Introduction

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The conference that prompted the publication of this volume was motivated by a simple idea, that the core function of entrepreneurs is to challenge incumbency. The novelty inherent in entrepreneurial action implies uncertainty, and hence experimentation, learning, and selection. We invited conference participants to explore issues such as: the incentive effect of legal rules on startup activity; the role of private ordering in facilitating or impeding entrepreneurial action; the influence of legal rules and practices on the creation of entrepreneurial opportunities; the role of law in promoting or foreclosing market entry; or the effect of entrepreneurial action on legal doctrine. This volume is the result of that invitation.

Gordon Smith and Travis Hunt begin the volume with a provocative series of assertions that provided the frame for the conference:

> *Entrepreneurial action* is the central idea that motivates the study of law and entrepreneurship. Promoting entrepreneurial action is a fundamental goal of the US legal system. [W]e offer a new conception of entrepreneurship that is consistent with understandings of entrepreneurship in other disciplines while being accessible and meaningful to legal scholars. We assert, in simplest terms, that the core function of entrepreneurs is to challenge incumbency.

The remainder of this volume is organized around three domains in which law facilitates or impedes entrepreneurial action: (1) lawmaking (legislation and regulation); (2) governance (private ordering); and (3) incentives. Seen together, these chapters demonstrate the pervasive influence of law on entrepreneurial action.

I LAW MAKING AND ENTREPRENEURIAL ACTION

Part I of this book begins with a series of chapters related to the dynamic interplay between entrepreneurial firms and the legislative bodies or regulators who create and revise the rules governing such firms. Startup firms, to the extent they challenge incumbent businesses, often have an incentive to push regulators to change and adopt rules that reimagine a particular industry or market so that it is open to new ways of doing business. On the other hand, incumbent firms may have an incentive to hide behind existing regulations that may inadvertently (or perhaps by design) block new firms from entering the market. For example, regulations that are defined around an existing technology, or securities regulation that may make it difficult for a new firm to raise capital, can have the effect of benefiting incumbent businesses. This setting puts pressure on startup firms to actively engage in lobbying and regulatory affairs. More broadly, it encourages startup firms to think of law itself as a dynamic and mutable input that can be changed through lobbying and engagement with regulators, rather than a fixed constraint. The chapters in this section addressed these and related topics.

In "The Rise of Regulatory Affairs in Innovative Startups," Elizabeth Pollman builds on her earlier coauthored work documenting a new form of entrepreneurship where changing the law is part of a startup's business plan.[1] In the current project, Pollman explores how startups respond to and manage tension between their business plan and existing regulation and the implications this has for theories of legal change. In the past decade, the tech industry has become increasingly engaged in politics and lobbying, with many startups hiring politically savvy experts to help them navigate tensions with existing regulation. This engagement in regulatory affairs/lobbying is made more possible by startup firms staying private longer and raising large amounts of money to "fund efforts to change laws, engage experts, and battle incumbents and regulators."

Pollman explores the implications of such regulatory engagement on how regulation responds to rapid changes in technological development. Pollman argues that the conventional story that regulation lags behind technology is overly simplistic. She emphasizes that there is more collaboration between regulators and startup firms early in the process – while the new product is being rolled out – than is often appreciated and that such collaboration "blurs the distinction that the traditional account draws between private technology development and reactive public lawmaking."

In "Gauguin, Darwin, and Design Thinking," Alice Armitage identifies a fundamental disjunction between innovative companies that embrace an ethos of disruption and a culture of "agile development" – a fast-moving, iterative, product-development process – and slow-moving regulators, whether operating under traditional administrative rulemaking through "command and control" or the collaborative model proposed by "new governance" scholars. In the sharing economy, the conflict between platform technologies like Uber and Airbnb and regulators impels entrepreneurs to adopt the mantra, "ask forgiveness, not permission," which undermines our traditional conceptions about the rule of law.

In Armitage's account, the platform technologies challenge not only the incumbent service providers but the incumbent regulatory regimes. Given the pervasiveness of

1 Elizabeth Pollman and Jordan M. Barry, *Regulatory Entrepreneurship*, 90 S. Cal. L. Rev. 383 (2016).

regulatory capture, it should not be surprising that disruption affects whole industries, including the rules and rule-makers that shape and govern those industries. Armitage critiques existing proposals to regulate platform technologies on the ground that they do not provide a mechanism for engaging platform technologies in a collaborative regulatory process. The traditional reliance on sanctions to force compliance is an ineffective strategy with platform companies, Armitage argues, so we must seek new approaches "to create a regulatory process with which entrepreneurs will be willing to engage and to comply." Armitage turns to principles of design thinking to produce a regulatory process that is "more nimble, more flexible, and more engaged."

