Institutionalized Disruption: The Rise of the Reformer Startup

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Institutionalized Disruption:  
The Rise of the Reformer Startup

Abraham J.B. Cable*


Drawing from the symposium, this essay considers why startups are increasingly taking up the mantle of regulatory reform, how they are achieving their successes, and whether the reformer startup is a positive development for our political economy. It tentatively proposes that: (1) features of the current venture-capital market and startup ecosystem, rather than the pace of technological advancement, might explain the timing, (2) a “bootleggers and Baptists” dynamic of well-resourced interest groups and popular messaging explains the successes, and (3) we should be cautiously optimistic about this “institutionalized disruption” of incumbents.

I. INTRODUCTION

There is nothing new about startups operating in regulated fields. For instance, a significant percentage of venture-capital dollars have always been invested in biotech, where FDA approval looms large.1 There is also nothing new about innovative technologies requiring new regulatory frameworks. Widespread use of social media, for

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1. NAT'L VENTURE CAPITAL ASS'N, 2015 NAT'L VENTURE CAPITAL ASS'N Y.B. (18 ed. 2015) [hereinafter NVCA YEARBOOK].
example, eventually necessitated enhanced protection of privacy and data security. The recent symposium, however, reveals a different trend: startups premised on regulatory reform or acquiescence because they operate in the face or shadow of prohibitive regulatory regimes ("reformer startups"). Examples include sharing-economy companies (taxi and hotel licensing), crowdfunding platforms (private-offering regulation), and Bitcoin startups (financial regulation). In each case, startups obtained significant funding or built large customer bases without resolution of regulatory uncertainty.

2. For an overview of the burgeoning field of privacy regulation, see David J. Solove & Paul M. Schwartz, Privacy Law Fundamentals (3d ed. 2015).

3. It is, of course, difficult to ascertain how apparent the need for regulatory reform was at the time of founding. One view is that the regulatory uncertainties revealed themselves only after the companies attracted attention. See Jeffrey Rabkin, Special Assistant Attorney General, Office of the Attorney General, Dep't of Justice, Keynote Address at Hastings Business Law Journal and Hastings Science and Technology Law Journal Symposium: Regulating the Disruption Economy (Mar. 20, 2015) (suggesting that regulatory issues are often the result of honest mistakes by entrepreneurs). Another view is that entrepreneurs have a more intentional mindset of asking for forgiveness rather than permission. See Lucas E. Buckley, Jesse K. Fishman & Matthew K. Kauffman, The Intersection of Innovation and the Law, Wyo. L.J., Aug. 2015, at 38 (noting that “[m]any innovative companies are using technology to invade highly-regulated industries”); see also Shredding the Rules, ECONOMIST (May 2, 2015), http://www.economist.com/news/business/21650142-striking-number-innovative-companies-have-business-models-flout-law-shredding [hereinafter Shredding the Rules] (“A striking number of innovative companies have business models that flout the law.”); Rabkin, supra note 3 (suggesting that entrepreneurs are not the type to “read the back of the Scrabble box”). In any event, one can assume that these companies, often represented by elite national law firms and vetted thoroughly by venture-capital investors, began thinking about their regulatory status sooner rather than later.


6. See Kevin V. Tu & Michael W. Meredith, Rethinking Virtual Currency Regulation in the Bitcoin Age, 90 Wash. L. Rev. 271, 300-13 (2015) (discussing the possible application of state and federal money-transmitting laws and other regulations to virtual currency).

7. For a description of Bitcoin’s successes, see Tu & Meredith, supra note 6, at 285 (noting that over three hundred thousand dollars in Bitcoin transactions are processed per day). See also Yuliya Chernova, Big Day for Bitcoin Startups: Three Startups Haul in $23.5M in Funding, WALL ST. J. (Mar. 26, 2014, 5:10 PM), http://blogs.wsj.com/venturecapital/2014/03/26/big-day-
Viewed this way, it is the regulatory successes rather than failures of these companies that most warrants our attention. While reformer startups hit some bumps in the road, they mostly maneuvered their way to regulatory truces that opened enough room for growth. For example, financial regulators have signaled a hands-off approach to many aspects of Bitcoin. Uber and Lyft operate under modified regulatory frameworks tailored to “transportation network companies.” San Francisco just enacted the nation's first...
“Airbnb law” to accommodate the company's popularity. Congress blessed crowdfunding and directed the Securities and Exchange Commission (“SEC”) to follow suit.

