

The Evolution of Entrepreneurial Finance: A New Typology

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There has been an explosion in new types of startup finance instruments. Whereas twenty years ago preferred stock dominated the field, startup companies and investors now use at least eight different instruments – six of which have only become widely used in the last decade. Legal scholars have yet to reflect upon the proliferation of instrument types in the aggregate. Notably missing is a way to organize instruments into a common framework that highlights their similarities and differences.

This Article makes four contributions. First, it catalogues the variety of startup investment forms. I describe novel instruments, such as revenue-based financing, which remain understudied within law and entrepreneurship. Second, this Article shows the limitations of the debt vs. equity distinction as a classification method for startup financial contracts. Reliance on this traditional distinction obscures understanding of how instruments function. Third, the Article proposes a “new typology” to classify investment instruments based upon their economic, control, time, and regulatory dimensions. Three new broad categories – Payouts, Lock-in, and Park-n-ride – provide an insightful way to group these contracts. And fourth, the new typology explains how an expansion in instrument types creates complex capital structures which increase horizontal conflicts among startup investors. Further, new instruments increasingly place investors into a non-shareholder role that is outside the

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boundaries of corporate law's protections. As early-stage investors increasingly fall outside the protections of corporate law, a greater burden shifts to contract law to resolve disputes arising from divergent investor interests.

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INTRODUCTION

New financial instruments confound the conventional wisdom that startups routinely rely upon stock issuances to raise capital.¹

The Telluride Venture Accelerator (TVA) is in the business of investing in and launching new startups.² The TVA offers capital and extensive help in exchange for a stake in a startup. The unusual part of TVA's program is that, in lieu of stock, the TVA invested in certain portfolio companies through a form of variable loan, called Revenue-Based Financing (RBF).³ This form of investment makes TVA a lender rather than a shareholder.

Meanwhile, MadKudu is a software startup in Mountain View, California, that sells big data tools to analyze customer behavior patterns. To fuel operations, in November 2015 MadKudu raised a \$1.4 million seed round from a French investment fund and several angel investors. The investment used an instrument popularized on the West Coast, the Simple Agreement for Future Equity (Safe).⁴

1. The "conventional wisdom" – increasingly debunked by scholars – is that startups "rely almost exclusively on equity funding from angel investors and venture capitalists (VCs)." Darian M. Ibrahim, *Debt as Venture Capital*, 2010 U. ILL. L. REV. 1169, 1170 [hereinafter *Debt as Venture Capital*]. The term "startup" in general parlance refers to a private company, with high growth ambition, that has yet to reach an exit event. See, e.g., Jeff Schwartz, *Should Mutual Funds Invest in Startups? A Case Study of Fidelity Magellan Fund's Investments in Unicorns (and Other Startups) and the Regulatory Implications*, 95 N.C. L. REV. 1341 (2017) (referring to startups including Uber and Airbnb). High growth ambition is important. "Startup" is typically used in contradistinction to "small business." A startup seeks to scale – that is, replicate and rapidly grow – a business idea or product in a short amount of time. See Brad Bernthal, *Investment Accelerators*, 21 STAN. J.L. BUS. & FIN. 139, 142 n.8 (2016). For example, a nifty software solution that creates a better search engine (i.e., Google) fuels a startup. In contrast, a small business pursues a business model or idea that is, relative to a startup, less replicable and less likely to experience rapid growth. A charismatic chef in a food truck who creates a great experience for a customer is involved in a small business. Of course, boundaries between a startup and small business are a matter of degree, not binary, and what initially appears as a small business may prove to be surprisingly scalable. For example, a better coffee shop experience (i.e., Starbucks) turned out to be more than just a small business.

2. The TVA is an example of an investment accelerator program. See Bernthal, *supra* note 1 (defining the *investment accelerator* and describing proliferation of accelerator programs).

3. See *Program*, TELLURIDE VENTURE ACCELERATOR, <http://www.tellurideva.com/program/> [https://perma.cc/U83U-BE4H] (noting financing option borrowed from Indie.vc) (form of TVA revenue-based financing note on file with author).

4. E-mail from Sam Levan, CEO of MadKudu, to Brad Bernthal, Assoc. Professor of Law, Univ. of Colo. Law Sch. (Feb. 16, 2018) (on file with author) (disclosure: the Author worked as a mentor with MadKudu during the Boulder Techstars program and participated

Like an RBF investor, a Safe holder is not a shareholder, at least for an indefinite period of time following investment.

Finally, Filecoin announced in 2017 a new type of data storage product. Investors piled into the proposed blockchain-based storage network.⁵ Filecoin's financial backers purchased, in lieu of stock, a right to tokens that permit use of the storage service. Investors bet that, if Filecoin's service takes off, then they will capture a profit by subsequent resale of tokens to others. As with an RBF investor and a Safe holder, a token holder is not a shareholder.

The accumulation of new investment instruments highlights a notable evolution in entrepreneurial finance for early-stage startups.⁶ The traditional way an early-stage startup raises outside

as an investor in the Safe offering); *see also* John F. Coyle & Joseph M. Green, *Contractual Innovation in Venture Capital*, 66 HASTINGS L.J. 133 (2014).

5. Filecoin is a decentralized storage network that turns cloud storage into an algorithmic market. *See* FILECOIN, <https://filecoin.io/> [<https://perma.cc/FKQ3-SQ9Q>] (Filecoin investment documents on file with author). Filecoin successfully raised \$52 million from its earliest investors, then another \$206 million in an initial coin offering. Stan Higgins, *Filecoin Presale Raises \$52 Million Ahead of ICO Launch*, COINDESK (Aug. 4, 2017, 9:05 AM), <https://www.coindesk.com/filecoin-presale-raises-52-million-ahead-ico-launch/> [<https://perma.cc/9LX5-PN9R>]; Stan Higgins, *\$257 Million: Filecoin Breaks All-Time Record for ICO Funding*, COINDESK (Sept. 7, 2017, 1:45 PM), <https://www.coindesk.com/257-million-file-coin-breaks-time-record-ico-funding/> [<https://perma.cc/CF9P-C4R3>].

6. Investors distinguish between stages of a private company. ANDREW METRICK, *VENTURE CAPITAL AND THE FINANCE OF INNOVATION* 16 (2007). Risks associated with investment into a newly hatched venture (think: three founders, a garage, and a PowerPoint deck) are markedly different than risk associated with investment into a private company with global operations valued at over \$1 billion (i.e., a so-called "unicorn" such as Uber, Pinterest, or Airbnb). It is particularly important to distinguish between company stages now that sizable companies, reluctant to go public, are staying private longer. *See generally* MICHAEL J. MAUBOUSSIN ET AL., *CREDIT SUISSE, THE INCREDIBLE SHRINKING UNIVERSE OF STOCKS* 11 (2017). Three stages distinguish where a private company is in its lifecycle: (1) *early stage*, (2) *growth stage* (also known as "mid stage"), and (3) *expansion stage* (also known as "late stage"). *Early stage* describes a company's most nascent period, spanning the founders' original idea roughly through initial launch of a product. A thriving venture will likely reach the growth stage, when the company seeks to scale its operations, including ramp-up of production, new employee hires, and emphasis on rapid customer and revenue growth. *See generally* METRICK, *supra* at 16. Finally, an expansion-stage company is the most mature type of private company and is often preparing for an "exit" event (i.e., either a sale or an initial public offering). Subcategories within these three stages provide additional resolution about an entrepreneurial firm's growth trajectory. *See* Chris Scheetz, *7 Business Stages Relating to Investing*, 1839 VENTURES (July 30, 2016), <https://www.1839ventures.com/7-business-stages-relating-to-investing/> [<https://perma.cc/3DRX-Y5TR>]. Small amounts of early-stage capital fundraising are often initially labeled with a botanical metaphor, such as a "pre-seed" and "seed" round. A larger investment receives an alphabetic designation, starting

capital is through an equity financing from an angel investor or venture capitalist—that is, an investor who takes an ownership stake in exchange for a capital contribution to the company.⁷ Yet RBF loans, Safes, and cryptocurrency tokens—as the TVA, MadKudu, and Filecoin examples illustrate—are part of expanding early-stage investment options.⁸ While legal literature does not yet include examination of RBF and crypto tokens, scholars

with an “A” round. Typical early-stage activities include ideation, proof of concept, identifying a product/market fit, and product development. Early-stage companies often have little to no revenues, have unclear product or service lines, aspire to operate within an ill-defined or yet-to-be formed market, disclose less information than a public company, and are highly resource constrained. Successive alphabetic labels (e.g., “B Round” then “C Round”) attend subsequent equity rounds of financing. A private company valued at over \$1 billion is a “unicorn.” See, e.g., *The Global Unicorn Club*, CB INSIGHTS, <https://www.cbinsights.com/research-unicorn-companies> [<https://perma.cc/SGX8-V85G>] (listing 234 companies, each valued at over \$1 billion).

7. See Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1420 (2008) [hereinafter *Puzzling Behavior*]. Equity is “a stock or any other security representing an ownership interest” in a company. *Equity*, INVESTOPEDIA, <https://www.investopedia.com/terms/e/equity.asp> [<https://perma.cc/VKC7-JHE9>]. An angel investor may purchase common stock or, more frequently, preferred equity. *Puzzling Behavior*, *supra*. An institutional investor, such as a venture capitalist, predominantly finances early-stage ventures through preferred equity. Convertible preferred stock today remains the most important vehicle for venture capital (VC) investment. See, e.g., BRAD FELD & JASON MENDELSON, *VENTURE DEALS: BE SMARTER THAN YOUR LAWYER AND VENTURE CAPITALIST* 68 (3d ed. 2016); METRICK, *supra* note 6. Special economic and control rights make the stock “preferred” relative to common stock. The preferred class is “convertible” insofar as the holders of preferred stock may elect to convert their shares to common. VCs use preferred convertible equity, instead of debt instruments, because new companies lack traits associated with reliable loan repayment. FELD & MENDELSON, *supra*; PAUL GOMPERS & JOSH LERNER, *THE VENTURE CAPITAL CYCLE* (2004); METRICK, *supra* note 6; Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1072 (2003); D. Gordon Smith, *Venture Capital Contracting in the Information Age*, 2 J. SMALL & EMERGING BUS. L. 133, 151 (1998) [hereinafter *VC Contracting*]. State corporate laws govern how stock is lawfully issued. Delaware law rules for equity are set forth in Delaware Code Annotated title 8, section 151(a). See DEL. CODE ANN. tit. 8, § 151 (West 2011) (prescribing rules of stock issuance and permitting preferred stock) (“Every corporation may issue 1 or more classes of stock . . . as shall be stated and expressed in the certificate of incorporation or of any amendment thereto, or in the resolution or resolutions providing for the issue of such stock adopted by the board of directors pursuant to authority expressly vested in it by the provisions of its certificate of incorporation.”); *Shintom Co. v. Audiovox Corp.*, 888 A.2d 225 (Del. 2005) (defining minimum requirements for preferred stock under Delaware law).

8. Law and entrepreneurship contributes “knowledge of what types of finance [structures] are available to entrepreneurs.” *Debt as Venture Capital*, *supra* note 1, at 1171.

nevertheless document startups' use of other types of instruments, such as the Safe and venture debt.⁹

Scholars have yet to consider, however, the proliferation in investment forms in the aggregate. This is not a trivial omission. It is critical to examine instruments not only in isolation but also together for two reasons. One, examining the full spectrum of startup investment instruments yields new insights into their contractual features. A panoramic perspective—namely, viewing instruments together—is needed to compare how investment structures function and, relatedly, the circumstances in which a particular instrument is (and is not) useful. Two, a company may use different types of instruments to raise capital over multiple rounds of financing during the course of a firm's lifecycle. Variety in investment structures provides different investors with disparate contingent and residual rights in a company. Law and entrepreneurship scholars have not examined the consequences when diverse instruments interact over time.¹⁰

This Article fills a gap in legal literature by reflecting upon the diversification of startup investment forms. I make four contributions.

First, this Article catalogues forms of startup investment instruments. A combination of academic literature and original research details how startups and investors today structure financial deals. I define an *instrument* as one or more contractual agreements that structure a high-risk capital investment into an entrepreneurial venture.¹¹ At least eight types of instruments,

9. See, e.g., Coyle & Green, *supra* note 4 (analyzing the Safe); *Debt as Venture Capital*, *supra* note 1 (discussing venture debt).

10. Robert Bartlett sets forth the importance of a dynamic model of agency costs arising from the staging of VC investments and use of convertible stock. See Robert P. Bartlett, III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 111 (2006) ("The dynamic character of agency problems has important—and understudied—implications for corporate scholarship."). Elizabeth Pollman furthers this analysis through close examination of agency costs resulting from changes over the lifecycle of an emerging private company. Elizabeth Pollman, *Startup Governance* (forthcoming) (on file with author). Dynamic agency costs are further discussed in Part V *infra*.

11. This Article refers to a form of financing as an "instrument." Implementation of an "instrument" may require amending entity documents filed with a secretary of state (aka, the "charter") as well as execution of private contractual arrangements. The instrument level of analysis typically encompasses more than isolated examination of an individual contract or specific provisions within an agreement. A preferred convertible equity financing, for example, is an instrument whose critical provisions are negotiated and set forth in a term

different than conventional common and preferred stock, now structure early-stage startup investments: (1) RBF, (2) investment structures customized for social entrepreneurship ventures, (3) venture debt, (4) permutations of light preferred contracts, (5) convertible debt, (6) the Safe and variants such as the Keep It Simple Security (KISS), (7) prepayment, and (8) the Simple Agreement for Future Tokens (SAFT).¹² These are each described in section II.A *infra*.