In her prior work, Usha Rodrigues has distinguished between legislation that dictates and legislation that delegates. She has argued that organized interest groups often prefer dictation, which allows them to have a hand in writing their preferences into law, but in times of crisis, when political pressure to act is high, these groups work to channel decision-making to an administrative agency, which can slow the rulemaking process and allow more time for industry input.[2] Rodrigues illustrated the dichotomy between dictation and delegation with the Jumpstart Our Business Startups (JOBS) Act, in which some titles are characterized by congressional dictation and other titles by congressional delegation. The rules in the dictated titles took effect immediately on passage of the JOBS Act, but the rules in the delegated sections required years of SEC rulemaking.

In her chapter entitled "Between the Devil and the SEC," Rodrigues extends her analysis of dictation and delegation to the Fixing America's Surface Transportation (FAST) Act, which was signed into law on December 4, 2015. Several titles in the FAST Act pertain to securities regulation, and Rodrigues examines those provisions through the dictation-delegation lens to gain insight into entrepreneurial finance. Most of the titles are "dictatorial," but one title includes a broad delegation of authority to the SEC. After reviewing events subsequent to the passage of the FAST Act, including instances of delegation that would serve as a cautionary tale for entrepreneurs, Rodrigues concludes that entrepreneurs "would be best served by asking Congress for specific reform that leaves nothing for the SEC to do."

In "The Politics of Entrepreneurial Capital-Raising," Donald C. Langevoort explores the political dance that occurs behind the scenes in passing legislation that regulates a firm's ability to raise capital through sale of equity. While his specific focus is on the Crowdfunding rules and other securities regulation reforms included in the JOBS act, Langevoort starts off with some history on registered public offerings and exemptions under US securities law. Going back to the 1930s, the rules reflect tension between entrepreneurial finance for smaller startup firms and the large costs associated with a public offering. This tension has led to numerous deregulation reform proposals over the intervening years, with the JOBS Act being a recent example.

From an outside perspective, these reform efforts reflect a "battle between capital-raisers and investor-protectors." Much of Langevoort's goal in this chapter is to

2 Usha R. Rodrigues, *Dictation and Delegation in Securities Regulation*, 92 Ind L.J. 435 (2017).

explore more deeply who falls into each camp, and in particular to better understand the position of institutional intermediaries, such as placement agents and brokers, in the reform process. Langevoort's analysis largely follows a public choice perspective, in which well-organized economic interests, even if small in number, tend to beat out diffuse interests in pushing for law reform. In the Crowdfunding setting, the organized economic interests tend to be institutional intermediaries that can capture some of the rents associated with capital-raising. Langevoort uses this framework to explain the compromised version of Crowdfunding in the JOBS act.

> [P]ublic choice wisely reminds us to also look for instances where business' distaste for too much competition produces bad regulation pretending to be good. Forced (or subsidized) intermediation may seem like a way of assuring better investor protection because of the supposed regulatory control over the intermediaries, but is often a myth that papers over the serious anti-competitive consequences of such a choice, burdening entrepreneurs and investors.

In "Venture Exchange Regulation: Listing Standards, Market Microstructure, and Investor Protection," Jeff Schwartz proposes a framework for a potential venture exchange – a securities market designed for trading stock in startup firms. Small firm IPOs have declined notably over the past two decades, and there are a number of potential benefits – greater liquidity for equity holders, improved incentives for employees who receive equity compensation, and greater transparency in the governance of larger private firms – that could come from creating a secondary market for startup firms. Schwartz embraces this potential and explores securities rules and market microstructure that might support a robust venture exchange.

In particular, to avoid a lemons problem, Schwartz argues for listing standards that would "eliminate the smallest and youngest firms, and those where the listing exchange perceives a heightened risk of fraud." Moreover, Schwartz proposes market microstructure rules that would eliminate intermediaries on the venture exchange. The exchange would operate via call-auction rather than continuous trading and trading would be limited to the listing exchange. Finally, Schwartz argues that less ex ante disclosure and more focus on ex post regulation – enforcement of rules against securities fraud, market manipulation, and insider trading – would be a more effective way to protect retail investors participating in the venture exchange.