This essay examines the rise of the reformer startup by posing three questions: why now, why have these reform efforts succeeded, and is the reformer startup a positive development for our political economy? In addressing those questions, I sketch out the following possible answers: (1) a frothy venture capital (“VC”) market and startup ecosystem explains the timing, (2) a combination of well-resourced startups and popular affection for Silicon Valley startups explains the success, and (3) a cautious optimism is warranted because reform-minded startups may be a helpful counterpart to the market and political power of incumbents.

II. WHY NOW? UNICORNS AND MEGAFUNDS

If reformer startups are a recent phenomenon, why are we seeing them now?

One possible answer is that the pace of technological innovation is quickening, creating a growing need for reform. The symposium was shot through with references to a “knowledge gap” between tech-savvy entrepreneurs and less sophisticated regulators. In light of classification and regulation under existing regimes, Uber and Lyft have themselves sought to exploit the logic of regulatory capture. See Rabkin, supra note 3 (suggesting we are at the “dawn of a new age” and citing Moore’s Law regarding computing power and Metcalf’s Law regarding network effects).


12. Congress created an exemption specifically for crowdfunding under the Jumpstart Our Business Startups Act of 2012 (“JOBS Act”). See generally Joan MacLeod Heminway, How Congress Killed Investment Crowdfunding: A Tale of Political Pressure, Hasty Decisions, and Inexpert Judgments That Begs for a Happy Ending, 102 KY. L.J. 865 (2014). Although the SEC has failed to finalize implementing regulations for the crowdfunding exemption, crowdfunding platforms have begun operations, with some restrictions on their investor pools, under alternative provisions of the JOBS Act that loosen regulation of online solicitations more broadly. See generally supra note 7.

13. See Rabkin, supra note 3 (suggesting we are at the “dawn of a new age” and citing Moore’s Law regarding computing power and Metcalf’s Law regarding network effects).

such a gap, lobbying efforts can be seen as an educational exercise, and reformer startups are doing the tough sledding of getting regulation right in a fast-moving world.\textsuperscript{15}

But one might question the underlying premise of this view—that we are in the midst of particularly transformative innovation. The products represented at the symposium are certainly popular,\textsuperscript{16} and they might even represent an important change in social organization.\textsuperscript{17} But change is always afoot, and it is not self-evident that the current period of innovation stands out.\textsuperscript{18} There is even a view from prominent economists that today's technological advances are modest compared to previous periods, at least when measured by their effects on economic productivity.\textsuperscript{19} At the very least, measuring the pace of innovation seems a vexing task, and it is worth exploring whether there is something else distinctive about today's startup ecosystem that could explain the rise of the reformer startup.

The most conspicuous feature of today's startups is their size. By one recent count, there were over one hundred startups valued at over one billion dollars—so-called “unicorn companies.”\textsuperscript{20} These companies are startups in only a loose sense. True, they have short operating histories and they have not had an initial public offering of

\textsuperscript{15} In this vein, several panel participants characterized interactions between entrepreneurs and regulators as efforts to “educate” or “help” the former. \textit{E.g.}, Taylor, supra note 14 (discussing efforts to help regulators understand the ride-sharing business).

\textsuperscript{16} See supra note 7 (discussing the successes of sharing-economy, crowdfunding, and Bitcoin startups in attracting customers).

\textsuperscript{17} Katie Biber, Senior Counsel, Airbnb, Address at \textit{Hastings Business Law Journal and Hastings Science and Technology Law Journal} Symposium: Regulating the Disruption Economy (Mar. 20, 2015) (describing AirBNB as having “real social power”).

\textsuperscript{18} For example, one could make the argument that changes in transportation technologies and industrial organization in the nineteenth and early twentieth centuries were particularly profound. \textit{E.g.} \textit{STEPHEN E. AMBROSE, UNDAUNTED COURAGE: MERIWETHER LEWIS, THOMAS JEFFERSON, AND THE OPENING OF THE AMERICAN WEST} 53–54 (1996) (observing that, prior to railroads, there had been very little innovation in transportation since ancient times).


stock ("IPO"). But they may have thousands of employees and may have obtained hundreds of millions (in some cases billions) in venture-capital and other forms of financing. These well-heeled startups have capacity to engage with regulators in ways that the archetypical startup—making do on a shoestring budget—might lack.