Second, this Article highlights the limited analytic value of existing categories used to classify startup instruments. Financial innovation yields instruments that are difficult—and even misleading—to classify as debt or equity.¹³ What the derivatives revolution did to traditional corporate finance categories, the new entrepreneurial finance revolution has done to the world of startup finance. Yet even as forms of startup investment proliferate, academic discussions default to the capital structure categories of debt and equity.¹⁴ The debt/equity dichotomy remains important

sheet. Upon closing a financing, parties operationalize the term sheet by amending a company's "charter" (i.e., the "articles of incorporation" or "certificate of incorporation," depending on jurisdiction) and bylaws, as well as entering into related contracts, including voting agreements and stock purchase agreements. The suite of documents typically involved in a VC financing is available through the National Venture Capital Association (NVCA). See *Model Legal Documents*, NAT'L VENTURE CAPITAL ASS'N, <https://nvca.org/resources/model-legal-documents/> [https://perma.cc/KT74-AD2M].

12. Whether an instrument is labeled "debt" or "equity" often turns on cosmetic—rather than functional—features of an instrument. Moreover, the debt/equity distinction also fails to capture some novel instruments. For example, Filecoin's crypto tokens defy the traditional boxes of debt/equity. So does the Safe, an instrument widely used by investors and nascent startups. See *infra* Parts II–III.

13. See, e.g., Paul Carman & Kelley Bender, *Debt, Equity or Other: Applying a Binary Analysis in a Multidimensional World*, J. TAX'N, July 2007, at 17, 17 ("Under a binary analysis, an investment along the borders of one or the other classification gets pushed completely into one of the two baskets, disguising the hybrid nature of the investment."). Financial innovation makes the traditional legal notions of how investors should be characterized "contradictory and meaningless." Frank Partnoy, *Financial Innovation in Corporate Law*, 31 J. CORP. L. 799, 802 (2006); see also Douglas G. Baird & M. Todd Henderson, *Other People's Money*, 60 STAN. L. REV. 1309, 1312 n.15 (2008) ("Modern financial engineering . . . make[s] any attempt to pigeonhole investments as one type or another nearly meaningless."); Alexander J. Triantis & George G. Triantis, *Conversion Rights and the Design of Financial Contracts*, 72 WASH. U. L. Q. 1231, 1231 (1994) ("[T]he attention of financial economists seems to have shifted from the optimal mix of debt and equity financing to the design of securities.").

14. See, e.g., *Debt as Venture Capital*, *supra* note 1; Triantis & Triantis, *supra* note 13, at 1231 ("Most of the academic insights into the capital structure decision of a corporation have

since regulations ranging from corporate law to tax still incorporate the distinction.¹⁵ But as a matter of contractual analysis, the oft-criticized debt/equity distinction¹⁶ fails to capture important dimensions of how contracts operate. The debt/equity framework need not frustrate development of more valuable analytic tools.¹⁷

A useful typology would liberate contractual analysis from legacy categories to promote understanding of how the contracts

been based on the dichotomous choice between debt and equity.”). Capital structure presents two broad financing options: rely upon internal company cash flows or, alternatively, attract money from outside the startup in the form of a loan (debt) or sale of stock (equity). Since entrepreneurial firms often lack revenues sufficient to fund operations, startups often choose to pursue outside financing. As discussed in Part II, ad hoc categories also describe novel instruments. *See, e.g.*, Joseph M. Green & John F. Coyle, *Crowdfunding and the Not-So-Safe Safe*, 102 VA. L. REV. ONLINE 168, 169 (2016) (discussing the simple agreement for future equity (Safe), an equity derivative); 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, 878 (2013) (analyzing investment contracts, termed “unequity” by Heminway, which is “a particular type of financial interest that provides for profit-sharing or revenue-sharing on a short-term basis, with no accompanying governance rights.”).

15. Certain legal, regulatory, and accounting determinations embed capital structure concepts and provide differing treatment based on whether an instrument is debt or equity. *See infra* Part III. This Article does not take a position on the utility of capital structure categories for the purposes for which they developed: matters of finance, accounting, and tax. But even in these contexts, there are reasons to suspect that these categories collapse.

16. Scholars criticize the distinction’s usage in tax law. “Few aspects of U.S. tax law have received greater criticism—and attracted fewer defenders—than the long-standing distinction between debt and equity.” Camden Hutchison, *The Historical Origins of the Debt-Equity Distinction*, 18 FLA. TAX REV. 95, 96 (2015); *see also* Baird & Henderson, *supra* note 13, at 1312 n.15; Partnoy, *supra* note 13, at 802; Katherine Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 VAND. L. REV. 1055, 1056 (2000). Hutchison argues that the inertia of the tax system and path dependence may explain why the distinction persists today. Hutchison, *supra* at 101–02. Hutchison examines development of the debt/equity distinction in tax during the eighty-year period beginning with the Civil War—and first U.S. income tax—up through the establishment of taxation of dividends in the 1930s. Hutchison concludes

that the debt-equity distinction is the unintended consequence of an extended series of discrete, reactive, short-term political decisions, rather than the intentional realization of any broader policy goal. . . . Due to the significant inertia of tax policy, decisions made in response to specific historical circumstances became difficult to change—even after the circumstances themselves changed or were no longer relevant.

Id. at 101–02.

17. The focus of this investigation is upon startup financial contracts. Notably, the logic behind the need for a better way to classify instruments, shedding the intellectual limitations of the debt/equity dichotomy, applies outside of startup instruments. Indeed, Triantis and Triantis anticipated the need for a new analytical scheme almost twenty-five years ago. Triantis & Triantis, *supra* note 13, at 1232.

work and to reveal similarities and differences between financial instruments. A classification scheme should account for elements that functionally differentiate one instrument form from another.¹⁸ I analyze instruments across a multidimensional framework: (1) economic rights (i.e., how the instrument allocates economic risk and reward), (2) control mechanisms (i.e., levers that constrain and influence the firm's actions), (3) use of time (i.e., when an investor's funds are provided to a startup and when monies are returned to an investor), and (4) regulatory status (i.e., whether investors are shareholders under corporate law, whether instrument is a security, and tax implications).

Third, this Article presents a new typology of modern entrepreneurial finance instruments. A *typology* is a working tool, less scientifically robust than a taxonomy, used to classify artifacts observed in empirical research.¹⁹ A typology of startup instruments was unnecessary in, say 1998, when entrepreneurs and investors had limited choices about how to structure capital investment. Yet today's landscape involves an array of alternatives. This Article delineates three categories to classify entrepreneurial investment instruments: (1) Lock-in, (2) Park-n-ride, and (3) Payout.²⁰ Each classification is described in turn.

18. See Emily Sherwin, *Legal Taxonomy*, 15 LEGAL THEORY 25, 32 (2009) (discussing functional taxonomies). Sherwin notes three organizational schemes used by modern scholars. *Id.* at 25 ("The first is a formal taxonomy that classifies legal materials according to rules of order and clarity. Formal taxonomy is primarily conventional and has no normative implications for judicial decision-making. The second possibility is a *function-based taxonomy* that classifies laws according to their social functions. *Function-based taxonomy* can influence legal decision-making indirectly, as a gatekeeping mechanism, but it does not provide decisional standards for courts. Its objective is to assist in analysis and criticism of law by providing an overview of the body of legal doctrine. The third possibility is a reason-based taxonomy that classifies legal rules and decisions according to the moral principles or 'legal principles' thought to justify them." (emphasis added)).

19. Typologies serve as "working tools in the identification of artifacts as empirical research progresses." RICHARD P. SMIRAGLIA, THE ELEMENTS OF KNOWLEDGE ORGANIZATION 53 (2014). In contrast to a taxonomy, a typology is generally viewed as "less robust scientifically than" a taxonomy. *Id.*; see *infra* Part III.

20. This typology comes with the humility of a pre-tenure professor that other minds can—and should—improve upon this approach. Yet there is force behind the old saying that "it takes a theory to beat a theory." This legal scholarly cliché apparently goes back to Richard Epstein. See Lawrence Solum, *Legal Theory Lexicon: It Takes a Theory to Beat a Theory*, LEGAL THEORY BLOG (Oct. 21, 2012), <http://lsolum.typepad.com/legaltheory/2012/10/introduction-it-takes-a-theory-to-beat-a-theory-this-is-surely-one-of-the-top-ten-all-time-comments-uttered-by-law-professo.html> [<https://perma.cc/EPM8-945M>]. An objection to classification of

Lock-in is an ownership interest where an early-stage investor's return is (1) uncertain as to timing, (2) not realistically expected until five to eight years after initial investment, and (3) a function of the underlying valuation of the company. This classification is where most of the traditional investment instruments fit—that is, common and preferred stock. Founders typically hold common stock, one type of Lock-in instrument, at the outset of a new venture.²¹ Convertible preferred equity, a second type of Lock-in instrument that features special economic and control rights, is traditionally sold to outside investors such as venture capitalists (VCs).²²

The typology's second category of investment structure is the *Park-n-ride*. In contrast to a Lock-in holder's *present* ownership interest, a Park-n-ride structure contemplates a *future* ownership interest in a company. Legal scholars document two instruments that the new typology classifies as a Park-n-ride: (1) convertible debt and (2) future equity derivative instruments, most notably the Safe.²³ I use the term *Park-n-ride* to highlight the two-step process common to these instruments. Step one is that an investor "parks" money with a startup. The startup puts capital to use during an indefinite period in which the investor lacks ownership. Step two is triggered by a financing tied to issuance of preferred stock. Upon a preferred financing, the investor's money converts automatically into equity and "rides" along the terms negotiated by the new

startup instruments is that, if financial engineering simply renders attempts to "pigeonhole investments as one type or another nearly meaningless," why is classification worth the candle? See Baird & Henderson, *supra* note 13, at 1312. As explained in Part III, typologies and classifications are nonetheless going to be used and serve a crucial role in framing understanding. See *infra* Part III. Broadly speaking, the history of contract scholarship reflects that fruitful examinations often require new terminology and categories to describe evolving business and legal practices. See, e.g., Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963) (categorizing relational and discrete contracts after surveying literature, case law, and interviews with practitioners); Ian R. Macneil, *Values in Contract: Internal and External*, 78 NW. U. L. REV. 340, 383 (1983) (developing terminology and categories associated with relational contracts).

21. Angels occasionally take common stock; however, this is more infrequent today. See generally *Puzzling Behavior*, *supra* note 7, at 1405, 1413–14, 1422, 1446–47.

22. *Debt as Venture Capital*, *supra* note 1, at 1170. Preferred equity still dominates in terms of total VC investment dollars.

23. Safe documents are publicly available through Y Combinator. *Startup Documents*, Y COMBINATOR (Feb. 2016), <https://www.ycombinator.com/documents/> [https://perma.cc/FT5M-4NC2].

investor(s).²⁴ Accordingly, a Park-n-ride structure exists where an investor (1) invests capital into a company, (2) lacks ownership for an indefinite post-investment period, and (3) agrees to take ownership, upon occurrence of a preferred financing event, on unknown terms led by an unknown future investor.

A *Payout* is where an investor's return is not based upon sale of company shares and, instead, an investor's return directly flows from startup revenues, profits, or provision of goods or services. Payouts avoid extreme investor lock-in—namely, instances where shareholders cannot redeem their shares for cash directly from a company or readily sell shares to other purchasers on a secondary market.²⁵ The relaxation of extreme investor lock-in is among the most notable developments associated with the proliferation of investment instrument forms.²⁶ Payouts are better suited than preferred equity for high-risk capital investment into certain startups—such as many so-called social impact ventures—that lack potential to reach a large enterprise valuation.²⁷ Additionally, a

24. Automatic conversion, especially associated with convertible debt, often requires a “qualified financing,” defined as an equity issuance over a certain threshold (typically pegged at an amount between \$250,000 and \$1 million). A Boulder-based attorney who actively works with startup companies reported that the qualified financing number “is more of a function of the size of the ‘park and ride’ round.” E-mail from Matt Burns, Attorney, Koenig, Oelsner, Taylor, Schoenfeld & Gaddis PC, to Brad Bernthal, Assoc. Professor of Law, Univ. of Colo. Law Sch. (Jan. 30, 2018) (on file with author). That is, the smaller (or larger) the Park-n-ride, the smaller (or larger) the qualified financing prescribed to trigger conversation. *Id.* This attorney said he rarely sees qualified financing set at \$1 million. *Id.*

25. See Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1, 6–7 (2012) [hereinafter *New Exit in VC*] (distinguishing capital lock-in—i.e., the inability of an investor to demand redemption from the company—from investor lock-in).

26. Payouts respond to problems associated with “the reality that most preferred stock is structured in a way that never obligates the corporation to redeem it and thus return equity, suggest[ing] that the preferred stockholders can, with impunity, be frozen out of realizing any value from the enterprise.” Lawrence E. Mitchell, *The Puzzling Paradox of Preferred Stock (And Why We Should Care About It)*, 51 BUS. LAW. 443, 444 (1996).

27. Investment into social impact ventures often comes from an impact investor or group of social VCs that provides capital to a social enterprise in hopes of a return in the form of financial gains as well as company actions that address a social problem. See *infra* Part II; see, e.g., MILLER CTR. FOR SOC. ENTREPREN., DEMAND DIVIDEND: CREATING RELIABLE RETURNS IN IMPACT INVESTING 2, <https://static1.squarespace.com/static/55036eefe4b0fe6c8e833e4a/t/56428004e4b024d1dbe1a775/1447198724492/Demand-Dividend-Description-2015.pdf> [https://perma.cc/76FZ-QYM2] [hereinafter DEMAND DIVIDEND] (“[The] Demand Dividend grew out of the need to find alternatives to debt, convertible debt, and equity as funding mechanisms for social enterprises.”).

startup manager may desire a Payout structure if she would like to raise outside capital while avoiding a “shot clock” — that is, a timetable by which a company must sell itself, wind down, or, less frequently, conduct an initial public offering (IPO). Examples of Payout instruments include RBF, demand dividend, prepayments, and venture debt.²⁸

The Article’s fourth contribution is that the new typology underscores an important but little-discussed development: an increasing number of startup investors — that is, sources of outside capital — are not shareholders.²⁹ New instruments leave some capital providers, wittingly or not, outside the shareholder protections of corporate law.³⁰ Startup investors now include inter alia creditors, derivative holders, consumers, and token holders. These developments shift a burden to contract law to interpret and determine the relationship between a startup and its non-shareholder investors.

