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A New Era of Shareholder Activism in Silicon Valley

By Alan Parker, LLM Candidate 2016 | February 26, 2016

We are all familiar with legendary hedge fund investors like Bill Ackman and many others making history with shareholder activism in Wall Street, but this trend is also starting to appear on a smaller scale in other places…notably venture capital in Silicon Valley.

Picture the following scenario: A venture-backed startup valued at $4.5 Billion in its latest investment round, a hotshot CEO, and venture capital investors with a history of acquiescence with its portfolio companies—contributing to growth without major interferences in management. It seems like the perfect Silicon Valley tale, until the California Department of Insurance starts to investigate the company and its CEO for allegedly circumventing California State regulations in connection with employee's insurance training. Zenefits exemplifies this scenario as it was subject to an investigation of such practices.

During a board meeting following an internal investigation, Andreessen Horowitz, one of Zenefits's investors, called for the resignation of Zenefit's CEO Parker Conrad, claiming he knowingly contributed to the company's violation of California state law.

The ousting of Zenefits's CEO represents the efficacy of shareholder activism from an otherwise passive investor. Investor activism in Silicon Valley is an ever-growing trend due and continues to grow for a number of reasons. First, as the venture capital industry experiences a downturn, venture capital participants will exercise more scrutiny on the considerations preceding and following a deal, leading to enhanced due diligence and greater involvement in the company's business operations after the initial investment, particularly regarding regulatory compliance. As investors are realizing lower returns in the following years, investments must be chosen more carefully and with heightened scrutiny for risk.

Second, as venture backed startups fail to meet their targeted financial expectations and substantial valuations, investors will increasingly enforce all of their contractual rights in order to influence the business strategy of the company. In extreme, but not rare cases, investors can use these clauses to force resignations or simply fire any management/owners as they see fit. Investors leverage influence through the Board of Directors, where institutional or high worth investors generally have a seat. This is but one of many tools of influence available to investors, who can exercise information rights, preferred stock voting rights, and stock option pools.

Silicon Valley entrepreneurs and venture capital investors should carefully negotiate employment agreements, vesting provisions, and anti-dilution clauses in order to align the exit interests of investors with the long-term, entrepreneurial goals. When these conditions are not carefully considered, the increase of shareholder activism in Silicon Valley may cause more founders to be pushed out of their companies and under unfavorable conditions.