Another distinctive feature of the startup landscape is the size of today's venture-capital ("VC") market. According to the industry's leading trade association, "[b]y any measure, 2014 was a remarkable year for the venture capital market in the United States." The total amount invested by VC funds in startups is the highest since the dot-com era. In addition, the amount that endowments, pension funds, and other institutional investors invest with VC managers has been on the upswing. In particular, top-tier VC managers are having unusual success in raising capital.

It is plausible that a VC manager will put money to work more creatively in this market. Historically, VC managers might have shied away from an investment premised on regulatory reform in order to focus on the types of technological and operational challenges that

21. Winkler & Demos, supra note 20. (noting that Uber has raised over five billion dollars in financing and is valued at over fifty billion dollars).
22. The mere fact that Symposium panelists featured titles like "Manager of Government Relations" suggests the garage is far in the rearview mirror for these startups. See Mike Isaac, Uber Picks David Plouffe to Wage Regulatory Fight, N.Y. TIMES (Aug. 19, 2014), http://www.nytimes.com/2014/08/20/technology/uber-picks-a-political-insider-to-wage-its-regulatory-battles.html?_r=0 (reporting that Uber hired David Plouffe, former campaign manager for President Obama); see also Mike Isaac, Airbnb Hires Chris Lehane, Former Aide to Bill Clinton, as Head of Policy, N.Y. TIMES: BITS BLOG (Aug. 27, 2015, 9:00 AM), http://bits.blogs.nytimes.com/2015/08/27/airbnb-appoints-chris-lehane-former-adviser-to-bill-clinton-as-head-of-policy/ (reporting that Airbnb hired a former adviser to Bill Clinton).
23. NVCA YEARBOOK, supra note 1, at 9.
24. Id.
25. Id.
26. According to National Venture Capital Fund statistics, thirty-one venture-capital managers manage over one billion dollars. Id. at 17-19. Average fund size is greater than the industry's heyday in the early 2000s. Id. at 9. Though average fund size has actually come down in recent years, see id. at 20, that may be because the industry is bifurcating into very large funds and smaller seed funds. Id. at 17 (noting that "the bulk of the capital (measured by dollars) being committed today is being raised by larger, specialty, and boutique firms."). In short, top-tier venture capital firms are capturing an increasing percentage of available capital. See Mark Suster, The Changing Structure of the VC Industry, FORTUNE (July 22, 2014, 9:15 AM), http://fortune.com/2014/07/22/the-changing-structure-of-the-vc-industry.
are better suited for the typical VC manager's skill set.\textsuperscript{27} But in a
headier environment, where venture capitalists face tough
tough competition for the most attractive traditional deals, funds might be
more willing to leave their comfort zone.\textsuperscript{28}

If a distinctive startup ecosystem—featuring atypically mature
startups and a particularly flush VC industry—help explain the
reformer startup, one might ask whether the trend is just a temporary
disequilibrium. Perhaps macroeconomic developments and hard
lessons will swing the pendulum, and the reformer startup will be no
more than a historical footnote.

I suspect, however, that such a trend could have staying power.
Even an investment model that is as path dependent as venture
capital can sometimes find a new path.\textsuperscript{29} If today's reformer startups
succeed, it may clear the way for others to follow suit.

In the end, this explanation for the rise of the reformer startup is
admittedly conjecture. But it is important to look hard for
alternatives to claims of technological exceptionalism. As described
in Part III below, we exhibit a collective enthusiasm for technological
innovation. But if we reflexively believe there is a widening
knowledge gap, we risk relying on the wrong policy prescriptions.

III. WHY SUCCESS? “BOOTLEGGERS AND BAPTISTS”

A separate question is how reformer startups are achieving their
successes. As a preliminary matter, it is useful to consider why these
successes might be surprising.

Companies featured at the symposium are all acting as a sort of
intermediary, connecting drivers and passengers, property owners
and travelers, payors and payees, and investors and issuers. In each

\textsuperscript{27} See Abraham J.B. Cable, \textit{Opportunity-Cost Conflicts in Corporate Law}, 66 CASE W.