II GOVERNANCE AND ENTREPRENEURIAL ACTION

Part II considers internal governance arrangements between the various parties to a startup or joint venture. This section includes contributions that address the explicit contracts that such parties enter into as well as implicit understandings shared between participants in a family business and background norms that operate within the broader community of entrepreneurs and investors. A central focus of this section is on internal disputes, where a controlling party or management team could behave opportunistically toward other parties within the firm. As such, governance arrangements for entrepreneurial firms also include background fiduciary obligations and the potential for judicial review of corporate actions. This highlights an alternative consideration for the governance of start-up firms: the need for flexibility to take large risks in the face of an uncertain future. The chapters in this section explore the governance features needed to support entrepreneurial action.

In "Relational Contracting and Business Norms in Entrepreneurial Finance," Brian J. Broughman begins with the familiar problem of opportunism in entrepreneurial finance. While contracts in entrepreneurial finance are designed to foreclose specified forms of opportunism, these contracts are inherently incomplete, and fiduciary law cannot fully address gaps in those contracts. Given these limits on formal law, Broughman turns to relational contracting theory, contemplating the possibility that the parties to these contracts may rely on informal norms and relational modes of governance to settle their disputes.

The search for innovative ideas pushes startup investors to look outside their existing network of repeat relationships, potentially undermining the power of relational contracting in this context. In the absence of relational checks on opportunism, we might expect more extensive governance provisions, but Broughman finds little evidence of "contractual tailoring" in venture capital contracts. Instead, Broughman contends that the parties to these agreements include structural provisions that are designed to "transform an unconnected entrepreneur into an embedded entrepreneur." Broughman argues that this happens through third-party intermediaries (such as lawyers, board members, managers, scientists, and other entrepreneurs) who engage investors and entrepreneurs as matchmakers, chaperones, and arbitrators. It also happens through the ubiquitous practice of staged financing, which requires investors and entrepreneurs to interact repeatedly as a company grows. Third-party intermediaries and staged financing both entail costs, leading Broughman to the following prediction: "when a VC contracts with an unconnected entrepreneur (i.e. one outside the VC's network) the degree of financial staging will be higher and the parties are more likely to make use of embedded third-parties as matchmakers, chaperones, and arbitrators."

In "Biotech Strategic Alliances in Law and Entrepreneurship," D. Daniel Sokol starts by identifying a gap in the existing literature; while there is a large body of research examining financing contracts and other agreements between founders and VC investors, less attention has been given to the set of contracts used in strategic alliances between startup firms and larger firms within the same industry. This form of contracting is particularly important to biotech. Sokol points out that because of its business model, biotech often falls outside traditional venture finance and relies more on strategic alliances with upstream competitors.

Sokol draws on insights from various fields of research – management, finance, strategy, and economics – to provide an overview of the motivations for such firms to enter into an alliance agreement as compared to a strategic acquisition by the larger firm. He describes various contractual terms – standstill, indemnification, right of first negotiation, exclusivity, share purchase agreement, and several others – that are key elements in the alliance relationship. Sokol's chapter concludes by emphasizing the need for further research, particularly empirical studies, that help us have a better understanding of contractual mechanisms used in biotech alliances.

In "The Entrepreneurial Business Judgment Rule," Andrew Gold provides an account of the business judgment rule as a legal standard designed to encourage entrepreneurial action. While Gold is not the first to observe that the business judgment rule encourages innovation, the chapter provides a deeper understanding of how the business judgement rule responds to decision-making under uncertainty – which is one mechanism through which the business judgment rule indirectly encourages innovation. "It is uncertainty – and not merely risk – that entrepreneurs must confront." In its pure form, uncertainty implies decision-making where the risks cannot be quantified or even described ex ante. As such, a board may be asked to make a decision on an entrepreneurial strategy without knowing the risks involved, and without even being able to adequately communicate the basis for the decision. This pushes up against the limits of uninformed decision-making, and one could easily imagine variants of the business judgment rule where judicial review is called upon to evaluate decisions made within the cloud of uncertainty.

In Gold's account, the fact that this form of ex post judicial review seldom occurs is especially important for encouraging entrepreneurial action. He points out that courts could alternatively adopt benchmarks (e.g., "courts might look to objective standards for excessive risk; to industry custom; or to shareholder preferences") that would provide clear exceptions to the business judgment rule. The fact that such exceptions, even if based on objective standards, are generally rejected is, in Gold's account, important for encouraging entrepreneurial decision-making in the face of uncertainty.