The new typology reveals, further, that new types of conflicts between investors (i.e., “horizontal conflicts”) are on the horizon.³¹ As capital structure gets more crowded and complex, the conflicts among shareholders also become more complicated. This Article highlights that scholars need to study and consider the changed role of corporate law as it relates to modern realities of entrepreneurial investment. More work is needed to appreciate the role performed by corporate law protections in the startup environment and, moreover, what contractual measures could compensate for its displacement.³²

28. See *infra* Section II.A.

29. This Article takes a capacious view of an “investor” as a provider of capital from outside the company with some expectation of return. Other scholars take a similar view. See, e.g., Baird & Henderson, *supra* note 13, at 1311 (“Identifying only shareholders as investors, as opposed to all providers of capital, is misleading.”).

30. Douglas Baird and Todd Henderson, observing a broader set of instruments than startup finance, make a similar observation. Baird & Henderson, *supra* note 13, at 1311 (“As financial innovation has accelerated over the past two decades, the terms ‘shareholder’ and ‘debtholder’ or ‘creditor’ have become less meaningful. Identifying only shareholders as investors, as opposed to all providers of capital, is misleading.”).

31. Mitchell, *supra* note 26, at 449 (defining horizontal conflicts between shareholders, as well as between shareholders and “bondholders, employees, and other corporate constituencies”); see *infra* Section V.B.

32. Ronald Gilson highlights the economic advantage that the United States enjoys as a consequence of healthy markets that match VC and startup entrepreneurs. Gilson, *supra*

This Article proceeds in five parts. Following this Introduction, Part I describes two waves of legal scholarship about entrepreneurial finance, which each emphasize categories of debt and equity. Part II then surveys the range of modern-day startup finance instruments. This includes discussion of two instruments: RBF and the SAFT, which legal literature has yet to explore. Part III examines existing classifications that frustrate rigorous analysis of investment instruments. Part IV then proposes a new typology of startup finance instruments to promote a more accurate analysis of investment arrangements. Finally, Part V considers implications with respect to corporate law.

I. THE TWO SCHOLARLY WAVES OF ENTREPRENEURIAL FINANCE

Scholars document a variety of instruments used in entrepreneurial finance. A first wave of legal scholarship, initiated in 1992, examined preferred equity structures familiar to venture capital (VC) deals. More recently, a second wave of scholarship explores debt and other non-equity instruments associated with entrepreneurial investments.

Combined, these two scholarly waves reflect that a debt/equity dichotomy is deeply rooted in law and entrepreneurship as a high-level way to classify investment instruments. The debt/equity distinction arises from a choice—known as the “capital structure decision”—which company managers must make about how to fuel company operations and growth.³³ Classic corporate finance

note 7, at 1067. Scholars have yet to address whether or not the diminished role of corporate law protection is problematic for the United States’ startup market and, if so, what changes in corporate law or entrepreneurial investment contracts might be warranted.

33. “[C]apital structure is how a firm finances its overall operations and growth by using different sources of funds.” *Capital Structure*, INVESTOPEDIA, <http://www.investopedia.com/terms/c/capitalstructure.asp#ixzz4qPl0KmU3> [https://perma.cc/44NH-9BNX]. Regarding capital structure decisions, Darian Ibrahim wrote, “Nobel Prize-winning economists have struggled to understand firm capital structures for over fifty years, devising grand theories that are consumed by students in corporate finance courses.” *Debt as Venture Capital*, *supra* note 1, at 1174. The goal is to maximize the firm’s value and the shareholders’ interests. STEPHEN A. ROSS ET AL., *CORPORATE FINANCE* 490 (11th ed. 2016). The calculus considers risk principally in the forms of information asymmetry and agency costs; ultimately, investors will demand greater returns for higher risk. *Debt as Venture Capital*, *supra* note 1, at 1203; *see also* Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have*, 13 J. FIN. ECON. 187 (1984).

presents three funding alternatives: (1) finance company operations through internal cash flows,³⁴ (2) borrow money through debt issuance, or (3) raise money through sale of company equity.³⁵ A startup firm's de facto alternatives are often debt or equity since a startup's revenues are typically insufficient to support operations.³⁶ Accordingly, outside financing (viz., funding from outside the firm) in the form of debt or equity is required to obtain cash needed to hire a team, conduct research, and engage in activities to bring a new product or service to market.³⁷

The debt/equity dichotomy intends to demarcate relative levels of risk associated with the provision of capital.³⁸ The comparatively greater level of risk is what—at least in theory—distinguishes an equity holder from a creditor. Creditors—so goes the argument—do not fully put their capital at risk when contracting with a borrower. Equity holders, in contrast, are owners who are “adventurers in the business”—that is, investors who tie the fate of their capital directly to the fortunes of the enterprise.³⁹

An initial wave of legal scholarship highlighted VCs' extensive reliance on equity instruments. In 1992, George Dent noted that although law review articles had largely ignored VC, the equity structure favored by VCs merited scholarly attention as a template for minority investor protection within close corporations.⁴⁰ Dent's analysis of VC agreements tracked the classic capital structure decision's framework, which emphasizes the debt/equity distinction. Dent observed that non-equity financing options are unavailable to entrepreneurial ventures because (1) a new company lacks retained earnings as a source of funding, (2) a new venture is too

34. A firm's business activities, such as the sale of goods and services, may generate internal cash flows available to finance operations. ROSS ET AL., *supra* note 33, at 32.

35. *Id.* at 474–77. A firm's “[c]apital structure can be a mixture of . . . long-term debt, short-term debt, common equity and preferred equity.” *Capital Structure*, *supra* note 33.

36. Typically, but not always. A startup's principle may “bootstrap” a company by selling services (e.g., consulting) that generate revenues. Such revenues are then used to finance costs associated with bringing a product to market.

37. *Debt as Venture Capital*, *supra* note 1, at 1203. Capital structure theory posits that a firm is likely to use its cash flows—which are known, predictable, and less costly—before drawing upon external sources.

38. Pratt, *supra* note 16, at 1057.

39. *Id.*

40. George W. Dent, Jr., *Venture Capital and the Future of Corporate Finance*, 70 WASH. U. L.Q. 1029, 1031 (1992).

risky for debt, and relatedly, (3) regulatory requirements militate against high-risk loans, especially by institutional lenders.⁴¹ Accordingly, while Dent argued that VC equity investment is “often the last choice of financing” as compared to internal cash flow or issuance of debt, VC investment is nonetheless attractive for entrepreneurs when it is the “only method of raising capital available.”⁴²

Legal scholars following Dent⁴³ analyze functional aspects of VC contracts through the prism of problems associated with financing a new venture (e.g., agency costs and information asymmetries between a venture capitalist and an entrepreneur)⁴⁴ and contractual and extra-contractual solutions to those problems (e.g., staging, compensation strategies, and use of reputation markets).⁴⁵ As a matter of instrument classification, commenters categorized VC investment agreements as equity, as set in contradistinction to debt. For example, an equity form of financing is explicitly set forth as part of Bernard Black and Ronald Gilson’s 1998 definition of VC.⁴⁶

41. Dent, *supra* note 40, at 1032–34. Dent notably explores some uses for convertible debt in the entrepreneurial context, arguing that convertible debt sometimes “modulates risk and payouts better than either straight debt or straight equity.” *Id.* at 1042. This observation is prescient insofar as many startup investment instruments blend traditional debt and equity elements.

42. *Id.* at 1032–34.

43. For a representative sample of legal scholarship that examines preferred convertible equity structures, which today still dominate VC investment, see Bartlett, *supra* note 10; William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 891 (2002); Brian J. Broughman & Jesse M. Fried, *Do VCs Use Inside Rounds to Dilute Founders? Some Evidence from Silicon Valley*, 18 J. CORP. FIN. 1104 (2012); Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 971–72 (2006); Gilson, *supra* note 7, at 1070–71; D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315 (2005) [hereinafter *Exit Structure of VC*]; *VC Contracting*, *supra* note 7.

44. For example, Gordon Smith focuses extensively on the problem of agency costs, especially ways that a venture capitalist may harm an entrepreneur through shirking, opportunism, and incompetence. *VC Contracting*, *supra* note 7, at 150. Ronald Gilson additionally focuses on problems of information asymmetries arising from an entrepreneur knowing more about the venture than an investor. Gilson, *supra* note 7, at 1076.

45. For example, Ronald Gilson highlights staging, control, compensation, exit, and reliance upon reputation markets as contractual and extra-contractual responses to problems associated with an early-stage financing. Gilson, *supra* note 7, at 1078–87.

46. Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 245 (1998).

We define “venture capital,” consistent with American understanding, as investment by specialized venture capital organizations (which we call “venture

Gordon Smith, in another influential early work on VC, highlighted that the equity form of investment—as opposed to debt—motivated a VC to stay involved with and work to maximize the value of portfolio companies.⁴⁷

Beginning in the mid-2000s, a second wave of scholarship documented additional ways that startups acquire capital.⁴⁸ The pronounced theme of this second wave is that, with respect to a startup’s capital structure decision, non-equity financing alternatives exist and—indeed—are expanding.⁴⁹ A variety of “new” instruments reveal that early-stage entrepreneurial ventures solve funding needs through a surprising range of options, including venture debt, convertible debt, the Safe, and crowdfunding tools.⁵⁰ Additional instruments, which legal scholars are only starting to examine, continue to surface.⁵¹ Part II *infra* catalogues and describes these instruments.

Accordingly, over the past thirty years the capital structure decision—especially classic conceptions of debt and equity—provided the dominant, default high-level categorization mechanism for startup instruments. Common stock and preferred stock

capital funds”) in high-growth, high-risk, often high-technology firms that need capital to finance product development or growth and must, by the nature of their business, obtain this capital largely in the form of equity rather than debt.

Id.

47. “By using equity rather than debt and by restricting the payment of dividends, a venture capital contract often limits the ability of a venture capitalist to exit without losing at least part of its investment.” *VC Contracting*, *supra* note 7, at 150.

48. A chronological exception is Ronald Mann. In 1999, Mann wrote about a type of alternative startup financing instrument, software financing, well ahead of other scholars. Ronald J. Mann, *Secured Credit and Software Financing*, 85 CORNELL L. REV. 134, 158 (1999) (documenting banks in the late 1990s willing to provide funding to software companies upon VC investment, “even if the company ha[d] no revenues at that time”).

49. Scholars observed adoption of instruments that contravened the received knowledge that startups “rely almost exclusively on equity funding from angel investors and venture capitalists (VCs).” *Debt as Venture Capital*, *supra* note 1, at 1170.

50. See discussion of each instrument and relevant legal literature in section II.A, *infra*.

51. Legal scholars have works in progress on two notable instruments—Revenue-Based Financing (RBF) and the Simple Agreement for Future Tokens (SAFT)—which are discussed in section II.A, *infra*. The Author is working on a study of RBF. Further, Shlomit Azgad-Tromer examines SAFTs and other cryptocurrency offerings. Shlomit Azgad-Tromer, *Crypto Securities: Blockchain-Based Assets and the Dilemmas of Securities Regulations* (forthcoming) (on file with author). And, more broadly, Usha Rodrigues considers implications of blockchain forms of organization for corporate law. Usha R. Rodrigues, *Law and the Blockchain* (forthcoming) (on file with author).

are, for example, characterized as equity instruments.⁵² Convertible debt and venture debt are, in contrast, cast as debt instruments.⁵³ We will return to the debt/equity dichotomy in Part III *infra*, where the shortcomings and problems of debt and equity classifications are addressed.

II. THE VARIETY OF MODERN STARTUP INVESTMENT INSTRUMENTS

Nontraditional instruments complicate the “conventional wisdom” that startup investment is synonymous with equity fundraising.⁵⁴ Section A surveys and defines nontraditional startup instruments (i.e., finance structures that differ from standard common or preferred stock).⁵⁵ Moreover, the expansion in investment instrument forms raises questions of “why now” – that is, why are certain instruments used today but not twenty years ago to fund startups? Section B presents factors relevant as to why the forms of startup instruments have proliferated.

A. A Catalogue of Nontraditional Investment Instruments

Eight types of instruments, in addition to standard common and convertible preferred stock, are available to structure startup investment. This Part examines each instrument from four perspectives in order to explain how the instrument functions:

52. Gilson, *supra* note 7, at 1072 (“The venture capital fund’s equity investments in portfolio companies typically take the form of convertible preferred stock.”).

53. Debt is a loan where a borrower contracts for repayment of principal plus interest to a lender. *Debt as Venture Capital*, *supra* note 1, at 1175. Banks, finance and leasing companies, and government lending programs are each traditional sources of debt and issue debt instruments like notes, debentures, and bonds. ROSET AL., *supra* note 33, at 477.

54. See, e.g., *Debt as Venture Capital*, *supra* note 1, at 1176 (discussing venture debt and scholarship that “rebuke[s] the conventional wisdom about debt and start-ups”).

55. This Part aims to make accessible the basic contours of startup investment agreements and, where appropriate, demystify terminology. Vivid terminology, such as “clawbacks,” “drag-alongs,” and “zombies,” populates startup finance. While these terms can be colorful, startup nomenclature can frustrate comprehension with a mix of acronym soup and word salad. FELD & MENDELSON, *supra* note 7, at 68 (clawbacks and drag-alongs). A “zombie” refers to startups that are “really hyped, raise a ton of money at high valuations [and] then stagnate” – that is, a company that should be dead (i.e., liquidated and no longer operating) but nonetheless survives. See Sathvik Tantry, *How Venture Capital Incentives Promote Zombie Companies*, TECHCRUNCH (Aug. 6, 2015), <https://techcrunch.com/2015/08/06/how-venture-capital-incentives-promote-zombie-companies/> [https://perma.cc/82CZ-HR88].