\textsuperscript{28} Christina Farr, \textit{Venture Capitalists Face a More Competitive, Global Market},
\textsc{VentureBeat} (Mar. 13, 2014, 12:15 PM), http://venturebeat.com/2014/03/13/venture-capital
ists-face-a-more-competitive-global-market (suggesting that increased competition among VC
managers means “[t]hey have become more global in their geographic outlook, more
sophisticated in their analysis of opportunities and more innovative in terms of how, where and
when to invest.”).

\textsuperscript{29} See Suster, supra note 26 (suggesting that the bifurcation of the VC industry into large
and small funds is an important “structural shift” in venture-capital investing).
case, incumbents provide similar intermediation (e.g., traditional banks or money transmitters offer services that compete with Bitcoin startups) or benefit from the absence of such intermediaries (e.g., traditional hotel groups benefit if property owners are not easily matched with travelers).

Public-interest theory predicts that these incumbents will fight hard to preserve the current regulatory environment as a barrier to entry. In some cases, the incumbents are formidable. Financial-institution and hospitality-industry giants may have considerable resources to expend on preserving the status quo. In other instances, the balance of power may be different. We can assume that Uber has a considerable war chest compared to local taxi owners. But even in these instances, incumbents have a tremendous amount at stake and may have long patterns of interactions with regulators—“capture” in the language of public interest theory. And regulatory flip-flops may have a high political cost to the regulator or lawmaker if the current regime plausibly produces public benefit. In the end, regulations tend to be “durable,” even if not impenetrable, barriers to competition.

How, then, are reformer startups making so much headway? Public-choice theory again offers some insight.

Public-choice theorists observe that the most ambitious efforts to influence law require a combination of economically minded interest groups and publicly minded rhetoric capable of achieving broader support. Bruce Yandle, for example, famously attributed Sunday

30. See Maxwell I. Stearns & Todd J. Zywicki, Public Choice Concepts and Applications in Law 67 (2009). One can adopt this view while being agnostic on the underlying merits of the regulatory regimes. Taxi and hotel licensing, securities regulation, and money-transmitting laws might have been enacted, and still operate, as public-regarding laws. Or they might be the result of self-interested rent seeking. For this essay’s purposes, the point is that they become valuable to incumbents as they structure their businesses around the existing regime. See id. (discussing the concept of “rent extraction”).

31. See Kaplan & Nadler, supra note 4, at 107 (“Airbnb hosts face strong headwinds from a well-funded coalition of landlords and hotel-industry leaders, which plans to spend millions of dollars on a public campaign criticizing Airbnb.”).

32. See Rabkin, supra note 3 (answering questions regarding possible unfairness to taxi cab owners).


34. Stearns & Zywicki, supra note 30, at 49 (describing rents from protectionist regulatory policies as being more “durable” than market-driven monopolistic pricing).
In the case of reformer startups, the narrow economic interests are easy enough to identify. The companies’ investors, founders, and employees (presumably compensated by stock options) have plenty to gain.

The Baptists are harder to pin down. Make no mistake, reformer startups have their evangelists. Proponents of Uber and Lyft literally take to the street in support of ride-sharing. “Tech missionaries” lobby on behalf of virtual currency. The “crowdfunding exemption movement” has a meticulously maintained Wikipedia page (not to mention an unpredicted celebrity endorsement by Whoopi Goldberg!). These are more fervent demonstrations of support than one might expect in connection with taxi regulation, payment systems, and private-offering regulation. But clearly, these technologies strike a chord—libertarian, egalitarian, or otherwise—with some subset of the population.

But what about the rest of us? Are we convinced of the transformative nature of these companies and their products? Does

35. See id. at 75, Yandle summarizes his theory as follows: “Durable social regulation evolves when it is demanded by both of two distinctly different groups. ‘Baptists’ point to the moral high ground and give vital and vocal endorsement of laudable public benefits promised by a desired regulation. Baptists flourish when their moral message forms a visible foundation for political action. ‘Bootleggers’ are much less visible but no less vital. Bootleggers, who expect to profit from the very regulatory restrictions desired by Baptists, grease the political machinery with some of their expected proceeds. They are simply in it for the money.” Bruce Yandle, Bootleggers and Baptists in Retrospect, 22 REGULATION 3 (1999).

