴ Yet, like other valuations, actual sales of stock may be, and often have been, used to guide a determination of fair market value in the venture capital context.²¹⁵ In fact, the Federal Circuit in *Okerlund v. United States*²¹⁶ asserted that “arms-length stock sales” should be used to value stock in venture capital companies whose valuation “is an inexact science (some might say an art).”²¹⁷ The fact that the sales price is negotiated by a seller seeking the highest available price and a buyer willing to pay that price after a diligent canvassing of the market supports the propriety of this valuation methodology for stock in venture capital companies.²¹⁸ Measures other than the “sales-price” measure necessarily rely on the subjective thought process of a valuation expert instead of a transaction price that “was forged in the crucible of objective market reality.”²¹⁹

Following this logic, courts generally are reluctant to consider facts that come to fruition after the sale of the stock to determine fair market value. For instance, in *Saltzman v. Commissioner*,²²⁰ a case involving assessed unpaid gift taxes, the Second Circuit stated that “subsequent events are not considered in fixing fair market value except to the extent that they were reasonably foreseeable” on the date of the donation.²²¹ The *Saltzman* analysis indicates that the valuation of stock in venture capital companies also may be accomplished “without reference to events which occur after the date” of the sale of the stock.²²² This is consistent with the *Scully* Court's refusal to calculate damages on an *ex post* basis and courts' general reluctance to rely on stock price projections to determine fair market value.²²³

date.”).

214. *Id.* at 760.

215. *See id.* (“Fair market value of unlisted stocks can be determined by examining actual sales made at arm's length in the normal course of business.”).

216. 365 F.3d 1044 (Fed. Cir. 2004).

217. *Id.* at 1052.

218. *See* Van de Walle v. Unimation, No. 7046, 1991 Del. Ch. LEXIS 27, at *50 (Del. Ch. Mar. 6, 1991) (finding that the merger price was fair because it was the result of an arms-length negotiation after an extensive canvassing of the market).

219. *Id.*; *see also* Krapf v. United States, 977 F.2d 1454, 1461 (Fed. Cir. 1992) (determining that part of “the willing-buyer/willing-seller analysis ensures that the value of the stock is realistic in light of true market conditions.”).

220. 131 F.3d 87 (2d Cir. 1997).

221. *Id.* at 93 (“[Value] depends largely on more or less certain prophecies of the future; and the value is no less real at that time if later the prophecy turns out false than when it comes out true.” (quoting Justice Holmes in *Ithaca Trust Co. v. United States*, 279 U.S. 151, 155 (1929))); *see also* Boyce v. Soundview Tech. Group, Inc., No. 03-2159, 2004 U.S. Dist. LEXIS 20635, at *5-6 (S.D.N.Y. Oct. 13, 2004) (rejecting a hypothetical damage assessment based on forward looking evidence because of its speculative and unreliable nature in determining stock prices).

222. *Saltzman*, 131 F.3d at 93 (quoting *Krapf*, 977 F.2d at 1458).

223. *Scully v. US WATS, Inc.*, 238 F.3d 497, 512-13 (3d Cir. 2001); *see Boyce*, 2004 U.S. Dist. LEXIS 20635, at *6 (“Estimates as to the potential value of a stock or predictions

3. *Expectancy as applied to the Google hypothetical*

The application of the expectancy formula of damages to the Google hypothetical requires the determination of: (1) the contract price of the Fund's allocable Google stock (had the Manager presented the opportunity to invest in Google to the Fund) and (2) the market value of what would have been the Fund's Google stock on the date of the breach. The analysis regarding the contract price of the Fund's allocable Google stock is relatively straightforward. Had the Manager offered the Fund its contractual fifty percent right of participation, the contract price of the Fund's Google investment would have been \$2.5 million (fifty percent of the Manager's \$5 million investment).

By contrast, the determination of the market value of the Google stock on the date of the breach is not as simple. Notably, Google was not a publicly-traded company on the date of the breach, and therefore, had no readily-available proxy (*i.e.* the stock's trading price) for the market value of its stock.²²⁴ However, as noted above, courts have asserted that in the absence of a traditional public market, the price investors are willing to pay for their investments in arms-length transactions reflects the market value of that investment.²²⁵ Applying the "sales-price" standard to the Google hypothetical, the market value of the Google stock on the date of the breach also would have been \$2.5 million—the price the Fund would have paid in an arms-length transaction for a four percent ownership interest in Google.²²⁶ Thus, the application of the expectancy formula (contract price (\$2.5 million)—market value on the date of the breach (\$2.5 million)) to the Google hypothetical would result in zero damages for the Fund.

Apart from the legal support for this remedial outcome based on existing law for analogous stock option cases, Part IV of this Article offers an economic-based justification for this outcome using an agency theory of monitoring costs.²²⁷ The theory of monitoring costs posits that an investor,

as to future stock prices are notoriously unreliable. Admitting market projections of . . . shares in the months following the breach as evidence would be tantamount to relying on the Farmer's Almanac predictions of rain for the upcoming harvest.”).