In "Entrepreneurial Action in Family-Controlled Companies," Benjamin Means offers new insights into corporate control by expanding our understanding to include the identity of the controlling owners, focusing on family ownership. Law-and-finance scholars have offered three nonexclusive explanations for controlled ownership of business organizations: private economic benefits (self-dealing), noneconomic benefits (such as enhanced social status), and the desire to maintain an idiosyncratic, entrepreneurial vision. While each of these rationales has explanatory value, most controlled ownership occurs in family-owned businesses, and Means uses the term "family stewardship" to suggest that the costs and benefits associated with all three of these rationales may be different in the family context.

Perhaps the most distinctive feature of family stewardship is succession planning, in which control passes from one generation to the next. According to Means, the resulting emphasis on stability affects business strategy in several ways. For example, owners of family businesses "tend to take a longer-term view, [and] may prioritize sustainability over profits." Family businesses may also sacrifice profitability to benefit workers and other stakeholders who come to be viewed as part of the "family." Moreover, "family owners may be more willing than non-family owners to accept personal financial risk for the sake of the business." For Means, the principal implication of these observations is that family stewards are not motivated primarily by selfish interests and may not need to be compensated through private economic benefits or special noneconomic benefits, nor may they need to pursue an idiosyncratic strategy to maximize the firm's profits. In short, "family owners may sometimes prefer stability to disruptive innovation."

III LEGAL INCENTIVES SUPPORTING (AND SOMETIMES DISCOURAGING) ENTREPRENEURIAL ACTION

The chapters in Part III explore various ways that law can provide incentives to form an entrepreneurial venture and also some hurdles that existing laws create for entrepreneurship. Various bodies of law (e.g. tax and intellectual property) as well as government awards, grants, and other subsidies aim to provide incentives for the formation of innovative businesses. While such efforts are laudable, in practice large established firms may often be better positioned to take advantage of such incentives. This can create a mismatch, as the legal incentives to encourage entrepreneurship may be unavailable to startup firms and are instead captured by incumbent businesses that may be poorly suited to explore entrepreneurial disruption. For example, for a large firm an innovate technology may threaten profits from an existing product line. Similarly, contracts and laws regulating human capital, such as non-compete agreements, are subject to capture by established firms and can be used to block a potential entrepreneur from forming a spin-off business. A separate problem can occur in underdeveloped legal systems where risk of corruption can undermine entrepreneurial efforts by imposing extra costs and uncertainties. The chapters in this section explore these challenges and propose reforms and private ordering solutions that could provide robust incentives for entrepreneurial action.

In "Entrepreneurship Incentives for Resource-Constrained Firms," Susan C. Morse examines tax incentives for innovation and entrepreneurship, contrasting how these incentives operate differently for large established firms as opposed to resource-constrained startup firms. Morse starts by noting that newer startup firms may be better suited to pursuing entrepreneurship than a large business. Because startup firms are typically loss-generating businesses early in their life cycle, however, tax incentives for entrepreneurial action are often delayed to a later date when the business is able to generate profits. By contrast, an established profitable firm can generally capture benefits from tax incentives for entrepreneurship much earlier because such investments can be offset against other sources of income. Moreover, "it is more challenging for a resource-constrained firm to pay the upfront cost … required to support the later claim for a benefit such as a tax rate break on future profits." Morse describes this as an investment in legal incentives, and notes that under the current tax system it is easier for established businesses to invest in legal incentives designed to encourage entrepreneurship.

She supports this argument by working through a discounted cash flow analysis for a startup firm with a high discount rate (i.e. cost of borrowing) as compared to an established firm with a low discount rate. Due to differences in access to capital and differences in timing of payouts, large established firms can more easily take advantage of tax incentives for entrepreneurship than a small startup firm, distorting the market for innovation. Morse considers various tax reforms that could address the problem. These include (i) policies that would minimize the upfront cost to enter into a tax incentive program, (ii) shifting the timing of tax benefits such that they are realized earlier, or (iii) allowing the transfer of entrepreneurial tax benefits to third-party investors in exchange for financing an innovative project.

In "Searching for the Optimal Legal Limits on Charity Entrepreneurship," Lloyd Hitoshi Mayer explores legal barriers to entrepreneurial action by charities. Meyer starts by contrasting for-profit or hybrid entities that want to do good while also making a profit (social entrepreneurship) with charitable organizations that engage in entrepreneurial action and innovation (charity entrepreneurship). While charities may face pressure to come up with innovative solutions to various problems hindering their public mission, they also face legal barriers that interfere with entrepreneurship.