36. Yandle’s theory emphasizes the importance of rhetoric in lowering the political cost of granting interest group concessions. See id. at 7 (“[R]hetoric matters a lot in the world of politics but . . . neither well-varnished moral prompting nor unvarnished campaign contributions can do the job alone. It takes both.”).

37. Christina Farr, Uber & Lyft Have a Secret Weapon in the Fight for Regulatory Approval: You, VENTUREBEAT (Sept. 11, 2013, 10:15 AM), http://venturebeat.com/2013/09/11/ridesharing/ (describing grassroots appeal of ride-sharing companies and their reform efforts, and indicating that such broad-based support has influenced venture-capital investment decisions).


the rhetoric of the technology evangelists provide sufficient cover for politicians and regulators to remake long-standing legal regimes in the image of a relatively small number of well-funded startups?

Consider two possibilities. One view is that the rhetoric doesn’t matter much, and what matters is straightforward consumer welfare (or perception thereof). These companies managed to scale rapidly in legal grey areas, and they delivered products at lower costs or with improved service. Inexpensive transportation, lodging, and money transmission are relatively salient benefits—felt more immediately by voters than the projected benefits of lifting a steel tariff, for example—and so they might obviate the need for the loftier messaging that Yandle and company envision.40

I would not be so quick to dismiss the social meaning of reformer startups, however. We may not share the evangelists’ more grandiose visions—for example, that the right software code compels a fundamental rethinking of the state.41 But reformer startups do seem to resonate with more broadly held views.

First, we often see technological innovation as the way forward in difficult times. For example, the “knowledge-based economy” is held out as a remedy for the dislocation caused by global economic trends.42 Even those with no intent to share a ride, spend a Bitcoin, or host a stranger may believe that our collective prosperity increasingly

40. Again, one need not reach a conclusion about the underlying merits of the current regulatory regimes to adopt this view. The highly salient benefits provided by reformer startups may or may not be outweighed by health, safety, and security concerns. But those costs, even if significant, are arguably murkier, or more contingent, than the immediate price and service benefits and might therefore be difficult for consumers to internalize.

41. Alan Feuer, The Bitcoin Ideology, N.Y. TIMES (Dec. 14, 2013), http://www.nytimes.com/2013/12/15/sunday-review/the-bitcoin-ideology.html (describing Bitcoin as a philosophy and movement with anarchic and libertarian roots, which has as its goals “to unleash repressed economies, to take down global banking or to wage a war against the Federal Reserve”); see also About, SHAREABLE, http://www.shareable.net/about (last visited Oct 26, 2015) (“The sharing transformation shows that it’s possible to govern ourselves, build a green economy that serves everyone, and create meaningful lives together.”).

42. Abraham J.B. Cable, Incubator Cities: Tomorrow’s Economy, Yesterday’s Start-Ups, 2 MICH. BUS. & ENTREPRENEURIAL L. REV. 195, 212–13 (2013) (discussing the effects that reduced transportation and communication costs have had on traditional manufacturing and natural-resource-extraction industries, and the perception that economic regions in the U.S. must be reoriented to participate in the “knowledge-based economy”) (citing EDWARD GLAESER, TRIUMPH OF THE CITY 49 (2011); RICHARD FLORIDA, THE RISE OF THE CREATIVE CLASS AND HOW ITS TRANSFORMING WORK, LEISURE, COMMUNITY AND EVERYDAY LIFE 44 (2002)).
depends on inventing, rather than making, things.

In addition, we have a distinctive affinity for the entrepreneurs who turn these innovative ideas into businesses.\textsuperscript{43} Entrepreneurship takes place everywhere,\textsuperscript{44} but one senses that it is especially valued in the United States.\textsuperscript{45} The origins of this sentiment are beyond the scope of this essay, but candidates include long-held commitments to upward mobility and decentralized power.