224. *See* *Schonfeld v. Hilliard*, 218 F.3d 164, 178 (2d Cir. 2000) (“Although it is easier to determine an asset's market value when it is actively traded on a standardized exchange or commodities market, an asset does not lose its value simply because no such market exists.” (citing JOHN D. CALAMARI & JOSEPH M. PERILLO, *THE LAW OF CONTRACTS* § 14-12 (3d ed. 1987))).

225. *See Boyce*, 2004 U.S. Dist. LEXIS 20635, at *7-8 (denying grounds for a new trial because jury was properly instructed to assess the fair market value of a stock as the sale price that resulted from arm's length negotiations).

226. *See id.* (evaluating the fair market value on the date of a breach by determining what a hypothetical willing buyer would pay for the stock on that day).

227. *See* Michele Bagella et al., *In Quest for Equity Partners: The Determinants of the Willingness to Go Public or to Find a Venture Capital Partner* 13-14 (Tor Vergata Univ., Ctr. for Int'l Studies on Econ. Growth, Working Paper No. 123, 1999), available at <http://ideas.repec.org/p/rtv/ceiswp/123.html> (explaining through algebraic formulas how

after the execution of a contract, will incur reasonable costs in monitoring a manager that are less than or equal to its expected *ex post* profits on an investment.²²⁸ Reflecting a non-breaching party's compensable expectancy interest, these monitoring costs serve as a measurable and identifiable proxy for damages in the event of a breach of contract. Part IV develops an analytical framework for the consideration of breaches of rights of first refusal based on the post-execution monitoring costs of non-breaching parties.

IV. AN ANALYTICAL FRAMEWORK FOR BREACHES OF RIGHTS OF FIRST REFUSAL BASED ON A THEORY OF MONITORING COSTS

As discussed in Part I, the inherent uncertainties surrounding the financing of innovation-intensive companies result in informational asymmetries within various venture capital arrangements, including the GP/limited partner, entrepreneur/investor and manager/fund relationships. Agency theory and practice have identified a number of mechanisms that mitigate these asymmetries through pre-contract screening, sophisticated contracting and post-contract monitoring.²²⁹ Before deciding whether to invest, investors engage in due diligence to screen out unprofitable projects, bad entrepreneurs or poor managers.²³⁰ Once the decision to invest has been made, complex financial contracts allocate various cash flow and control rights (*e.g.*, voting rights, liquidation rights and board rights) among the contracting parties.²³¹ These rights facilitate post-contract monitoring and reduce some of the risks associated with venture capital finance.²³² After the parties execute the financial contract, investors and/or funds incur post-execution monitoring costs which are intended to minimize potential losses arising out of an investment or increase the potential upside value of an investment.²³³

The last of these mechanisms—post-execution monitoring—has substantial analytical and theoretical appeal as the basis for establishing a remedial regime for breaches of rights of first refusal. After setting forth

monitoring costs affect profits).

228. *See id.* (illustrating how a change in monitoring costs disproportionate to projected value makes venture capital an advantage over going public).

229. Steven N. Kaplan & Per Strömberg, *Venture Capitalists as Principals: Contracting, Screening, and Monitoring* 8-9 (Nat'l Bureau of Econ. Research, Working Paper No. 8202, 2001), available at <http://www.nber.org/papers/w8202.pdf> (showing that pre-contract screening, sophisticated contracting, and post-contract monitoring and advising are closely interrelated and mitigate Fund/Manager conflicts).

230. *See id.* at 1 (enumerating ways in which investors may screen out unprofitable projects, such as structuring the financial contracts, collecting information before deciding whether to invest and monitoring during the project).

231. *Id.* at 2.

232. *Id.* at 9.

233. *Id.*

the basic framework of the monitoring costs theory, this Part applies the theory to the Google hypothetical and three factual scenarios derived from the Google hypothetical.

A. *Description of the Monitoring Costs Framework*

Monitoring is a concept that has had its greatest support and application in the field of economics. Monitoring costs generally consist of those expenses associated with investigation, risk-assessment, underwriting and auditing.²³⁴ In the Google hypothetical, monitoring costs would entail those expenses incurred by the Fund in ensuring that the Manager presented all investment opportunities identified during the term of the contract. Those expenses might include costs relating to the inspection and audit of the Manager's books, review of venture-capital financed companies' public disclosures, repeated discussions with the Manager regarding its "prospecting" activities, review of trade journals and industry-specific web sites and continuing and proactive conversations with other industry participants to collect information on potential investment opportunities.

The theory of monitoring costs posits that a principal will incur reasonable costs in monitoring its agent that are less than or equal to the principal's expected *ex post* profits on the contract.²³⁵ Applying this theory to the Google hypothetical, the Fund, the principal, will expend costs monitoring the Manager, its agent, in the post-execution period of the co-investment agreement that are less than or equal to the Fund's expected *ex post* profits on the contract. This Article proposes that these monitoring costs reflect the Fund's compensable expectancy interest in the co-investment agreement, and accordingly, serve as a measurable and identifiable proxy for expectation damages in the event of a breach of contract.

In protecting a contracting party's *ex ante* calculation of expected profit (as opposed to its *ex post* calculation of actual profit), the monitoring costs framework comports with the existing expectancy formula for damages. However, unconstrained by the formulaic methodology of the existing damages regime, a remedial framework based on monitoring costs would offer a more practical, fact-based approach to analyzing damages for breaches of rights of first refusal in the venture capital context.