(1) economic rights (how the instrument allocates economic risk and reward), (2) control mechanisms (levers that constrain and influence the firm's actions), (3) use of time (when an investor's funds are provided to a startup and when monies are returned to an investor), and (4) regulatory status (whether instrument is a security, whether investors are shareholders under corporate law, and tax implications).⁵⁶

1. Revenue-based financing

The TVA's loans to three of its 2018 early-stage portfolio startup companies used RBF.⁵⁷ In simplest terms, RBF is a loan with variable repayment terms.⁵⁸

Legal authors rarely discuss RBF.⁵⁹ But RBF is a high-risk capital version of retro fashion chic. RBF's basic structure—namely, an

56. This multidimensional approach incorporates considerations beyond economic rights and waterfall payouts. Control provisions permit consideration of the safeguards by which parties protect against agency costs. Time considerations affect how parties address information asymmetry, uncertainty associated with the startup, and how an instrument's time horizon influences the incentives of relevant parties. Scholars make a distinction, following Frank Knight's classic work, between uncertainty and risk. Knight argues that uncertainty—and the willingness to bear it—is the essential element of entrepreneurship. Uncertainty refers to unknown data points, relevant to a firm's prospects, which frustrate probabilistic projections about future outcomes. Risk, in contrast, refers to future projections that may be meaningfully expressed in objectively measurable probabilities. FRANK H. KNIGHT, *RISK, UNCERTAINTY AND PROFIT* 231 (Dover 2006) (1971) (defining uncertainty as instances in which "an objectively measurable probability or chance is simply inapplicable"). Paul Gompers and Josh Lerner define uncertainty as "a measure of the array of potential outcomes for a company or project." GOMPERS & LERNER, *supra* note 7, at 157. Uncertainty is endemic to entrepreneurial ventures because information gaps inevitably exist about a firm at its earliest stages. Information gaps are irresolvable for two reasons. One, the data does not yet exist. Two, to the extent relevant data points exist, the data is so highly dispersed as to be impractical to assemble. *Id.*

57. See *supra* text accompanying note 2. The form of RBF agreement used by TVA, entitled *Revenue Loan Agreement* (hereinafter *TVA Revenue Loan Agreement*), is on file with the Author.

58. More traditional versions of debt—including bank debt—historically offered some level of financing help to certain software companies. See, e.g., Mann, *supra* note 48, at 158 (documenting banks in the late 1990s willing to provide funding to software companies upon VC investment, "even if the company ha[d] no revenues at that time").

59. To date, only one scholarly article briefly identifies RBF usage in the startup world. Abraham J.B. Cable, *Incubator Cities: Tomorrow's Economy, Yesterday's Start-Ups*, 2 MICH. J. PRIV. EQUITY & VENTURE CAP. L. 195, 241–42 (2013) ("Entrepreneurs are making increasing use of revenue loans. . . . [and the RBF instrument] fund[s] a mix of livelihood businesses and high-growth start-ups."). More broadly, even outside of startups, RBF is little discussed in legal scholarship. Only a few secondary sources even mention RBF or the variant of

investor gets repaid as a percentage of a company's revenue stream—is not a novel financial tool.⁶⁰ Oil and gas ventures have long used RBF structures and continue to do so today.⁶¹ RBF-type instruments have been used in film production.⁶² Moreover, biosciences and healthcare commonly use a closely related variant, royalty-based financing,⁶³ where an investor contracts for a

royalty-based financing. See Jim Chester, *Level Up: Legal Issues Facing Software, App, and Video Game Entrepreneurs*, 80 TEX. B.J. 334 (2017) (“Debt and royalty-based financing can be difficult to obtain for early stage companies except at outrageous interest rates.”); JOSEPH W. BARTLETT, *EQUITY FINANCE: VENTURE CAPITAL BUYOUTS, RESTRUCTURINGS AND REORGANIZATION* §6.21 (Aspen Publishers 2d ed. 2018) (§6.21, “Royalty Based Financing as a New Tool for Start-Up Financing?,” authored by Beth J. Felder) (“One innovative vehicle for raising capital that is generating attention in the market lately is royalty-based financing.”). “Unequity,” as described by Joan Heminway, is a financial instrument used in crowdfunding contexts with some resemblance to RBF. Joan MacLeod Heminway, *What Is a Security in the Crowdfunding Era?*, 7 OHIO ST. ENTREPREN. BUS. L.J. 335, 360 (2012). Unequity provides an investor a short-term profit or revenue-sharing interest without governance or ownership rights in a startup.

60. For example, payment of a percentage of revenues (or royalties) has long been used in consideration for funding in sectors such as biotechnology, pharmaceuticals, and mining. See Scott Austin, *An Alternative Financing Option for Start-Ups; Entrepreneurs Going the Royalty Route Use a Share of Revenue to Pay Back Loans*, WALL STREET J., Dec. 2, 2010, at B6 (“Traditionally found in industries such as mining, film production and drug development, royalty financing is being seen more among technology companies and other early-stage firms with growth potential.”).

61. Dating back to the 1930s in Texas and Oklahoma, “[f]unds were made available to oil and gas companies based on the revenues generated from the exploration activities and subsequent long-term sale contracts of oil and gas extracted from wells.” Muhammad Waqas, *Project Finance*, OIL & GAS FIN. J. (Mar. 11, 2015), <http://www.ogfj.com/articles/print/volume-12/issue-3/features/energy-banking-section/project-finance.html> [<https://perma.cc/PLR7-VVMD>]. The structure remains in use today. See, e.g., *Business Model: Overview*, ROYAL GOLD, INC., <http://www.royalgold.com/business-model/overview/default.aspx> [<https://perma.cc/QLU3-HFGL>] (describing how a company “provid[es] capital to an operator or explorer in exchange for a royalty”); see also *Royalty Based Financing – Don’t Give Up Your Equity!*, FIN. RESOURCE, <http://www.thefinanceresource.com/article14.aspx> [<https://perma.cc/H2CK-P5B8>] (“The model for royalty based financing is not new, and has been in use for countless decades in oil and gas reserves and other stream of income trusts.”).

62. See Fred Wilson, *Revenue Based Financing*, AVC (Oct. 17, 2011), <http://avc.com/2011/10/revenue-based-financing/> [<https://perma.cc/D89C-W6K8>].

63. Also sometimes known as “revenue interest financing.” See John R. Leone & Louis P. Berneman, *Revenue Interest Financing: A Strategic Alternative to Accessing Capital Through Licensing in the Life Sciences*, 43 LES NOUVELLES 285, 285 (2008) (“Revenue interest financing is a transaction that involves the creation of a synthetic royalty derived from product revenues for products that are developed and marketed internally . . . and selling that revenue interest to a buyer (capital provider).”). On use of RBF in biotech, see Eric David et al., *New Frontiers in Pharma R&D Investment*, MCKINSEY & CO. (Feb. 2010) (discussing the July 2008 deal where TPG-Axon Capital “agreed to finance up to \$325 million of

percentage of cash streams arising from sales of a specific product or asset.⁶⁴

What is new is investors' use of RBF instruments to fund the initial portions of private company lifecycles.⁶⁵ Early-stage RBF investors, like the TVA, target new companies previously thought unsuitable for high-risk credit instruments.⁶⁶ New crowdfunding portals, furthermore, offer RBF as a template that companies seeking investment may use in fundraising over the internet pursuant to Regulation Crowdfunding rules.⁶⁷

RBF agreements have two significant economic terms. One, a debtor company pays back the loan as a percentage (typically in the 4–5% range) of its top line monthly cash receipts.⁶⁸ In this way, repayment is variable, as RBF creates a “blend between bank debt and venture capital,” where a lender's return varies with company performance.⁶⁹ The startup's revenue-based payments continue, acting as a lien on future revenues, until the investment is repaid

development expenses in exchange for milestones and royalties” on products involved in a Phase III development).

64. Under royalty-based financing, the investor contracts for a percentage of a product's revenues rather than a percentage of the entire company's revenues.

65. See Austin, *supra* note 60. RBF is also used to fund growth-stage companies. See generally BARTLETT, *supra* note 59 (emphasizing profit margins of RBF targets). RBF funds, such as Cypress and Decathlon Capital, have over \$50 million under management.

66. IndieVC specializes in loans to early-stage businesses with revenue, a sustainable business model, and long-term prospects. See INDIEVC, <http://www.indie.vc/> [<https://perma.cc/9259-8AC2>]. Seedlify (now “Corl”) allows individuals worldwide to fund Canadian companies using cryptocurrency and share in the companies' profits. See SEEDLIFY, <https://perma.cc/5NFD-489S>. Startwise similarly focuses on crowdfunding startups with returns via a revenue share. See STARTWISE, <https://angel.co/startwise/> (last visited Jan. 1, 2019).

67. *Legal Primer for Founders*, WEFUNDER, <https://wefunder.com/faq/legal-primer#securities> [<https://perma.cc/LM57-CG5Y>]. A *Revenue Loan Agreement* form, described as “[b]est for businesses with revenues[.] This is a promissory note that is paid back from a share of the revenues of the business. It's typically more exciting for investors than a standard loan. Since the payments vary based on revenues, it can also be safer for a company with less predictable cash flows.”

68. *TVA Revenue Loan Agreement*, *supra* note 57, § 3. The repayment obligation is triggered when a startup reaches an agreed-upon amount of gross revenues, an executive receives salary of over \$100,000, or when there is a distribution to a shareholder. See *TVA Revenue Loan Agreement*, *supra* note 57, § 3(a).

69. An RBF investor acts like a bank insofar as the investment is a loan. Meanwhile, an RBF investor acts like a venture capitalist insofar as her return is largely predicated on company performance. Sam Kawtharani, *Legal 101 for Revenue Based Financing*, CORAL (Dec. 7, 2016) <https://medium.com/corl/legal-101-for-revenue-based-financing-1cde8763b2af> [<https://perma.cc/T4TA-CT7E>]; see also George G. Triantis, *Financial Contract Design in the World of Venture Capital*, 68 U. CHI. L. REV. 305 (2001) (comparing bank financing and VC).

up to an agreed-upon multiple, such as three times the original investment. Two, RBF caps an investor's upside (i.e., profits) associated with the investment.⁷⁰ Once a debtor startup pays back three times the loan to TVA, for example, then the loan is repaid. A notable exception to limits on a lender's upside is that if a startup issues preferred stock in exchange for an investment in excess of \$500,000, then the lender receives stock worth 2–5% of the startup, depending on how much of the loan has been paid off at the time of the sale of shares.⁷¹ Relatedly, the lender also retains an option to participate in any future sale of the startup's preferred stock until the company reaches a liquidity event.⁷²

From a control perspective, RBF structures investment as a loan secured against the company's assets.⁷³ As a lender, the RBF investor has a priority over shareholders in case of liquidation of the company.⁷⁴ Unlike bank debt, however, founders and managers are not required to personally guarantee the RBF loan,⁷⁵ even in the absence of significant tangible collateral or revenue streams.⁷⁶ As a

70. RBF's inherent limitations on investment return (i.e., a capped multiple of the investment) precludes a home run (i.e., 10x or greater) return on investment. Such outsized returns are often thought necessary to make a venture fund successful since outsized returns compensate for the many inevitable investment failures associated with highly uncertain environments. Fred Wilson, *What Is a Good Venture Return?*, AVC (Mar. 20, 2009), <http://avc.com/2009/03/what-is-a-good-venture-return/> [https://perma.cc/H64P-VC6F].

71. *TVA Revenue Loan Agreement*, *supra* note 57, §§ 1, 2, Exhibit A. A minor exception is that if a startup debtor raises a qualified financing within six months following full repayment of the loan, then TVA is entitled to 1% of the startup. *See id.* § 3.

72. *Id.* §§ 4, 10, Exhibit A.

73. *See, e.g., Revenue Loan Agreement*, WEFUNDER, <https://wefunder-production.s3.amazonaws.com/static/RevenueLoanAgreement.rtf> [hereinafter *Wefunder Revenue Loan Agreement*]. Section 7 of this form states that the borrower "grants Lender a security interest in all its personal property." This security interest is not robust as many startups are asset-light, i.e., company assets are intangible, typically intellectual property, with high asset specificity characteristics that make the startup's IP of low value to users outside the company. *See generally Debt as Venture Capital*, *supra* note 1, at 1175 ("Intangible assets are more difficult to foreclose on and realize value from.").

74. Lenders are creditors that receive preferential treatment ahead of firm shareholders in the event of liquidation or bankruptcy. *Debt as Venture Capital*, *supra* note 1, at 1203.

75. RBF "typically requires no personal guarantees from management." Wilson, *supra* note 62. As a practical matter, banks are unlikely to lend to early-stage startups due to their high risk and intangible assets. *See generally Debt as Venture Capital*, *supra* note 1, at 1175 (explaining business and regulatory reasons why banks and traditional lenders must "use extreme caution when choosing their borrowers to avoid defaults").

76. As RBF is used in the information technology sector, two aspects distinguish RBF from bank debt. One, RBF lacks the type of robust downside protection secured by a bank

mechanism to monitor startup activities, a debtor company contracts to provide financial information to the lender upon request.⁷⁷ The lender does not take a governance role in the startup. Instead, the debtor startup agrees to a restrictive covenant that restricts how loan proceeds will be used and, further, limits the company's ability to incur additional indebtedness absent lender consent.⁷⁸

From a time perspective, parties to RBF agreements anticipate financial returns to investors within a few years of investment, even in the absence of a company-wide liquidity event (such as a sale of the company or an IPO). For example, a startup's repayment obligation to the TVA is triggered when the company reaches an agreed-upon amount of gross revenues, an executive receives salary of over \$100,000, or when there is a distribution to a shareholder.⁷⁹ Three regulatory dimensions of RBF are notable. As a matter of securities law, RBF instruments are a security. Further, an RBF investor is a lender, not a shareholder entitled to fiduciary duties or other state law shareholder rights under corporate law.⁸⁰ Finally, tax deductions on RBF interest payments may be attractive to a debtor company.