Mayer outlines four legal barriers. First, the commerciality doctrine under federal tax law can interfere with a charity's effort to be more economically efficient and business-like. This concern is emphasized if a charity develops a new product or service that furthers the charity's mission but also provide a revenue stream that is used to fund new activity. Second, rules relating to private inurnment and private benefits may limit a charity's effort to develop innovative compensation arrangements. Third, the dead hand problem imposed by restrictions on the use of charitable gifts may limit charity entrepreneurship. Fourth, if a charity determines that it could better pursue its mission by converting from a charitable entity to a for-profit entity, restriction on exit and transfer may block such efforts. Mayer concludes by noting a need for further study to determine how often such legal barriers prevent charity entrepreneurship and suggests that greater uncertainty or malleability in the application of the legal barriers may encourage charities to engage in entrepreneurial action.

In "Corrupting Entrepreneurial Action," Joseph W. Yockey surveys the negative effect of corruption on entrepreneurial action. At its simplest level, corruption (e.g. the need to bribe government officials for a permit) is simply an additional transaction cost to starting a new business, and like other sources of red-tape, corruption can be expected to dampen entrepreneurship. But as Yockey points out, corruption also introduces complexity and uncertainty, making it hard to plan for the future and undermining predictable enforcement of contract and property rights, ingredients that are essential to an entrepreneur's willingness to take risks.

After surveying existing research on ways that corruption negatively impacts entrepreneurial action, Yockey suggests possible solutions that do not rely solely on law enforcement. Part of his reason for this approach is that developed countries can only regulate the payment of bribes (e.g. the Foreign Corrupt Practices Act), and are more limited in their ability to address "incentives to take and demand bribes that are so often built into underlying economic structures within developing markets." Yockey suggests that private ordering among entrepreneurs, knowledge sharing, and innovative market-based solutions may serve as "complements to a traditional enforcement regime." The involvement of entrepreneurs as private actors in the creation of anti-corruption systems can be seen as a type of new governance that is based less on top-down rulemaking and more on collaboration among stakeholders.

In "The Spinoff Advantage: Human Capital Law and Entrepreneurship," Orly Lobel explores the impact of post-employment job mobility restrictions – non-compete clauses, non-disclosure agreements, proprietary information agreements, innovation assignment clauses, and other mechanisms – on entrepreneurial spinoffs. Lobel refers to this category of contractual and regulatory restrictions impacting job mobility as "human capital law." Her chapter starts by noting that spinoff businesses, where a company is founded by a former employee of a competitor, are an especially important category of innovation, economic growth, and entrepreneurship. While states adopt various policies that "affirmatively support entrepreneurship through tax credits, subsidies, and awards," Lobel argues that when it comes to human capital law, many of these same states enforce strong restrictions on post-employment mobility. She argues that these mobility restrictions dampen overall levels of entrepreneurship, and spinoff-base entrepreneurship specifically.

There is, of course, a conventional justification for strong enforcement of non-competes and restrictions on human capital. With strong enforcement, "employers will have confidence in the longevity of their employees' service, and will therefore be incentivized to invest more in their employees and to share knowledge and trade secrets more freely." Lobel argues, however, that such benefits are outweighed by often overlooked costs. For instance, strong enforcement of restrictions on human capital mobility can undermine incentives for effort among existing employees and can entrench incumbent firms. Lobel supports her argument with a number of examples and empirical results suggesting a benefit to looser restrictions on post-employment mobility. Lobel also notes that regardless whether a non-compete agreement or other restriction covers a particular setting, a startup can be crippled by costly litigation of such contracts, further insulating incumbent firms from entrepreneurial challengers.

In "Organ Entrepreneurs," Kieran Healy and Kimberly D. Krawiec acknowledge that "[t]he supply of human organs for transplantation might seem an unlikely place to begin thinking about entrepreneurship," given the absence of a production market in human organs and the fact that the sale of human organs is illegal in most countries. Nevertheless, the authors argue that "entrepreneurs have been very much present throughout the history of organ transplantation," not only in the form of medical advances, but in the "active exploration, innovation, and management of a potentially very controversial exchange at the seemingly clear boundaries that separate giving from selling, life from death, and right from wrong."

For many people, organ exchange is novel and challenging, perhaps even immoral. On the other hand, many people are motivated to facilitate organ exchange and seek to leverage reciprocity and gift-exchange to make organ exchange seem analogous to more familiar transactions. The authors examine three innovations to illustrate the way organ entrepreneurs attempt to socially legitimate or legally reclassify organ exchanges. Healy and Krawiec deploy these examples to help explain "the more general phenomenon of innovation in the shadow of the law, and the role of reciprocity and the logic of gift-exchange in that process."