234. Avery Wiener Katz, *An Economic Analysis of the Guaranty Contract*, 66 U. CHI. L. REV. 47, 113 (1999) (listing the various costs associated with supplying credit in the standard guaranty transaction).

235. See Bagella et al., *supra* note 227, at 13 (calculating the profit function for shareholders assuming that monitoring costs are not proportional to *ex post* cash flow).

B. The Fundamental Assumptions of the Monitoring Costs Framework

A number of assumptions underlie the monitoring costs framework. First, the contracting parties (the Fund and the Manager) have not bargained in advance for a liquidated damages clause. Second, the contracting parties are rational and sophisticated. Third, litigation costs and transaction costs are zero. Fourth, after entering the co-investment agreement with the Manager, the Fund will calculate its expected profits on that contract. In theory, the profits will encompass a continuum of possible profits and an accompanying set of probabilities ranging from zero to one-hundred percent, as well as a continuum (bounded by the contractual terms between the Manager and the Fund) of possible percentage ownerships up to fifty percent by the Fund in any investment opportunity. Fifth, the Fund is risk neutral. For instance, the utility to the Fund of a certain \$5 is equivalent to the utility of an equally valuable gamble (*e.g.*, an investment that has a fifty percent chance of a \$0 return and a fifty percent chance of a \$10 return). Sixth, while in the Google hypothetical a number of investment opportunities could have been the subject of a breach, for the sake of simplicity, the proposed framework assumes that there is only one opportunity to obtain an investment made by the Manager. Seventh, the Fund's calculation of expected profit does not change from the date the parties enter into the contract (the "Execution Date") to the date the Manager sells the opportunity for a gain (the "Sale Date"). Eighth, the Fund's costs of monitoring are fixed from the Execution Date to the Sale Date. Ninth, the costs of monitoring are expenses that, by default, the Fund alone bears and that cannot be passed to the Manager in a lawsuit. Finally, if the Fund monitors, it will detect the Manager's breaches with one-hundred percent probability before the Sale Date, whereas if the Fund elects not to monitor, it will detect the Manager's breaches with zero percent probability before the Sale Date.

The application of this analytical framework to breaches of rights of first refusal requires courts to undertake a fact-based inquiry into the post-execution monitoring behavior of non-breaching parties. When a court weighs the various legal remedies available to a non-breaching party, it should consider the reasonableness of that party's post-execution conduct. The costs that a party incurs in monitoring the breaching party's post-execution (and pre-breach) behavior are a proxy for the reasonableness of a non-breaching party's conduct. Using the facts of the Google hypothetical, the following sections consider the appropriate legal remedy when: (1) the Fund's expected profits are greater than its monitoring costs, (2) the Fund's expected profits equal its monitoring costs and (3) the Fund's expected profits are less than its monitoring costs.

C. Monitoring Costs Theory as Applied to Varying Factual Circumstances Based on the Google Hypothetical

As explained above, the pertinent facts of the Google hypothetical are as follows: (i) on the Execution Date, the Fund and the Manager entered into a contract pursuant to which the Fund had a right of participation of up to fifty percent in an investment opportunity to be identified by the Manager; (ii) between the Execution Date and the Sale Date, the Manager identified an opportunity and invested \$5 million in Google (representing an eight percent ownership interest in the company); (iii) in breach of the right of first refusal, the Manager failed to present that opportunity to the Fund; and (iv) on the Sale Date, the Manager sold its investment in Google (post-IPO) for approximately \$2 billion. Whereas the expectancy formula discussed in Part III resolved the question of damages by determining the contract price and market value of the investment on the date of the breach, the monitoring costs regime approaches the issue of damages by analyzing the non-breaching party's post-execution monitoring costs.

1. When expected profits exceed monitoring costs

Consider first the situation where on the Execution Date, the Fund expects substantial profits on the investment opportunity. Based on that valuation, the Fund (like any rational contracting party) will incur high monitoring costs after the Execution Date in an effort to maximize the opportunity to receive substantial profits. If the Fund's expected profits on the investment opportunity are greater than the monitoring costs that the Fund elects to incur after the Execution Date, the Fund will discover the Manager's breach with one-hundred percent probability before the Sale Date according to the assumptions of the model set forth above. Upon discovery of the breach, the Fund may seek either of the following legal remedies: (1) the receipt of monetary damages in the amount of its monitoring costs; or (2) an award of specific performance whereby the Fund would buy into the investment opportunity up to its contractual fifty percent right of participation.²³⁶ As between the two remedies, the Fund