2. Demand dividend and social entrepreneurship variants

A type of startup, often referred to as a social impact venture, has gained popularity over the past decade. So-called social entrepreneurs launch startups with a business model reflecting twin aspirations: (1) impact a social problem and (2) generate financial returns.⁸¹ Motivations of social enterprise investors vary. But at

lender. Two, RBF repayment is variable, rather than fixed by a predetermined repayment schedule. BARTLETT, *supra* note 59. Variable repayment may be attractive for startups that have uncertainty about their future cash flows or expect to have "lumpy" revenue streams. A business with seasonal aspects, for example, may have lumpy revenues where sales are higher at some portions of the year than others. Wilson, *supra* note 62.

77. See *TVA Revenue Loan Agreement*, *supra* note 57, § 5. But see *Wefunder Revenue Loan Agreement*, *supra* note 73 (no obligation of company to provide financial information to lender).

78. See *TVA Revenue Loan Agreement*, *supra* note 57, § 8.

79. See *id.* § 3(a).

80. See *Wefunder Revenue Loan Agreement*, *supra* note 73, § 17 (lender not entitled to be deemed "holder of capital stock" for any purpose).

81. One description is that social enterprise startups are more "zebras" than unicorns—i.e., they aspire to be "both black and white: they are profitable and improve society." See Jennifer Brandel et al., *Zebras Fix What Unicorns Break*, MEDIUM (Mar. 8, 2017),

least a subset is willing to fund an impact venture, even when the “risk profile of an angel impact investment is insane.”⁸²

Nontraditional structures, at least in theory,⁸³ could be especially useful for impact startups and their investors.⁸⁴ Traditional

<https://medium.com/@sexandstartups/zebrasfix-c467e55f9d96> [<https://perma.cc/PP4H-RXJ8>] (“The business model is the message. . . . We believe that developing alternative business models to the startup status quo has become a central moral challenge of our time.” (internal punctuation omitted)).

82. Interview with Tom Virden, angel investor (May 26, 2017). Virden, a Boulder-based investor who invested in over thirty startups in 2016–17, readily acknowledges the long-shot nature of many of his impact investments. But he sees it as a way to give back to the community and “invest in people that I care about.”

83. Contractual innovation in impact investing merits further study. Social impact investing presents a puzzle in contractual innovation. Interviews with individuals in social entrepreneurship suggest relatively slow adoption of nontraditional types of investment instruments for impact companies. One view hypothesizes that social impact already involves a lot of uncertainty and that a “new” instrument would create more problems. Interview with Brian Axelrad, Attorney with Illinois-based startup practice that works with twenty-five to forty deals per year (Sept. 22, 2017). Another suggests that investors would like new instruments but entrepreneurs are less interested. Interview with Victor Grau, Former Director, MIT D-Lab (June 28, 2017). A third view is that lawyers are risk-averse and “aren’t going to school to be creative.” Interview with Stephanie Gripne, Director, Impact Finance Center (July 3, 2017).

84. Experimentation with new instruments is ongoing. Some high-profile impact investors, such as Village Capital, advocate for the utility of novel instruments. For example, Village Capital highlights that nine of its seventy early-stage investments involve “non-equity structures such as revenue share agreements or flexible debt.” See, e.g., Victoria Fram, *Why an Equity-Only Investment Strategy Overlooks Many Promising Entrepreneurs*, MEDIUM (Feb. 1, 2017), <https://medium.com/village-capital/why-an-equity-only-investment-strategy-overlooks-many-promising-entrepreneurs-ec5f69bd104c> [<https://perma.cc/B9B5-7J8C>].

Startwise, Fledge, and certain angel investors use nontraditional investment instruments in connection with social enterprise. See *supra* note 66. Fledge is a social impact accelerator that uses RBF instruments with its portfolio companies. *About*, FLEDGE, <http://fledge.co/about/> [<https://perma.cc/E9K7-24CF>]. Fledge actually mixes a 6% ownership stake alongside a revenue-based agreement as part of its investment arrangement. *Details*, FLEDGE, <http://fledge.co/about/details/#investment> [<https://perma.cc/TC58-9UET>] (“[W]e ask for 6% ownership in each startup. This investment is uniquely structured as redeemable equity, with the startup repurchasing Fledge’s shares using 4% of future revenues.”).

Another alternative form of social impact investment is FLY Paper, a hybrid debt instrument proposed by Professors Reiser and Dean, which is designed to make an enterprise’s social mission “sticky” for both investors and entrepreneurs. Dana Brakman Reiser & Steven A. Dean, *Hunting Stag with Fly Paper: A Hybrid Financial Instrument for Social Enterprise*, 54 B.C. L. REV. 1495, 1498 (2013). A company receives modest capital from a FLY Paper holder, who in return receives a below-market return on a flexible repayment schedule. If the entrepreneur sells her shares, then the FLY Paper holder may convert her debt into equity to capture any benefit associated with the sale. This way, an early enterprise with an aspirational social mission gains flexibility to choose between profits and mission while avoiding the permanency associated with a charitable organization. If an entrepreneur chooses to sell, the instrument provides equity-type benefit to the capital provider.

instruments such as common and preferred equity typically require a sale, IPO, or other “exit” event before an investor receives a return. But the “notion of an exit is artificial and weird” for a social impact startup that lacks high growth potential and, moreover, does not aspire to a future sale.⁸⁵ Social investment instruments address this problem through investor liquidity based on a startup’s revenues or profits.⁸⁶ These instruments allow a social entrepreneur to be more “honest” with investors about likely outcomes since they avoid a structure where investor return is predicated on a large – and highly unlikely – exit.⁸⁷

One type of instrument expressly designed for social impact ventures, the demand dividend, is styled as a “debt vehicle” that blends equity-like aspects.⁸⁸ The demand dividend provides an investor a temporary ownership stake, labeled as preferred stock. From an economic perspective, the demand dividend has two key characteristics. One, after investment the demand dividend allows for a holiday period (typically ten to twenty-four months) during which the company does not owe payment to an investor. Following the dividend holiday, a startup pays a dividend to the investor based on a percentage of its “free cash flow” – defined roughly as a percentage of the company’s profits. In this way, demand dividends share a key characteristic – variable repayment – with RBF.⁸⁹

85. Gripne Interview, *supra* note 83.

86. One social impact investor said that when he received his first wire transferring funds that provided liquidity from a social venture, “I almost cried.” Interview with Rich Hoops, Co-founder, Board Chair, Impact HUB Boulder (Dec. 8, 2016). *See, e.g.*, DEMAND DIVIDEND, *supra* note 27 (“[The] Demand Dividend grew out of the need to find alternatives to debt, convertible debt, and equity as funding mechanisms for social enterprises.”).

87. Under a structure that builds in liquidity, an entrepreneur can be honest with the investor and say “there is not a chance of an exit . . . but there is a chance I can pay your money back.” Virden Interview, *supra* note 82.

88. *See* DEMAND DIVIDEND, *supra* note 27 (demand dividend is “a debt vehicle”); *Term Sheet for Variable Dividend*, MILLER CTR. FOR SOC. ENTREPREN., <https://static1.squarespace.com/static/55036eefe4b0fe6c8e833e4a/t/5642944be4b07a45a862cce6/1447203915020/Term+Sheet-for-Variable+Dividend.pdf> [<https://perma.cc/JC4R-6R3B>].

89. The demand dividend attracts more scholarly attention. *See, e.g.*, Dana Brakman Reiser & Steven A. Dean, *Financing the Benefit Corporation*, 40 SEATTLE U. L. REV. 793, 814 (2017) (“Intentionally a profit-sharing – rather than merely revenue-sharing – vehicle, [the demand dividend] will appeal to the needs of more mature benefit corporations and dedicated impact investors.”). The demand dividend is also briefly mentioned by Deborah Burand. *See* Deborah Burand, *Resolving Impact Investment Disputes: When Doing Good Goes Bad*, 48 WASH. U. J.L. & POL’Y 55, 62 n.21 (2015).

Unlike RBF payments to investors, which are predicated upon top-line revenues, demand dividends are bottom line based (i.e., payments to investors are tied to profits). Dividends are payable when declared by the board of directors. Two, similar to RBF, the demand dividend caps the investor's upside in a startup's profits. Once a startup pays back a multiple of the original investment, the investor's shares are "redeemed" by the company (i.e., the shares go away and the investor is no longer a shareholder).⁹⁰

The demand dividend has three notable control elements. One, similar to RBF, a demand dividend instrument entitles an investor to financial information about the company. This allows an investor to monitor payments from the startup to investor. Two, a demand dividend empowers investors to affect a startup's spending decisions. A startup must provide to investors "an outline of projected spending revenue, and capital use[,]" and once approved, any change to a business plan requires written consent of investors.⁹¹ This control provision provides an exceptional amount of power to investors who, typically, are at an information disadvantage relative to management about company strategy. At a minimum, this control provision reduces the ability of startups to quickly change direction. Heightened transaction costs may result from steps associated with business plan discussions between a company and its investors, as well as obtaining investor approvals for changes. Three, a demand dividend holder does not have shareholder voting rights. But the demand dividend holders are entitled to a board seat. The preferred shareholder aspect of the demand dividend, including the governance right to a board seat, may be viewed as a type of "collateral" that is held pending repayment to investors.

With respect to time, like RBF, the demand dividend instrument intends to create financial returns to investors within a few years of investment, even in the absence of a company-wide liquidity event (such as a sale or IPO). In an effort to force liquidity, a demand dividend must be paid in full by the startup to the

90. See *Term Sheet for Variable Dividend*, *supra* note 88, at 2.

91. *Id.* at 1.

investor within seven years.⁹² As a matter of securities law, demand dividend instruments are a security. Further, the intent is that a demand dividend investor is a lender rather than a shareholder entitled to fiduciary duties or other state law shareholder rights under corporate law.⁹³ If tested in court, however, it is unclear whether a demand dividend holder may successfully claim that her preferred stock entitles her to basic shareholder rights under state law.

3. *Venture debt*

In his detailed study of venture debt, Darian Ibrahim highlights that venture lenders—typically specialty banks or venture debt firms⁹⁴—offer debt to VC-backed startups.⁹⁵ Venture debt lending extends to early-stage startups.⁹⁶ A startup's eligibility for venture debt, importantly, does not hinge on commonly used bank loan criteria like cash flows or tangible assets.⁹⁷ Rather, venture debt is typically available to startups that reach a VC funding round.⁹⁸

From an economic perspective, venture debt differs from RBF and other variable instruments insofar as the repayment schedule is fixed.⁹⁹ Venture loans are usually straight (not convertible) debt, have an average term of two to three years, and are fully amortized, with equal monthly payments of principal and interest.¹⁰⁰ Interest

92. This is accomplished through a redemption provision. Of course, if a startup lacks funds, then this provision has little benefit to an investor. *See id.* at 2.

93. In this respect, drafters intend that a demand dividend be treated similarly to a revenue loan agreement. *See Wefunder Revenue Loan Agreement, supra* note 73, § 17 (lender not entitled to be deemed “holder of capital stock” for any purpose).

94. Prominent specialty venture banks include Silicon Valley Bank, Comerica, and Square 1, while venture debt firms include Western Technology Investment (WTI) and Orix Capital. *See* Samir Kaji, *Venture Debt 101 – Banks vs. Venture Debt Firms*, PEVCBANKER (May 19, 2013), <http://pevcbanker.com/venture-debt-101-banks-vs-venture-debt-firms/> [<https://perma.cc/TM3D-6H27>].

95. *Debt as Venture Capital, supra* note 1, at 1173.

96. *Id.* at 1185 (discussing lenders' preference for loans to startups at early, pre-revenue stages).

97. *Id.* at 1173.

98. Low interest rates in recent years made venture debt attractive for early-stage companies. Early-stage startups use venture debt for purposes such as financing inventory.

99. *Debt as Venture Capital, supra* note 1, at 1179.

100. *Id.* (24–36 months, “sometimes with an interest-only period of three to nine months before the term begins”).

rates are in the 10–15% range.¹⁰¹ Another distinguishing economic feature of venture debt is that warrants accompany the loan. Venture lenders take warrant coverage in the startups, typically ranging from 5 to 15% of the loan amount, which provides an option for equity ownership in the startup.¹⁰² If the company fails or is unable to pay, lenders retain traditional debt remedies, including repayment ahead of equity holders. If the company succeeds, lenders not only receive principal plus interest but also often have the option to share in the upside through exercise of warrants traditionally bundled with the debt.¹⁰³

From a control perspective, a startup's intellectual property provides intangible collateral that holds some value by venture lenders.¹⁰⁴ But venture lenders primarily rely upon third parties, VCs, for an "implicit guarantee" that the startup will pay back the loan.¹⁰⁵ From a time perspective, venture debt agreements provide for repayment to investors within two to three years of investment.¹⁰⁶ As a matter of securities law, venture debt instruments are a security. Further, the RBF investor is a lender, not a shareholder entitled to fiduciary duties or other state law shareholder rights under corporate law.

101. Patrick Gordan, *Venture Debt: A Capital Idea for Startups*, KAUFFMAN FELLOWS REP., Fall/Winter 2012, https://www.kauffmanfellows.org/journal_posts/venture-debt-a-capital-idea-for-startups/ [<https://perma.cc/MC4Y-J4BF>].

102. *Debt as Venture Capital*, *supra* note 1, at 1179–80.

103. *Id.* at 1175, 1179.

104. *Id.* at 1187; *see also* Gordan, *supra* note 101 ("Growth capital term loans are secured by a blanket lien on a company's assets, which may nor may not include a lien on intellectual property.").

