Contractual Innovation in Venture Capital: How the Rise of Cloud Computing Disrupted the Way Startup Technology Companies are Financed

Insights
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The following post comes to us from John F. Coyle, Assistant Professor of Law at the University of North Carolina at Chapel Hill, and Joseph M. Green, Associate at Gunderson Dettmer Stough Villeneuve Franklin & Hachigian, LLP in New York, and is based on their forthcoming article in the Hastings Law Journal, "Contractual Innovation in Venture Capital." The full paper is available here.

How do the investment contracts used by venture capitalists today differ from those used in the past? Our forthcoming article in the *Hastings Law Journal* offers a partial answer to this question. Drawing upon interviews with some of the leading venture capital attorneys in the United States, we chronicle how two specific types of venture finance contracts—the convertible note and simplified convertible preferred stock—have come to be widely used to provide capital to early-stage technology companies in recent years.

Prior to 2005, individuals who invested in early-stage technology companies (be they the founder's friends and family or so-called "angel" investors) would typically invest alongside the founder of the new venture by purchasing shares of common stock. Institutional venture capital funds, which invested more substantial amounts of capital at later stages in a company's development, would typically receive convertible preferred stock, along with a host of additional contractual rights and protections. And in situations in which a company needed cash from its current investors to keep it afloat until a new infusion of outside capital could be raised—a so-called bridge loan—investors would typically receive promissory notes that were convertible into preferred stock at a future date.

Around 2005, however, this stable contractual infrastructure began to evolve. 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 shocks to the venture financing landscape, 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 capital to these fledgling companies. Second, investors in early-stage technology companies increasingly turned to much simplified versions of traditional convertible preferred stock documents to structure their investments.

These changes have fundamentally reshaped the contractual infrastructure of early-stage venture finance in the United States. To date, however, they have attracted scant attention in the legal literature. Our paper seeks to remedy this oversight by providing a comprehensive account of these changes against the backdrop of the legal literature exploring the process of contractual innovation more generally.

We hope that that this account will be of interest to entrepreneurs, venture capitalists and the lawyers who represent them. Our paper provides readers with a better understanding of how many of the now "standard" terms in convertible notes and early-stage equity financing documentation came to be included in such documents. It discusses, for example, a lengthy account of the origins of several "model" simplified convertible preferred stock documents. It also considers the future of these instruments by examining new hybrid types of seed financing contracts such as the convertible security and the Simple Agreement for Future Equity (SAFE).

We also hope that this account will prove useful to academics who study the process of contractual innovation more generally. We argue that current theories of contractual innovation only partially explain the changes to these venture finance contracts over the past decade. Our research also indicates 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, we suggest that the substitution of one type of contract for another—using convertible equity instead of convertible debt, for example—is itself an innovation that has gone largely unappreciated in the contractual innovation literature.

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