236. This scenario contemplates the absence of fraud on the part of the Manager. Hypothetically, suppose expected profits are greater than monitoring costs, and the Fund monitored the Manager by inspecting and auditing the Manager's books, reviewing disclosures of venture capital-financed companies and engaging in ongoing discussions with the Manager regarding its "prospecting" activities. Suppose further that the Manager misrepresented or concealed information relating to the Google investment opportunity, and in so doing, subverted the Fund's monitoring efforts such that the Fund did not bring a lawsuit until the Sale Date. In either misrepresenting the fact of its investment in Google or concealing material information relating to the Google investment opportunity, the Manager would have committed fraud—a knowing misrepresentation of the truth, which occurs either by a reckless misrepresentation despite a disbelief of its truth or a concealment of a material fact to induce another person to act (or not act) in reliance on the concealment. BLACK'S

would prefer the latter remedy because a recovery of monetary damages in the form of its sunk monitoring costs would be under-compensatory where the Fund's expected return exceeds its monitoring costs. Ultimately, the timeliness (or lack thereof) of the Fund's detection of the breach would inform the court's determination of an appropriate remedy.²³⁷ The court's analysis of the timeliness of the Fund's discovery of the breach would depend on a number of factors, including the Manager's ability to deliver the contracted performance.²³⁸ Even before the Sale Date, the court might deny specific relief in the Google hypothetical due to the incongruity between the remedy and the circumstances at the time of the breach, as evidenced by the ascent in the value of the Google shares in the period between the Execution Date and the Sale Date.²³⁹

2. *When expected profits equal monitoring costs*

Consider next the scenario where on the Execution Date, the Fund expects that the costs it will incur in monitoring the contract will equal the expected return of the investment identified by the Manager. Based on that valuation, the Fund will be indifferent as to monitoring or not monitoring. Assuming the Fund elects to monitor, the analysis would proceed as set forth in the prior section. The Fund would discover the breach before the Sale Date and would elect between: (1) the receipt of monetary damages in the amount of its monitoring costs; or (2) an award of specific performance whereby the Fund would buy into the investment opportunity up to its contractual fifty percent right of participation. However, given that the Fund has monitored to the extent of its expected profits, it is likely, due to its preference for the opportunity to invest in Google, to select specific performance. Assuming that the Fund elects not to monitor, its failure to

LAW DICTIONARY 670 (7th ed. 1999). The Fund's failure to bring the lawsuit until the Sale Date would have indicated that expected profits were less than or equal to monitoring costs and that the Fund did not monitor. However, the Fund's failure to bring the lawsuit until the Sale Date would have been excusable because of the circumstances of fraud surrounding its post-contract monitoring. Thus, the theory of monitoring costs would support the Fund's recovery of monetary damages to the extent of the amount it expended on post-contract information collection and monitoring.

237. Specific performance typically is awarded in those instances where the good in question is unique. *See* RESTATEMENT (SECOND) OF CONTRACTS § 359(1) (1981) ("Specific performance or an injunction will not be ordered if damages would be adequate to protect the expectation interest of the injured party."). However, even when the market for the good in question is scarce, a court may deny specific relief if a delay in litigation has caused the remedy to be incongruous with the circumstances as they existed at the time of the breach. *See* Narasimhan, *supra* note 157, at 69 (illustrating that a significant delay in litigation could render specific performance untenable).

238. *See supra* Part III.C.3 (discussing specific relief in relation to the timeliness of the detection of a breach and the effect on ensuing litigation).

239. *See id.* (providing the World Series example of how specific performance may be inappropriate if the time has lapsed to the extent that the court is no longer able to compel specific performance).

incur monitoring costs would mean that there is a zero percent probability that it will detect the Manager's breach until the Sale Date (under the assumptions of the model). On the Sale Date, the Fund should receive zero monetary damages. This remedial outcome is appropriate for two reasons. First, the Fund should not be compensated for costs it did not incur. Second, if the Fund's expected profits equaled its monitoring costs, the Fund would have made a zero profit on the investment (expected profits minus monitoring costs equals zero). Thus, the remedial outcome of zero monetary damages would be consistent with the Fund's expectancy interest in the investment.

3. *When expected profits are less than monitoring costs*

Finally, consider the scenario where on the Execution Date, the Fund expects that the profits on the investment opportunity will be less than the costs it will incur in monitoring the contract. Based on that valuation, the Fund (like any rational contracting party) will not monitor (its monitoring costs will be zero). Under the assumptions of the model, the Fund's failure to invest in monitoring will result in its inability to detect the Manager's breach until the Sale Date. On that date, the Fund should receive zero damages for the same reasons the Fund should receive zero damages when expected profits equal monitoring costs and the Fund elects not to monitor. The Fund's failure to incur monitoring costs would evidence its lack of a compensable expectancy interest in the investment. In fact, if expected profits were less than monitoring costs, the Fund would have made a negative profit on the investment. An award of zero monetary damages therefore would be appropriate given the Fund's lack of, and indeed negative, expectancy interest in the investment.

4. *Monitoring costs framework as applied to the Google hypothetical*

In the Google hypothetical, the Fund's failure to detect the Manager's breach until the Sale Date points to one of two possibilities: either (1) the Fund's expected profits equaled its monitoring costs and the Fund elected not to monitor or (2) the Fund's expected profits were less than its monitoring costs and the Fund did not monitor. Under either of these two scenarios, the monitoring costs framework indicates that the appropriate remedial outcome is zero damages. As discussed in Part III, the application of the expectancy formula to the Google hypothetical would also result in zero damages for the Fund. The legal outcome of the expectancy formula is consistent with and supported by the theory of monitoring costs. Had the Fund expected a profit on the investment, it would have incurred monitoring costs in an amount up to its proportionate share of expected *ex post* profits. In failing to monitor the Manager, however, the Fund