105. *Debt as Venture Capital*, *supra* note 1, at 1184 ("VCs make an implicit promise to repay venture loans out of their present and future equity investments."); Mann, *supra* note 48, at 137; *see also* E-mail from Joel Gheen, formerly with RBF provider Cyprus Capital, to Brad Bernthal, Assoc. Professor, Univ. of Colo. Law Sch. (Jan. 23, 2018) (on file with author) ("The reality is that true Venture Debt is almost always offered only on the tails of a significant equity event, and that equity has to come from a certain profile of deep-pocketed, institutional VC or PE. Thus, the bank's risk is minimized by knowing there is a large, interested financial partner, and the bank can make more upside being . . . involved in the later IPO or liquidity event. Banks rarely if ever offer Venture Debt without a flagship equity sponsor in place.").

106. *Debt as Venture Capital*, *supra* note 1, at 1173 n.13, 1179 (term of loans is 24–36 months, "sometimes with an interest-only period of three to nine months before the term begins").

4. Light preferred (aka, series seed preferred)

This Article refers to a stripped-down version of traditional preferred equity as a “light preferred” instrument.¹⁰⁷ John Coyle and Joseph Green trace the development of this instrument, which is used for the earliest investment (i.e., pre-seed and seed stage) into a startup.¹⁰⁸ Form documents that effect a light preferred financing—entitled “Series AA” and “Series Seed Preferred”—publicly emerged in 2008. Series Seed documents today are shared through an open source license.¹⁰⁹

A light preferred instrument provides special economic and control rights to an investor. Those rights are not, however, as elaborate as rights that a VC takes later in the firm’s lifecycle when investment funding amounts increase.¹¹⁰ Light preferred differs from a traditional preferred equity round in two important ways: (1) lower direct transaction costs and (2) reduced investor control over a startup.¹¹¹ Light preferred results in fewer provisions to

107. Another development in startup investment relates to dual class structures. This trend, however, is more important for growth-stage and emerging-stage investments. Dual class stock is a governance arrangement that entrenches manager power—namely, dual class stock that vests governance power in founders—and alters the control rights of preferred investors. This structure provides founder’s common stock with outsized voting power, giving founders up to ten times the voting rights of other equity holders (including preferred shareholders). Steve Blank, *When Founders Go Too Far*, HARV. BUS. REV. (2017), <https://hbr.org/2017/11/when-founders-go-too-far> [<https://perma.cc/HWY3-W9G6>]. “This allows them to outvote their preferred-stock-holding VCs, giving founders extraordinary control.” *Id.* Founder’s stock is part of, as Steve Blank calls it, the “founders’ revenge”—i.e., “the remarkable and little-understood ways in which founders, no longer systematically pushed aside as their start-ups grow, have come to dominate their boardrooms.” *Id.*

108. Coyle & Green, *supra* note 4, at 173–74 (discussing work of Cooley attorneys Mike Platt and Noah Pittard in creating a Series AA set of light preferred documents, followed by Ted Wang’s release of Series Seed documents); FELDMAN & MENDELSON, *supra* note 7.

109. See Brad Newman, *Announcing New Series Seed Convertible Note and Updated Equity Financing Documents and Generators*, COOLEY GO, <https://www.cooleygo.com/announcing-new-series-seed-equity-and-note-financing-documents-and-generators/> [<https://perma.cc/RVF7-VMV7>]. The open source Series Seed documents are available at <https://github.com/seriesseed/equity> [<https://perma.cc/3NHN-QBJ4>].

110. For example, some forms of light preferred do not provide anti-dilution protection to an investor, and the company’s representations and warranties are limited. See Yokum, *How Do the Sample Series Seed Financing Documents Differ from Typical Series A Financing Documents?* STARTUP COMPANY LAW. (Mar. 14, 2010), <http://www.startupcompanylawyer.com/2010/03/14/how-do-the-sample-series-seed-financing-documents-differ-from-typical-series-a-financing-documents/> [<https://perma.cc/K5T5-SWBR>].

111. See Ted Wang, *About the Series Seed Documents*, SERIES SEED (Feb. 24, 2010), <https://www.seriesseed.com/posts/2010/02/about-the-series-seed-documents.html> [<https://perma>

negotiate and draft *ex ante* in the deal documents, which saves on legal fees.¹¹² Transaction costs can become outsized, as a percentage of a small fundraise, in early-stage fundraising when negotiation and drafting costs become significant.¹¹³ Further, in contrast to the extensive involvement of a demand dividend investor in a startup's business plan, fewer protections reduce the chance of *ex post* hold up by an early investor with respect to company decisions.

Light preferred retains three notable economic provisions that are typical in a traditional preferred offering. One, in order to determine the "price" of light preferred shares, an investor and a company must agree upon a startup's enterprise value. Early-stage private company valuation is a speculative endeavor that requires considerable guesswork and can be a contentious point for negotiation.¹¹⁴ Two, a light preferred investor secures a preference, in the event of company liquidation, to receive payment ahead of common shareholders.¹¹⁵ Three, a light preferred investor retains an option to participate in future company fundraising rounds.¹¹⁶ This provides an investor the ability to invest additional capital at a future point when uncertainty about the startup's prospects is

.cc/F9BM-PF48]. Startup attorney Ted Wang, who wrote the blog entry, notes that "[f]rom an investor's perspective, while moving away from the traditional full-blown financing documents entails giving up a number of rights and protections, when taken across numerous transactions, the benefits of spending less time and money on the documents outweigh the cost of sacrificing these additional rights and protections." *Id.*

112. To effectuate a series seed light preferred deal, for example, legal attention is only required for the charter and an investment agreement, rather than the five standard NVCA agreements (stock purchase agreement, voting agreement, investors' rights agreement, ROFR/co-sale agreement, and charter). Moreover, negotiation of the terms is punted to the next round. "Deleting anti-dilution rights saves several pages of text in the Certificate of Incorporation." Yokum, *supra* note 110.

113. Document standardization and automation continue to drive legal prices down. But even \$10,000 in legal costs, for example, constitute a material portion of the small fundraise (e.g., 4% of a \$250,000 round).

114. GOMPERS & LERNER, *supra* note 7; FELD & MENDELSON, *supra* note 7.

115. See *Amended and Restated Certificate of Incorporation*, GITHUB art. 5(B) (Aug. 9, 2017), <https://github.com/CooleyLLP/seriesseed/blob/master/equity/Series%20Seed%20-%20Restated%20Certificate%20of%20Incorporation.md> [<https://perma.cc/3J8R-CLLC>] [hereinafter *Certificate of Incorporation*] (Cooley LLP Series Seed Form Documents).

116. See *Series Seed Preferred Stock Investment Agreement*, GITHUB § 6 (June 24, 2017), <https://github.com/CooleyLLP/seriesseed/blob/master/equity/Series%20Seed%20-%20Preferred%20Stock%20Investment%20Agreement.md> [<https://perma.cc/ZZ2F-QQ65>] [hereinafter *Preferred Stock Investment Agreement*] (Cooley LLP Series Seed Form Documents) (discussing participation rights).

reduced and, moreover, information asymmetry between the company and the investor is diminished.

With respect to control provisions, light preferred provides voting and board governance rights to investors.¹¹⁷ But a light preferred instrument reduces the muscle of protective provisions.¹¹⁸ A VC typically requires extensive protective provisions, which function as negative covenants that prohibit company actions unless preferred shareholders consent.¹¹⁹ A light preferred instrument retains certain protective provisions, such as prohibition on sale of the company absent preferred investor approval. But the light preferred instrument relaxes other prohibitions, such as the ability of the company to borrow money.¹²⁰ These relaxed investor protections may be fortified upon later financing rounds, however, since light preferred investors secure a modified most-favored-nations clause.¹²¹ Upon a startup's subsequent financing, the light preferred investors receive the rights granted to investors in the future round.¹²²

Counterintuitively, as a company matures, less robust deal terms may benefit an early-stage investor at later stages of a startup's lifecycle. As a company grows, investors invest greater amounts of money and wield more control not only over the startup, but also over early-stage investors. Investors at later stages of a startup tend to look to the precedent terms set by early investment rounds—namely, a later-in-time investor seeks terms that are equal or superior to terms obtained by early investors.¹²³

117. See *Certificate of Incorporation*, *supra* note 115, art. 5(B), § 2 (discussing voting and election of directors).

118. *Light Preferred*, STARTUP LAW., <http://startuplawyer.com/startup-law-glossary/light-preferred> [<https://perma.cc/3T5S-68EC>] (“Light Preferred, also known as seed preferred, is a term used to describe a financing via preferred stock that is watered-down or not up to the level of a full-fledged ‘series A’ financing.”).

119. FELD & MENDELSON, *supra* note 7, at 71.

120. See *Certificate of Incorporation*, *supra* note 115.

121. See *Preferred Stock Investment Agreement*, *supra* note 116, Exhibit B, § 4.2 (discussing additional rights and obligations, including registration rights and price-based anti-dilution protection).

122. For example, a VC round of financing may include registration rights and co-sale rights that are absent in a light preferred round.

123. FELD & MENDELSON, *supra* note 7, at 153 (“Given how important precedent is in future financings, if you reach a bad outcome on a specific term, you might be stuck with it for the life of your company.”).

Reduced controls associated with an early investment establishes a precedent where the baseline level of investor control is relatively low. So if a later-in-time investor takes the same terms, or only incrementally more control terms, the net effect is that late-stage investor controls are lower than they would be than if the early control terms were set at a high level.¹²⁴

From a time perspective, light preferred investors are unlikely to see a financial return for an extended period of time, likely in the range of five to eight years required for the average startup to reach a liquidity event.¹²⁵ In view of this extended duration, investors require key founders and executives to bond themselves to the startup. This is accomplished by forcing key founders and executives to enter into vesting agreements. An individual deemed critical to the company's success must agree to stay with the company or, if the individual departs within four years, then the individual will lose some portion of her ownership in the startup.¹²⁶ With respect to regulation, as a matter of securities law, light preferred instruments are a security. A light preferred investor is a shareholder entitled to fiduciary duties or other state law shareholder rights under corporate law. Finally, a light preferred investor's purchase of shares starts the clock for a holding period required for capital gains tax treatment.

5. Convertible debt

Convertible debt structures a high-risk capital investment in the form of a loan (aka, a "note") that anticipates a subsequent round of equity financing. In short, unlike a venture debt lender, a convertible debt investor does not seek her return through loan repayment. Rather, an investor parks capital with a company, in hopes that the investment will convert into ownership upon a

124. *Id.*

125. PITCHBOOK, PITCHBOOK 2018 VENTURE CAPITAL OUTLOOK 14 (2018) (finding a median time to exit of 6.8 years for an IPO, 5.1 years for an acquisition, and 7.6 years for a secondary buyout); see also *For Largest Venture-Backed Tech Exits, It Takes 6.3 Years*, CB INSIGHTS: RESEARCH BRIEFS (Apr. 8, 2014), <https://www.cbinsights.com/research/venture-time-exit-marathon/> [<https://perma.cc/5T8N-7YFQ>] (finding an average of 6.3 years); see also *New Exit in VC*, *supra* note 25, at 14 (citing an average of around 7 years).

126. See *Preferred Stock Investment Agreement*, *supra* note 116, Exhibit B, § 2.2.3.

subsequent preferred stock financing led by a sophisticated – often an institutional – investor.

Investors used convertible debt prior to 2005; however, earlier uses were primarily for growth and emerging stage company’s “bridge” rounds.¹²⁷ Beginning around 2005, convertible debt increasingly became used as a stand-alone financing round.¹²⁸ For example, consider a Boulder-based startup from that time, Justin’s Nut Butter. Justin Gold loved long bike rides.¹²⁹ To power his bicycling passion, Justin made nut butter from original recipes, which provided an ideal high-protein snack during rides. In 2004, he produced jars of an eponymous product – Justin’s Nut Butter – while working another full-time job. By 2006, with his product gaining popularity, Justin recognized a new market opportunity: an on-the-go squeeze pack to compete with sports gel packs and energy shots. To help fund this effort, Justin’s Nut Butter raised outside capital from angel investors through an emerging startup investment instrument: convertible debt.

Convertible debt generally lowers direct, ex ante transaction costs relative to preferred stock issuances. Convertible debt does not require extended negotiations between a company and investors. Further, once an investment is complete, changes to a startup’s charter and associated documents are typically unnecessary. Convertible debt’s direct legal costs, as a result, are typically lower than traditional and light preferred equity.¹³⁰

Convertible debt has three key economic features. One, parties create a period of temporary debt during which the note holder is a creditor to the firm. Interest accrues on the note; however, no payment is required by the startup to a noteholder prior to maturity.¹³¹ Convertible debt does not require that a startup and its

127. Bridge rounds are a short-term capital infusion, usually paid back within twelve months or less, meant to allow a company to reach another financing or a liquidation event, such as an IPO. See, e.g., *Debt as Venture Capital*, *supra* note 1, 1173 at n.13 (citing J.V. Rizzi, *A Framework to Mitigate the Risks of Bridge Lending*, 17 *COM. LENDING REV.* 5, 8 (2002)).

128. Axelrad Interview, *supra* note 83; Coyle & Green, *supra* note 4, at 162.

129. *About Justin’s*, JUSTIN’S, <http://justins.com/justins-story/company-story> [https://perma.cc/4HRD-KTYZ].