As the embodiment of both technological innovation and entrepreneurship,\textsuperscript{46} Silicon Valley seems to have attained privileged status in our political economy.\textsuperscript{47} Tax policy, securities regulation, and a dizzying array of public programs seek to spread and replicate its distinctive system for incubating new businesses.\textsuperscript{48} Its appeal extends far beyond economic-development wonks. Silicon Valley's distinctive lexicon permeates television and movies.\textsuperscript{49} We mourned the passing of Steve Jobs like a beloved public figure. In short, our heroes seem to wear hoodies these days.


\textsuperscript{44} \textit{E.g.}, id. at 1533-34 (recounting one entrepreneur’s tale of starting a business in remote Siberia).

\textsuperscript{45} This point is implied by an anecdote in Smith and Ibrahim’s ambitious piece arguing that entrepreneurship is an animating value in U.S. law. They describe a German colleague who holds entrepreneurship in low regard. See id. at 1550. Similarly, scholars have argued that efforts to replicate the U.S. venture-capital market in other societies have failed because of less favorable cultural attitudes towards entrepreneurship. Ronald J. Gilson, \textit{Engineering a Venture Capital Market: Lessons from the American Experience}, 55 \textit{STAN. L. REV.} 1067, 1102-03 (2003) (discussing, with some skepticism, the extent to which cultural differences might affect efforts to “engineer” a venture-capital market).

\textsuperscript{46} In previous work, I have argued that policy makers are sometimes too quick to conflate entrepreneurship and Silicon Valley-style venture capital. See Cable, \textit{ supra} note 42, at 198 (citing PAUL KEDROSKY, \textit{RIGHT-SIZING THE U.S. VENTURE CAPITAL INDUSTRY} 1 (2009), http://www.kauffman.org/uploadedfiles/usventcap061009r1.pdf).

\textsuperscript{47} I borrow the term “privileged status” from my colleague Jodi Short, who noted that participants in one panel were ascribing such status to the term “innovation.”

\textsuperscript{48} Cable, \textit{ supra} note 42, at 197-98 (explaining a variety of public programs supporting Silicon Valley-style entrepreneurship); \textit{generally} JOSH LERNER, \textit{BOULEVARD OF BROKEN DREAMS: WHY PUBLIC EFFORTS TO BOOST ENTREPRENEURSHIP HAVE FAILED—AND WHAT TO DO ABOUT IT} (2009) (describing efforts in the U.S. and globally to emulate Silicon Valley).

And here is where the reformer startup may go off script a bit. In Yandle's formulation, the bootleggers must work behind the scenes and rely on the Baptists to be the public face of the movement. Reformer startups, however, can plausibly occupy the pulpit themselves. As a society, we are inclined to see some broader significance in their economic successes. With potentially deep pockets and a shiny public image, reformer startups are potential lobbying juggernauts.

IV. A CAUTIOUS OPTIMISM

So far, this essay suggests that market conditions in Silicon Valley explain the rise of the reformer startup, and that a “bootleggers and Baptists” dynamic explains reformer startups’ successes. If true, what to make of it all?

There is a cynical view that we are witnessing nothing more than old-fashioned rent-seeking with only a veneer of broader importance. By this view, neither the incumbents nor the current crop of startups can be trusted to pursue anything but self-interest, and the regulatory environment is available to the highest bidder (net of political costs).

At the other extreme, reformer startups represent the public interest. The success of their products exposes current regulation as wrongheaded. Reformer startups and their grassroots advocates educate, or expose, regulators and lawmakers who would otherwise be hopelessly anachronistic or beholden to incumbents.

Perhaps we can draw something from each view. We should be careful about treating innovation and entrepreneurship as trump cards in policy debate. In the current environment, it can be hard to tell who is the David and who is the Goliath. Each regulatory battle has its own political economy, and we cannot assume that the benefits of innovation necessarily outweigh traditional health, safety, and investor protections.

On the other hand, I am cautiously optimistic about the big picture. Silicon Valley’s distinctive systems of finance, labor, and industrial organization are the envy of the world. Together, they form an important institution—the startup ecosystem—that enables

50. See LERNER, supra note 48 (discussing efforts to import the Silicon Valley model).
long-shot efforts to unseat incumbents. This “institutionalized disruption” could be an important counter to the inertia of anticompetitive regulation. In the long run, I hope we might see more thoughtful regulation if well-financed and politically palatable startups regularly take aim at the status quo. Only time will tell.