expressed its lack of any compensable expectancy interest in the investment.²⁴⁰

The fact that the Manager sold the Google investment on the Sale Date for an extremely large profit should have no bearing on the remedial outcome of the Google hypothetical under either the expectancy formula for damages or the monitoring costs regime. Both frameworks protect a non-breaching party's *ex ante* calculation of expected return on the Execution Date. While the Google investment surpassed (by far) the Fund's *ex ante* expectation of the value of the investment opportunity both on the Execution Date and at any time before the Sale Date, neither the expectancy formula nor the monitoring costs framework permit recovery based on actual *ex post* outcomes. Particularly with inherently risky investments such as venture capital investments, courts should be even more reluctant to consider actual *ex post* outcomes as a basis for damages. As sophisticated contracting parties, participants in venture capital finance appreciate the risks associated with investing in innovation-intensive, start-up and early-stage enterprises. To allow recovery for a breach of contract based on actual *ex post* profits is to accord to a non-breaching party an investment free of any risk of market downturn—a result inconsistent with the nature of venture capital investment.²⁴¹

Thus, the avoidance of opportunistic post-breach behavior in the form of the *ex post* “cherry picking” of successful investment opportunities provides a further justification for the remedial outcome of zero monetary damages where expected profits are less than or equal to monitoring costs and the investor elects not to monitor. In *Scully*, the Third Circuit observed that by measuring damages from the date of the breach pursuant to the expectancy formula, the law endeavors to obviate incentives for such adverse post-breach behavior.²⁴² To award recovery based on actual *ex post* profits (where the non-breaching party's expected profits were less than or equal to its monitoring costs and such party did not monitor) in opposition to the *Scully* Court's articulated preference for *ex ante* damages might incentivize “free-riding” by permitting non-breaching parties selectively to reap the gains of successful investments, while eschewing the losses of unsuccessful investments. To minimize opportunistic post-breach behavior in the context of the Google hypothetical, the Fund's decision not

240. Even in the unusual situation where the Fund has not monitored and yet still learns that the Manager has failed to present an opportunity before the Sale Date, the Fund should receive zero damages based on its expectancy interest as established by the amount (\$0) it spent monitoring the Manager.

241. See *Scully v. US WATS, Inc.*, 238 F.3d 497, 513 (3d Cir. 2001) (rejecting a plaintiff's after-the-fact assertion because it would minimize his risk and guarantee a profit in contrast to the risk and reality of a stock option).

242. *Id.* at 510.

to monitor either because its monitoring costs equaled or exceeded its expected profits should preclude the Fund from “cherry-picking” specific successful investment opportunities on an *ex post* basis. According to both the expectancy formula for damages and the monitoring costs regime, the Fund's *ex ante* valuation of the Google investment as measured by the price the Fund would have paid for the investment or the costs the Fund would have incurred in monitoring the Manager, respectively, governs the appropriate measure of damages (not the actual *ex post* profits of the Google investment).

The proposed framework offers a fact-based approach from which to consider breaches of rights of first refusal that is consistent with the existing legal regime of expectation damages because it protects *ex ante* expected profits and minimizes adverse post-breach behavior. Unconstrained by the prescribed methodology of the existing damages regime for breaches of stock or stock option agreements, the monitoring costs framework considers the post-execution monitoring behavior of the non-breaching party and determines the appropriate remedial outcome based on a measurable and identifiable proxy for expectation damages—the post-execution monitoring costs incurred by the non-breaching party.

Notwithstanding the analytical and theoretical appeal of the monitoring costs framework, inherent limitations call into question the practicability of such a regime. Most significantly, the model is based on a number of assumptions that are difficult to replicate in the real world—assumptions such as litigation costs being zero, the inherent certainty of the detection of breaches and calculations of expected profit remaining static over time. In addition to these limitations, the fact-based nature of the framework may lead to excessive uncertainty with respect to the calculation of damages. To avoid the fact-based inquiries and uncertainty attendant to the monitoring costs framework, Part V considers the desirability and practicability of a liquidated damages regime for venture capital. Part V begins by setting forth the current legal standards for liquidated damages clauses and then develops a legally supportable methodology upon which to formulate such a clause in the context of venture capital investment.

V. A PROPOSAL FOR A LIQUIDATED DAMAGES CLAUSE AS AN ALTERNATIVE TO THE EXISTING REMEDIAL REGIME

A. *A Theoretical Framework for Liquidated Damages Clauses*

To the extent permitted by law, contracting parties may customize their liability by specifying damages in advance.²⁴³ Parties to a contract have the

243. Lee Anne Fennell, *Revealing Options*, 118 HARV. L. REV. 1401, 1437-38 (2005).

option to include in their agreement a provision that sets forth a monetary amount payable for loss they reasonably anticipate may be suffered by one of the parties in the event of a breach of contract.²⁴⁴ Such contractual provisions are commonly called liquidated damages clauses.²⁴⁵ Contract law reflects a dichotomy between enforceable liquidated damages clauses and unenforceable penalty clauses.²⁴⁶ While parties may elect to include an advanced stipulation of damages in their contracts, if the court construes the clause as unreasonable or supra-compensatory, the court will refuse to enforce the clause.²⁴⁷