130. Burns E-mail, *supra* note 24; Coyle & Green, *supra* note 4, at 162.

131. At maturity, or in the event of default, a note holder has the ability to “call” the debt (i.e., demand payment). Most note holders, however, are hesitant to do so because –

investors agree upon a company valuation. Convertible debt postpones the valuation decision, at least in theory, until a later time when more information about the company is available and the enterprise value can be more readily determined.¹³² Two, convertible debt prescribes that a subsequent qualified financing, defined as an equity issuance over a prescribed amount (which may range from \$250,000 to \$1 million), triggers automatic conversion of the outstanding balance of the note into equity.¹³³ Upon conversion, the noteholder becomes an equity shareholder that holds the same class of preferred stock as the later investor takes. Three, the note may include mechanisms that provide a price benefit to an early investor upon conversion. For example, a valuation cap prescribes a ceiling on the price at which a convertible note converts.¹³⁴ A conversion “discount,” commonly prescribed in the note at 10–30%, rewards the noteholder for her early investment into a company.¹³⁵ A noteholder typically may elect the benefit of the discount or a valuation cap, but not both.

From a control perspective, a holder of convertible debt has priority over shareholders in the event of company liquidation.¹³⁶ Further, a most-favored-nations clause guarantees a convertible note investor that, if the company subsequently issues more debt on more favorable terms, then the investor has the option to adopt

even if the note has matured – the action to call a note could hasten the end of the company (and result in little to no payment).

132. As discussed in *infra* Part IV, a valuation cap nonetheless functions as at least a shadow valuation.

133. Convertible note holders typically have a discretionary right to convert to common at maturity. However, exercise of this option is attractive only in rare circumstances, such as when a company is so successful that additional financing is unnecessary.

134. For example, say an investor makes a \$100,000 investment that uses a Park-n-ride instrument that includes a \$1 million valuation cap. The company flourishes and, a year later, raises a qualified financing round with a \$5 million pre-money valuation. Upon conversion, excluding any interest, the Park-n-ride holder is entitled to 10% of the company under the cap.

135. Another economic benefit to the note holder is a conversion cap. The conversion cap sets a maximum valuation at which the investment converts. This benefits an early investor when a company’s valuation skyrockets. For example, if a cap is \$2 million, but a VC round is set at \$10 million, the original investment converts at the \$2 million valuation. FELD & MENDELSON, *supra* note 7, at 111.

136. Lenders are creditors that receive preferential treatment ahead of firm shareholders in the event of liquidation or bankruptcy. See *Debt as Venture Capital*, *supra* note 1, at 1203.

the terms.¹³⁷ Like RBF investment, founders and managers are not required to personally guarantee the convertible debt loan. Upon maturity of a convertible note, the investor often has the option to either require repayment of a note or, alternatively, to convert into preferred stock.¹³⁸

From a time perspective, convertible note investors resemble light preferred investors and are unlikely to see a financial return for a relatively long period of time, likely in the range of five to eight years required for the average startup to reach a liquidity event.¹³⁹ Unlike a light preferred instrument, however, it is unusual for convertible noteholders to bind key founders and executives to the startup for an extended period of time through vesting agreements. With respect to regulatory categories, as a matter of securities law, a convertible debt instrument is a security. Further, a convertible debt holder is not a shareholder entitled to fiduciary duties or other state law shareholder rights under corporate law.¹⁴⁰ Finally, tax deductions on convertible debt interest payments may be available to a startup, so long as the debt is not viewed as a de facto equity position.¹⁴¹

6. Simple agreement for future equity (Safe) and similar variants

The Simple Agreement for Future Equity (Safe) retains most aspects of convertible debt – except for the debt part. The Safe is an instrument popularized on the West Coast that is closely associated with accelerator programs.¹⁴² For example, MadKudu participated

137. *Convertible Promissory Note*, GITHUB § 1.4 (June 20, 2017), <https://github.com/CooleyLLP/seriesseed/blob/master/notes/Series%20Seed%20Notes%20-%20Convertible%20Promissory%20Note.md> [<https://perma.cc/ED8G-67M4>] [hereinafter *Convertible Promissory Note*].

138. *See id.* § 2.3.

139. PITCHBOOK, *supra* note 125, at 14 (finding a median time to exit of 6.8 years for an IPO, 5.1 years for an acquisition, and 7.6 years for a secondary buyout); *see also For Largest Venture-Backed Tech Exits*, *supra* note 125; *New Exit in VC*, *supra* note 25, at 14 (citing an average of around 7 years).

140. *See Wefunder Revenue Loan Agreement*, *supra* note 73, § 17 (explaining that lender not entitled to be deemed “holder of capital stock” for any purpose).

141. *See* Dan Wright, *Convertible Debt Tax Issues for Startups: An Introduction to the Federal Income Tax Issues Associated with Conversion Features*, STARTUP L. BLOG (June 2, 2012), <http://www.startuplawblog.com/2012/06/02/convertible-debt/> [<https://perma.cc/VU97-HCLE>].

142. Coyle & Green, *supra* note 4, at 168 (describing origins of Safe as constructed by Y Combinator partner Carlynn Levy).

in the 2015 Techstars Boulder investment accelerator. MadKudu created a product, based upon big data tools and analytics, that small and mid-size companies use to identify useful patterns in customer behavior.¹⁴³ Once the Techstars Boulder problem concluded, the startup's founders relocated to Mountain View, California. There they rejoined their families and worked to grow their company. To fuel operations, in November 2015 MadKudu raised a \$1.4 million seed round from a French investment fund and several angel investors in the form of a Safe.¹⁴⁴

A Safe retains much of the structure of convertible debt; however, it eliminates an investor's right to loan repayment. For a startup like MadKudu, the Safe presents the same attraction as convertible debt: (1) lower direct transaction costs¹⁴⁵ and (2) an instrument that sidesteps formal valuation.¹⁴⁶ But since a Safe removes the loan feature, it is most accurately viewed as a type of contractual derivative—that is, an instrument with value derived from the value of another asset, in this case the startup's stock.¹⁴⁷

Economic aspects of the Safe closely resemble convertible debt. The Safe anticipates conversion of investment into future ownership upon issuance of preferred stock.¹⁴⁸ Upon conversion, the Safe holder becomes an equity shareholder that holds the same class of

143. Levan E-mail, *supra* note 4; Green & Coyle, *supra* note 14, at 172 (“The SAFE is, in essence, a contractual derivative instrument. It is a deferred equity investment that will prove valuable to the holder if, and only if, the company that issues it raises a subsequent round of financing, is sold, or goes public.”).

144. Levan E-mail, *supra* note 4.

145. All else equal, a Safe's direct legal fees associated with investment will be lower than convertible debt.

146. As with convertible debt, a valuation cap, if included, acts as at least a shadow valuation in a Safe.

147. Green & Coyle, *supra* note 14, at 172 (“[Safe] is a deferred equity investment that will prove valuable to the holder if, and only if, the company that issues it raises a subsequent round of financing, is sold, or goes public.”).

148. Unlike convertible debt, many Safes do not require a qualifying amount of financing, only that the subsequent issuance involves preferred stock. See *Safe Primer*, Y COMBINATOR (Feb. 2016), <https://www.ycombinator.com/documents/> [https://perma.cc/85GA-GM6K] (“There is no threshold amount that the company must raise to trigger the conversion.”).

preferred stock that the later investor takes.¹⁴⁹ A valuation cap and a discount may be included.¹⁵⁰

In control aspects, however, the Safe differs considerably from convertible debt. The Safe diminishes the control an investor may exercise over a company. By removing the debt feature in the Safe, deal architects address two perceived problems with convertible debt. One, startups are often cash poor, which spurred concerns that use of debt may pull a startup into insolvency.¹⁵¹ Two, after a note matures, debt may be “called” by an investor. Pulling this control lever to demand payment after the note is due—so goes the argument—is inappropriately harsh in an entrepreneurial environment. The Safe removes this possibility for an early investor to “call” a note and potentially drag a company into insolvency.¹⁵² Indeed, if a company does not issue preferred stock, then a Safe holder lacks a mechanism to force conversion or repayment, which may leave an investment stranded in indefinite limbo.

From a time perspective, Safe investors are unlikely to see a financial return for the five-to-eight-year range that the average startup takes to reach a liquidity event.¹⁵³ With respect to regulatory categories, as a matter of securities law, a Safe instrument is a security. Further, a Safe holder is not a shareholder entitled to

149. A minor technical exception exists where a preferred equity financing occurs at a valuation in excess of the valuation cap, in which case the Safe holder receives Safe preferred stock. *See id.*

150. *See Startup Documents, Safe: Cap and Discount*, Y COMBINATOR (Feb. 2016), <https://www.ycombinator.com/documents/> [<https://perma.cc/85GA-GM6K>].

151. FELD & MENDELSON, *supra* note 7. More specifically, the Safe was created during a time in which Delaware courts appeared to consider a “zone of insolvency” where obligations could shift to creditors. In 2015, *Quadrant Structured Products Co. v. Vertin* brought some clarity concerning Delaware law’s approach to duties owed by directors to creditors. 115 A.3d 535, 546–47 (Del. Ch. 2015). *Quadrant* clarified that directors owe fiduciary duties to residual claimants where a corporation is insolvent. *Id.* Creditors become a residual claimant at the point of insolvency and, accordingly, may bring a derivative suit against directors of an insolvent corporation. *Id.* at 546. But a “zone of insolvency” does not appear to trigger any shifting duties from directors to creditors. *Id.*

152. Coyle & Green, *supra* note 4, at 162 (discussing challenges for a startup when a convertible note matures prior to a conversion event).

153. PITCHBOOK, *supra* note 125, at 14 (finding a median time to exit of 6.8 years for an IPO, 5.1 years for an acquisition, and 7.6 years for a secondary buyout); *see also For Largest Venture-Backed Tech Exits*, *supra* note 125 (finding an average of 6.3 years); *New Exit in VC*, *supra* note 25, at 14 (citing an average of around 7 years).

fiduciary duties or other state law shareholder rights under corporate law.¹⁵⁴

Variants of the Safe exist, including the lesser-known Keep It Simple Security (“KISS”). The deferred ownership feature of these instruments, notably, is also attractive for regulatory reasons to effectuate investment into startups domesticated in certain foreign jurisdictions. For example, the international version of a Safe-type agreement used by Techstars, entitled the “Fixed Percentage Convertible Equity Agreement,” avoids certain countries’ prohibitions on foreign ownership of companies.¹⁵⁵ By deferring ownership until some future time, the Safe-variant investment provides Techstars a future interest in a company while maintaining formal compliance with foreign ownership laws in countries that ban non-domestic shareholders.¹⁵⁶

7. Prepayment

Another novel form of startup investment is prepayment for goods enabled by crowdfunding portals. Prepayment helps startups raise money from many individuals who anticipate a “return” in the form of a future good or service. Online intermediaries, including Kickstarter and Indiegogo, match creators with crowd-funded financial support to help produce a good or service. When a campaign is fully funded, a company promises to deliver the new product to the financial supporter.

Whether prepayment is a form of entrepreneurial finance is subject to dispute. Prepayment is not designed to return profit to an investor and is not (usually) an investment contract. On the other hand, prepayment is a meaningful way by which startups obtain funds, and moreover, a provider of capital expects “return” in the form of a good or service, delivery of which is uncertain. This Article is not alone in taking the view that prepayment today

154. See *Wefunder Revenue Loan Agreement*, *supra* note 73, § 17 (providing that lender not entitled to be deemed “holder of capital stock” for any purpose).

155. *Fixed Percentage Convertible Equity Agreement*, Techstars (on file with author).

156. E-mail from Sierra Moller, Associate Corporate Counsel, Techstars, to Brad Bernthal, Assoc. Professor of Law, Univ. of Colo. Law Sch. (Nov. 3, 2017) (on file with author).

provides startups a notable financing option.¹⁵⁷ Venture-funded startups, significantly, use prepayment to raise additional capital and gauge market interest. Glowforge, for example, in 2015 raised \$27.9 million through Kickstarter presales of its 3-D laser printer. The Glowforge campaign is exceptional, to be sure, but it underscores the potential magnitude of prepayment financing as a new form of capital fundraising.¹⁵⁸

Rather than attracting investment with an expectation of profit, prepayment attracts capital with an expectation of early access to a good or service. For example, consider the financing history of New York City-based startup, Bluffworks. While living as an expatriate in Vietnam, Stefan Loble grew fond of “functional” clothes – that is, attire that accommodates dual demands of the workplace as well as travel (and other physical activity).¹⁵⁹ Upon returning to New York City, Loble decided to launch a new venture, Bluffworks, to provide versatile apparel.¹⁶⁰ A minimum run of pants, however, required production of 500 pair, for which Loble lacked capital. Therefore, in 2012, Loble posted a video on Kickstarter. Crowd-funding backers ordered \$129,000 worth of his functional pants over just thirty-five days.¹⁶¹ Capital raised through Kickstarter is

157. Oranburg argues that prepayment represents an important innovation in corporate finance. He distinguishes prepayment through online intermediaries from prepayment directly between a company and consumer. Seth C. Oranburg, *Hyperfunding: Regulating Financial Innovation*, 89 U. COLO. L. REV. 1033, 1082 (2018).

158. Taylor Soper, *Glowforge 3D Laser Printer Breaks 30-day Crowdfunding Record After \$27.9M in Sales*, GEEKWIRE (Oct. 26, 2015), <https://www.geekwire.com/2015/glowforge-3d-laser-printer-breaks-30-day-crowdfunding-record-after-27-9m-in-sales/> [<https://perma.cc/A75P-D369>]. A variant of prepayment, termed “hyperfunding,” cuts out the intermediary that matches companies and funders. Tesla’s Model 3 presales underscore the magnitude of prepayment financing. For example, Tesla’s 2016 presale of its Model 3 car offered customers an opportunity to reserve a spot in the purchase line of a forthcoming vehicle. Through this strategy, “in one week, Tesla, Inc. presold almost 400,000 to-be-developed Model 3 electric vehicles (EVs), projecting almost \$20 billion in net sales.” Oranburg, *supra* note 157, at 1036.

