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Contractual Innovation in Venture Capital

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Scholars agree that contractual innovation, though sometimes slow to occur, can and will take place if certain conditions are met. The Article argues that the evolution of certain venture finance contracts over the past decade constitutes a prime example of such innovation.

Drawing upon interviews with some of the leading venture capital attorneys in the United States, it chronicles how two types of venture finance contracts — the convertible note and convertible preferred stock — evolved in response to technological advances that greatly reduced the cost of launching a start-up technology company. Prior to 2005, individuals who invested in early-stage technology companies would typically invest alongside the founder of the new venture by purchasing shares of common stock. Venture capital funds, which invested more substantial amounts of capital at later stages in a company's development, would typically receive convertible preferred stock. And in situations in which a company needed a loan from its current investors to keep it afloat until a new infusion of capital could be raised — a so-called bridge loan — investors would typically receive promissory notes that were convertible into equity at a future date. Each of these types of investment contracts reliably matched up with a particular mode of financing transaction.

Around 2005, however, this stable contractual infrastructure began to change. A number of technological developments — including, most significantly, the rise of cloud computing — led to a dramatic decline in the costs of launching a technology company. In the wake of these changes, the contracts used by investors to structure their investments in these ventures evolved in two important ways. First, convertible notes, previously used primarily in the context of bridge financing, were increasingly used to provide financing to early-stage technology companies. Second, investors in early-stage technology companies increasingly turned to much simplified versions of traditional convertible preferred stock documents to structure their investments. While these changes have fundamentally reshaped the contractual infrastructure of early-stage venture finance in the United States, they have attracted scant attention in the legal literature to date. This Article aspires to fill that gap.

The Article then draws upon this account of evolution and change in the venture capital space to develop insights into the process of contractual innovation more generally. It argues that current theories of contractual innovation only partially explain the changes to these venture finance contracts over the past decade. It argues that while attorneys can and do serve to drive the process of contractual innovation, the success of these efforts is highly dependent upon partnerships that they develop with the end users of these contracts. Finally, the Article suggests that the substitution of one type of contract for another — using equity instead of debt, for example — is itself an innovation that has gone largely unappreciated in the contractual innovation literature.

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