When reviewing a challenge to a liquidated damages clause, most courts examine whether the clause was the product of an honest effort by the parties to estimate reasonably the actual harm caused by the breach.²⁴⁸ If the clause reflects a reasonable estimate of loss that would be caused by a breach, the provision typically is upheld as an enforceable liquidated damages clause.²⁴⁹ If, on the other hand, the clause is designed to coerce contractual performance by punishing a party for its breach, courts will invalidate the clause as a matter of public policy, citing to the clause's

244. Cheryl A. Davis, Note, *Liquidated Damage Clauses*, 1 TRANSACTIONS: TENN. J. OF BUS. L. 32, 32 (1999).

245. *Id.*

246. Larry A. DiMatteo, *A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages*, 38 AM. BUS. L.J. 633, 635 (2001); see also Robert E. Scott & George G. Triantis, *Embedded Options and the Case Against Compensation in Contract Law*, 104 COLUM. L. REV. 1428, 1454 n.108 (2004) (noting that advance stipulations of damages were invalidated as penalties in thirty-seven percent of a sample of 109 federal and state appellate cases between January 1998 and January 2004 in which enforceability was at issue, further supporting why parties may be disincentivized from stipulating damages in advance). The law against penalties emerged from the English courts of equity to limit the enforcement of penal bonds that were used to ensure a contractual performance. The penal nature of such bonds was considered inappropriate for redressing the harm resulting from a breach of contract. 5 WILLIAM S. HOLDSWORTH, A HISTORY OF ENGLISH LAW 293 (1924).

247. See FARNSWORTH, *supra* note 129, § 12.18, at 283 (noting that while contracting parties have extensive bargaining power, their power to stipulate damages in advance is surprisingly limited as courts may invalidate what they deem to be high money damages); see also DiMatteo, *supra* note 246, at 635 (analyzing why liquidated damages are given scrutiny so as not to subject a breaching party to a penalty); Paul Bennett Marrow, *The Unconscionability of a Liquidated Damage Clause: A Practical Application of Behavioral Decision Theory*, 22 PACE L. REV. 27, 34-35 (2001) (explaining that an "overly sufficient" liquidated damages clause often becomes an unenforceable penalty); Ulen, *supra* note 64, at 350 (stating that courts will not enforce a liquidated damages clause which appears to be punitive). For cases holding that a contractual provision represented a penalty, see *Rye v. Pub. Serv. Mut. Ins. Co.*, 315 N.E.2d 458, 459 (N.Y. 1974) (invalidating damages of \$200 per day up to \$100,000 for delay in building a complex); *Seeman v. Biemann*, 84 N.W. 490, 492-93 (Wis. 1900) (invalidating damages of \$10 a day for delay in completing a building that had a rental value of \$38 per month). For cases upholding contractual provisions as liquidated damages clauses, see *Banta v. Stamford Motor Co.*, 92 A. 665, 667-68 (Conn. 1914) (finding reasonable \$15 a day damages for failure to deliver \$5,500 yacht); see also *Dave Gustafson & Co. v. State*, 156 N.W.2d 185, 186-89 (S.D. 1968) (finding reasonable \$210 a day for delay in completing highway contract worth \$530,742).

248. Davis, *supra* note 244, at 32.

249. *Id.* at 32-33.

punitive nature.²⁵⁰ It bears emphasis that courts will resolve doubts concerning the reasonableness of an advanced stipulation of damages in favor of finding a penalty in most cases.²⁵¹

The limited enforcement of liquidated damages clauses represents a long-recognized exception to freedom of contract.²⁵² Professor Robert A. Hillman of Cornell Law School has noted the irony between the notion of freedom of contract and courts' reluctance to recognize the freedom of parties to contract for an advanced stipulation of damages, referring to the law of liquidated damages as the "great paradox in contract law."²⁵³ Unless the stipulated damages clause meets certain requirements, courts typically will supplant the contracting parties' pre-agreed remedial response to a breach of contract with their own remedy.²⁵⁴ In light of the current judicial propensity not to enforce advanced stipulations of damages, the following section sets forth a number of arguments that support a less restrictive approach to the enforcement of liquidated damages clauses.

B. *The Practical Advantages of Liquidated Damages Clauses*

If courts uphold liquidated damages clauses, parties will accrue benefits throughout the three phases of contract: formation, breach and enforcement.²⁵⁵ Allowing parties to specify the remedy for a breach during

250. *Id.* at 33. There is a split of authority regarding whether courts should use a prospective approach or retrospective approach, or both, to evaluate the reasonableness of an advance stipulation of damages. *Id.* Under the prospective method, courts consider whether the stipulated damages reflect a reasonable estimate of potential loss and whether actual loss was indeterminable or difficult to measure at the time of the execution of the contract. *Id.* When an advance stipulation of damages satisfies those two requirements, then the provision will be enforceable as a liquidated damages clause. *Id.* Under the prospective analysis, the actual harm suffered by the non-breaching party is immaterial to granting recovery. *Id.* However, a court may invalidate an advance stipulation of damages if it is 'grossly disproportionate' to the actual damages suffered by the non-breaching party. *Id.*; see *Beasley v. Horrell*, 864 S.W.2d 45, 48-49 (Tenn. Ct. App. 1993) (invalidating the cancellation provision of a contract because it was not in the amount of estimated damages; rather it was punitive because it called for an amount that far exceeded the actual damages at the time of the breach), *overruled by* *Guiliano v. Cleo, Inc.*, 955 S.W.2d 88, 100 (Tenn. 1999). The difference between the prospective and retrospective approaches is timing: whether the reasonableness of the advance stipulation of damages is evaluated from the perspective of the parties at the time of the execution of the contract or after the breach occurred. *Davis*, *supra* note 244, at 33.

251. See *Davis*, *supra* note 244, at 42 (emphasizing that courts in Tennessee use the default rule of finding in favor of a penalty when determining the validity of stipulated damages).

252. DiMatteo, *supra* note 246, at 634-35.

253. See *id.* at 638 ("Ironically, courts have voided liquidated damages clauses under the banner of *intentionality*—namely that one of the parties did not intend to liquidate damages despite the existence of an express term stating otherwise.").

254. *Id.*

255. James Arthur Weisfield, Note, "Keep the Change!": *A Critique of the No Actual Injury Defense to Liquidated Damages—Lind Building Corp. v. Pacific Bellevue Developments*, 55 *Wash. App.* 70, 776 P.2d 977 (Div. 1), *review denied*, 113 *Wash. 2d* 1021, 781 P.2d 1322 (1989), 65 *WASH. L. REV.* 977, 978 (1990).

contract formation enables them to allocate risks in three significant ways.²⁵⁶ First, as a result of the negotiations, the contracting parties assess the nature and scope of harm caused by a breach, which enables them to weigh the costs of breach against the gains of contractual performance.²⁵⁷ To avoid excessive risk, parties should negotiate for more favorable terms before accepting liability.²⁵⁸ For example, during contract negotiations, the Manager in the Google hypothetical might seek a higher management fee in exchange for the assumption of liability. Second, the process and result of these negotiations help promisees identify reliable promisors with whom to contract.²⁵⁹ By agreeing to liquidate damages, promisors may enhance their credibility (and reputational value) in the industry in which they operate. Finally, advanced stipulations of damages enable parties to reduce the risk of under-compensation, particularly when ordinary legal measures are inadequate.²⁶⁰

Liquidated damages clauses also help parties evaluate the efficiency of a breach. The theory of efficient breach maintains that, all other factors being equal, parties should breach contracts when the expected costs of a breach are less than the expected gains of performance.²⁶¹ The uncertainty of litigation complicates the calculus for an efficient breach.²⁶² However, when a liquidated damages clause is enforceable, the cost of a breach is fixed and the parties may identify more accurately when a breach becomes efficient.²⁶³

Furthermore, the enforcement of liquidated damages clauses enables parties to avoid the risks of litigation.²⁶⁴ At a minimum, such clauses may encourage the contracting parties to settle their dispute before trial.²⁶⁵ In addition to saving the parties the expense and delay of litigating complex damages issues, the enforcement of the parties' pre-determined remedial response to a breach allows them to avoid the uncertainties attendant to *ex*

256. *Id.*

257. *Id.*

258. *Id.*

259. *Id.*

260. Weisfield, *supra* note 255, at 979.

261. *Id.*

262. *Id.*

263. *Id.* Some commentators contend that the enforcement of liquidated damages clauses whose sums substantially exceed actual damages create adverse incentives for the inducement of breach. See Kenneth W. Clarkson et al., *Liquidated Damages v. Penalties: Sense or Nonsense?*, 1978 WIS. L. REV. 351, 368-69 (using an example of a bridge construction with a stipulated damage clause of \$500 a day for each day that the bridge is delayed beyond a specific date, authors illustrate how the amount of the clause, the amount of actual damages and the legal posture towards stipulated damages change incentives for breach inducement).

264. See DiMatteo, *supra* note 246, at 634 (stating that parties generally draft liquidated damages clauses with the hopes of avoiding litigation).

265. *Id.*

post remedies fashioned by courts.²⁶⁶ The certainty of a liquidated damages clause affords protection to both parties to a contract—protection to the promisee from damages caused by unsatisfactory performance or non-performance (where the indeterminate nature of a loss would make proof of loss difficult) and assurance to the promisor that her liability is both defined and limited in the event that she breaches the contract.²⁶⁷ The avoidance of uncertainty should be of particular significance to contracting parties in the venture capital context where the uncertainties surrounding the financing of innovation-intensive firms may make damages indeterminate or difficult to prove.

The following section endeavors to develop a methodology upon which to formulate a legally supportable liquidated damages clause for breaches of rights of first refusal in the venture capital context.²⁶⁸

C. Proposed Methodology for the Formulation of a Liquidated Damages Clause for Breaches of Rights of First Refusal in the Venture Capital Context

The substantive terms of the right of first refusal should inform the methodology that the parties use to formulate a liquidated damages clause for the breach of such a right. The parties should structure the liquidated damages clause to approximate the profits gained by the breaching party (*i.e.*, up to, but not exceeding, the percentage contractual right of participation allocated to the non-breaching party). This regime best can be understood by referring back to the Google hypothetical. The right of first refusal at issue in the Google hypothetical provided that during the stated term of the contract the Fund had the opportunity to participate in up to fifty percent of the Manager's investments. Under the proposed framework, the liquidated damages clause should specify that if the Manager breaches the Fund's right of first refusal, the Manager would pay the Fund damages in the amount of the profits gained by the Manager (up to fifty percent—the maximum percentage the Fund was contractually allowed to invest) in the investment(s) it failed to present to the Fund, measured from the date of the lawsuit or the date on which the Manager sold the investment, whichever is earlier.

Whether the liquidated damages clause should permit the Fund to receive the full fifty percent of the profits of each investment opportunity that the Manager failed to present is an interesting question. Because the Fund may not have elected to invest to the extent of its full fifty percent

266. Davis, *supra* note 244, at 32.

267. *Id.*

268. Underlying any proposed liquidated damages regime is the fundamental assumption that the contracting parties will agree to stipulate damages in advance.

contractual right of participation, if at all, the proposed methodology sets the allocable percentage of participation (fifty percent) as the upper threshold for profits. The parties may, of course, negotiate for a percentage lower than fifty percent. If the Fund and Manager have had no prior transactional history, during contract negotiations, the parties must determine an appropriate limit on profits up to, but not exceeding, the fifty percent threshold. On the other hand, if the parties have had a transactional history, they may elect to base the percentage threshold of the liquidated damages clause on the prior average of amounts invested by the Fund in investment opportunities identified by the Manager. Suppose, for instance, that the Fund had participated in four prior investments with the Manager. For each of those transactions, the Fund, pursuant to a right of first refusal, could invest in the opportunity up to fifty percent of the amounts invested by the Manager. If the Fund had invested forty, ten, twenty and ten percent of the amounts invested by the Manager in each of the four investments, respectively, the prior average of amounts invested by the Fund in identified investment opportunities is twenty percent. Under this factual scenario, the liquidated damages clause between the Fund and the Manager should stipulate that the Fund is entitled to damages in the amount of twenty percent of the profits earned by the Manager in the investment(s) it failed to present to the Fund (as measured from the date of the lawsuit or the date on which the Manager sold the investment, whichever is earlier).

Notwithstanding its practical and theoretical appeal, a liquidated damages regime has some inherent limitations. Perhaps the most significant limitation is the disincentive for promisors to agree to damages in advance. As a general proposition, sophisticated contracting parties prefer not to stipulate damages in advance and instead opt to rely on the courts to apply an appropriate remedy. While the potential signal of unreliability (and accompanying reputational damage) that a refusal to agree to liquidated damages might send to industry participants mitigates against existing disincentives, the omission of liquidated damages clauses from venture capital contracts points to the continued potency of these disincentives.²⁶⁹ However, the practical advantages of liquidated damages clauses identified in the prior section should outweigh promisor disincentives, particularly in the venture capital context where the nature of investment results in high uncertainty regarding damages outcomes for a breach of contract. By protecting the contracting parties' pre-agreed remedial response to a breach, and in so doing, supplanting a remedy that otherwise would be fashioned by a court *ex post*, a liquidated damages

²⁶⁹. See Schell, *supra* note 55, at App. E (providing a sample standard Investment Management Agreement which contains no liquidated damages provision).

regime avoids the fact-based inquiries and related uncertainty attendant to judicial remedies. In addition to the practical advantages of a liquidated damages regime, the proposed methodology for the formulation of a liquidated damages clause for the breach of a right of first refusal results in a damages award that reflects the actual profits of a non-breaching party had there been no breach. This measure of recovery is neither over- nor under-compensatory and likely would satisfy the reasonableness standards of the law of liquidated damages. Thus, liquidated damages clauses offer a desirable alternative to the existing judicial remedies and should become standard in venture capital co-investment agreements.

CONCLUSION

There is currently a gaping hole in the law regarding the manner in which damages should be measured in cases involving breaches of rights of first refusal in venture capital. As the venture capital market matures and with the diminished efficacy of reputation as an enforcement mechanism, litigation will increase, making the resolution of the damages issue raised in this Article particularly salient. Existing law governing breaches of stock option agreements points to the applicability of substitutional relief theory, and in particular expectancy damages, to the facts of the Google hypothetical and offers a legally supportable outcome under those facts. In addition to analyzing existing law, this Article developed an agency theory of monitoring costs from which to consider breaches of rights of first refusal. Beyond providing support for the remedial outcome of the Google hypothetical under existing law, the monitoring costs framework offers an innovative approach for the consideration of breaches of rights of first refusal under varying factual circumstances. Despite the analytical and theoretical appeal of the monitoring costs framework, inherent limitations, particularly the difficulty of replicating in the real world some of the assumptions of the monitoring costs model, call into question the practicability of such a regime.

Therefore, as an alternative to the existing judicial remedies and the monitoring costs framework, this Article considered the desirability and practicability of a liquidated damages regime for venture capital. Recognizing the desirability and practicability of such a regime, this Article concludes that liquidated damages clauses should become standard in venture capital co-investment agreements. Finally, the proposed methodology for the formulation of a liquidated damages clause is both consistent with the legal standards for such clauses and appropriate for use in the context of venture capital investment.