159. Interview with Stefan Loble, Founder and CEO, Bluffworks (Feb. 6, 2018).

160. See BLUFFWORKS, <https://shop.bluffworks.com> [<https://perma.cc/9EXZ-WMMU>] (“It’s not about the clothes – it’s what you do in them. Bluffworks was founded to fit into every aspect of your life’s journey – work, travel, play (and everything in between). Our apparel’s comfort, stylish versatility, and durability are designed to go the distance and help you focus on the journey ahead.”).

161. Loble Interview, *supra* note 159 (“I would not have a company without Kickstarter.”). The campaign worked so well that Bluffworks launched a blazer campaign. The blazer campaign raised \$340,000. *The Blazer by Bluffworks*, KICKSTARTER, <https://www.kickstarter.com/projects/594084262/the-blazer-by-bluffworks> [<https://perma.cc/PUH2-3KRK>].

not “free.”¹⁶² But the capital, along with customer interest, allowed Bluffworks to grow into a viable enterprise. Bluffwork’s 2017 revenues eclipsed \$2 million and Loble is now raising an outside equity financing.¹⁶³

The economic aspects of prepayment are straightforward: an investor provides capital, and in turn, a startup agrees to produce a good or service. Control terms are minimal. While a portal’s terms of use require a creator to fulfill orders of a successful campaign,¹⁶⁴ in the event of a failure to fulfill an order, recovery of funds from a startup is unlikely as a practical matter.¹⁶⁵ The time between prepayment and delivery of a product varies. A prepayment investor is not a shareholder for purposes of corporate law. Finally, prepayment for a product does not typically involve the sale of a security.

8. Simple agreement for future tokens

New phenomena sometimes outrun old legal categories. Filecoin’s use of a Simple Agreement for Future Tokens (SAFT), for example, presents a form of startup investment that is difficult to categorize. A SAFT facilitates investment of capital to help build out fledgling blockchain infrastructure. A SAFT involves the preliminary sale of tokens that anticipates a future initial coin offering (ICO) in a form of cryptocurrency.¹⁶⁶ For example, when

162. A common misperception about prepayment crowdfunding, through sources like Kickstarter, is that it is “free” money. Loble underscores that an entrepreneur should expect the cost of capital through prepayment crowdfunding to run around 10% or more. First, Kickstarter takes a percentage (5% of money raised). Second, prepayments will be made via credit card, resulting in a 3% credit card processing fee. Third, in order to attract an audience to a campaign, most companies will need to use Facebook and other forms of advertising—i.e., costs associated with customer acquisition. Fourth, campaigns require photography and videography work, which can be expensive, up to the \$40,000 range. Loble Interview, *supra* note 159.

163. *Id.* (“We just completely changed. We became viable.”).

164. Yancey Strickler et al., *Accountability on Kickstarter*, KICKSTARTER: KICKSTARTER BLOG (Sept. 4, 2012), <https://www.kickstarter.com/blog/accountability-on-kickstarter> [https://perma.cc/X88J-BYVL] (“Kickstarter’s Terms of Use require creators to fulfill all rewards of their project or refund any backer whose reward they do not or cannot fulfill.”).

165. Luke Dormehl, *Too Big to Flop: Inside Indiegogo’s Plan to Circumvent Crowdfunding Failures*, DIGITAL TRENDS (Feb. 5, 2017), <https://www.digitaltrends.com/cool-tech/indiegogo-fighting-crowdfunding-fails/> [https://perma.cc/V8C8-48W5] (discussing portal’s efforts to limit high-profile failures of companies to deliver goods promised on Indiegogo).

166. JUAN BATIZ-BENET ET AL., *THE SAFT PROJECT*, THE SAFT PROJECT: TOWARD A COMPLIANT TOKEN SALE FRAMEWORK 3 (2017), <https://saftproject.com/static/SAFT-Project>

Filecoin announced in 2017 a new type of storage product, a SAFT instrument structured funding from early investors to Filecoin.¹⁶⁷ Filecoin successfully raised \$52 million from its earliest investors, then another \$206 million in an ICO.¹⁶⁸

From an economic perspective, rather than purchasing ownership in a venture, the SAFT investor secures a right to “tokens” – which the investor hopes to eventually sell at a profit – that grants use of the blockchain service. Investors bet that, if Filecoin’s service takes off, then they will capture a profit by selling tokens to others. From a control perspective, the SAFT is bereft of formal mechanisms that would allow an investor to meaningfully constrain company actions.¹⁶⁹ An investor lacks voting rights, board rights, protective provisions, or virtually any type of control over the company. Moreover, issuance of tokens may escape investor control provisions of other instruments, such as protective provisions limiting issuance of new stock.¹⁷⁰ From a time perspective, the investor’s return hinges upon the timing of a “network launch,” at which time tokens will be provided that an investor may resell to others, subject to any time-based limitations on such sales.¹⁷¹

From a regulatory perspective, a SAFT is in certain respects a familiar legal creature – that is, a high-risk investment designed to generate investor profits based upon a new product or service. VCs and other investors invest in SAFTs, which are an investment contract subject to careful regulatory scrutiny.¹⁷² Yet a SAFT is, in

-Whitepaper.pdf (last visited Nov. 20, 2018); Becky Peterson, *Here’s Everything You Need to Know About Blockchains, the Ground-Breaking Tech That Could Be As Disruptive As the Internet*, BUS. INSIDER (Nov. 26, 2017), <http://www.businessinsider.com/what-is-blockchain-how-does-it-work-explainer-2017-11> [<https://perma.cc/9J9D-LLRQ>].

167. See Protocol Labs, Inc., *Simple Agreement for Future Tokens* (2017) (documents on file with author).

168. See *supra* note 5.

169. See THE SAFT PROJECT, <https://saftproject.com/#saft-forms> [<https://perma.cc/BKF2-MWM7>] (providing a form of *Simple Agreement for Future Tokens*).

170. Dror Futter, Opinion, “We Never Thought of That” – When Venture-Backed Companies Undertake Reverse ICOs, BITCOIN MAG. (Nov. 20, 2017), <https://bitcoinmagazine.com/articles/op-ed-we-never-thought-when-venture-backed-companies-undertake-reverse-icos/> [<https://perma.cc/X9YQ-CBSQ>] (discussing shareholder rights where a company raises capital through an ICO).

171. See THE SAFT PROJECT, *supra* note 169.

172. *Id.* As of this writing, the U.S. Securities and Exchange Commission (SEC) has not provided definitive guidance about SAFTs, but it has taken steps that signal skepticism about ICOs in general and, further, that tokens will be closely scrutinized as to whether they are

other respects, a financial instrument alien. A SAFT investor is not a company owner (at least in any conventional sense). Nor is the SAFT investor a creditor with significant contractual protections. As a result, the SAFT presents a strange type of instrument and, additionally, results in investors that are outside the protections of corporate law. Legal scholars are starting to examine the puzzle of SAFTs and, more broadly, cryptocurrency and blockchain forms of organization.¹⁷³

securities. See *Initial Coin Offerings (ICOs)*, SEC, <https://www.sec.gov/ICO> (last visited Jan. 2, 2019) (citing “5 Things You Need to Know About ICOs” including that “ICOs can be securities offerings[;] They may need to be registered[;] Tokens sold in ICOs can be called many things[;] ICOs may pose substantial risks[;] and Ask questions before investing”); see also Daniel Roberts, *SEC Tightens the Noose on ICO-Funded Startups*, DECRYPT MEDIA (Oct. 10, 2018), <https://decryptmedia.com/2018/10/10/sec-tightens-the-noose-on-ico-funded-startups/> (summarizing subpoenas issued by SEC to ICO issuers in early 2018 and subsequent activity between SEC and ICO issuers leading to settlements of possible securities violations).

173. Among works in progress, Shlomit Azgad-Tromer examines SAFTs and other cryptocurrency offerings in *Crypto Securities: Blockchain-Based Assets and the Dilemmas of Securities Regulations* (forthcoming) (on file with author). And, more broadly, Usha Rodrigues considers implications of blockchain forms of organization for corporate law. Usha R. Rodrigues, *Law and the Blockchain* (forthcoming) (on file with author). Cryptocurrency fundraising, as well as some of the services launched on blockchain platforms, have characteristics of “regulatory entrepreneurship” where companies gain advantage while bending or breaking existing law and policy. See Elizabeth Pollman & Jordan M. Barry, *Regulatory Entrepreneurship*, 90 S. CAL. L. REV. 383 (2017). Yet cryptocurrency is more than simply a dodge of law and policy. Two key aspects differentiate cryptocurrency from other types of startup investment instruments. One, cryptocurrency is in some instances more than just an investment security. Cryptocurrency allows an investor to buy a piece of—and access to—the infrastructure. A “utility token” provides its holder tangible and practical use in the blockchain economy, akin to an art collector who may enjoy a painting on her wall. Once a blockchain entity conducts an ICO, a cryptocurrency investor owns a security that is more liquid than most private stocks. Liquidity of cryptocurrency is unlike illiquid VC investments. From a time perspective, it is even more liquid than publicly traded stock since one can buy or sell cryptocurrency instantaneously at, say, 3:00 A.M. on Sunday morning—that is, no need to wait for a public exchange such as the NASDAQ or NYSE to open. To date, tokens can be readily bought and sold to accredited and unaccredited investors, at virtually all times and often across international borders, although nations’ regulatory approach to cryptocurrency is very much unsettled. South Korea was expected, for example, to ban cryptocurrency trades. As of this writing, however, a ban appeared much less likely. See, e.g., Sam Kim & Kanga Kong, *Crypto Trading Ban Downplayed by South Korea After Backlash*, BLOOMBERG (Feb. 13, 2018), <https://www.bloomberg.com/news/articles/2018-02-14/crypto-trading-ban-downplayed-by-south-korea-after-backlash> [<https://perma.cc/2LZL-6ZJF>]. Two, the value of cryptocurrency is not derived from an ownership stake pegged to the underlying enterprise value of an entity. Users build blockchain infrastructure. Cryptocurrency’s value, accordingly, flows from network effects associated with blockchain infrastructure and fluctuations in token values.

*B. Why Now? New Startup Investment Participants
Embrace Novel Instruments*

A panoramic twenty-year perspective, shown in *Figure [1]* below, contrasts the menu of entrepreneurial financial instruments between 1998 and today. The increasing variety of instruments begs the question “why now?” That is, why are certain instruments used today but not twenty years ago to fund startups?

Figure [1]: Comparison menu of common startup finance instruments, 1998 and 2018

Traditional instruments available to structure an early-stage capital investment in 1998	<ul style="list-style-type: none"> • Common equity • Preferred equity
Market accepted instruments available to structure an early-stage capital investment in 2018	<ul style="list-style-type: none"> • Common equity • Preferred equity • Revenue-based financing • Demand dividend • Venture debt • Light preferred equity • Convertible debt • Safe/KISS • Prepayment • SAFT (associated with Initial Coin Offerings)

Empirical work that studies adoption and use of startup instruments remains incomplete; however, scholars are beginning to grapple with how traditional accounts of contractual innovation square with empirical observations in startup finance.¹⁷⁴ This

174. Some scholarly efforts are in motion. John Coyle and Joseph Green recently conducted a survey, for example, about use of Safes and the Keep It Simple Security (KISS), tracking attorney familiarity and usage of the instruments across state jurisdictions. John Coyle, *The Safe, the Kiss, and the Note: A Survey of Seed Financing Contracts in Venture Capital*, Presentation at the BYU Law Winter Deals Conference (Mar. 2, 2018). Jack Wroldsen analyzes types of instruments used in crowdfunding environments. Jack Wroldsen, *Crowdfunding Investment Contracts*, 11 VA. L. & BUS. REV. 543, 559 (2017).

section describes two relevant developments correlated with adoption of new investment instruments: (1) plunging information technology (IT) costs for startups on the demand side of capital and (2) the entrance of new types of startup investors on the supply side of capital.¹⁷⁵

Broad changes in IT industries shape the environment in which startups operate.¹⁷⁶ Since the 1980s, the most important industry for high-risk investors has been software.¹⁷⁷ Software-based IT products involve four basic types of information-oriented inputs: movement, processing, storage, and creation.¹⁷⁸ The cost of each input has plummeted even as capabilities increased. Today it costs a startup an estimated 1/200 as much, compared to the late 1980s, to bring a new IT product to market.¹⁷⁹ Shocks to the overall IT environment correlate with the emergence of novel startup investment instruments.¹⁸⁰

The changed economics in IT alters participants' characteristics and behaviors on both the high-risk capital supply side (i.e.,

175. Questions of contractual innovation implicate a range of issues, including industrial adaptation, document standardization, economic efficiency, bounded rationality, and path dependence. Legal scholars are using broader literature, from strategy and management, for tools to examine the innovation process. See, e.g., Matthew Jennejohn, *The Architecture of Contract Innovation*, 59 B.C. L. REV. 71 (2018).

176. Bernthal, *supra* note 1, at 49 n.40 ("Startup capital requirements dropped so much that it was said that '\$500,000 is the new \$5 million.'").

177. Scott Shane & Nicos Nicolaou, *Exploring the Changing Institutions of Early-Stage Finance*, 14 J. INSTITUTIONAL ECON. 1121, 1124 (2017).

178. Former Level 3 CEO James Crowe highlights three core aspects of IT: storage, movement, and processing of information. Not included, but obviously relevant to many types of IT startups, is the creation of new information. See James Crowe, *Regulation and Free Markets Redux: Additional Insights on Regulating the Telecommunications Industry in the New Economy*, 5 J. TELECOMM. & HIGH TECH. L. 487, 488 (2007) ("[W]e are right in the middle of the information revolution That revolution is really about the three component parts of information technology—the things we do with information. We *process* it—computing, if you would; we *store* it in various forms, on magnetic media, on optical media, and on discs; and we *move* it—which is my business. . . . Today, if my calculations are somewhere near correct, we buy about 70 million times as much computing per dollar spent as we did in 1965." (emphasis added)).

179. See *supra* text accompanying note 176. Other reports estimate a 100-times reduction in technology costs to store, process, and move information over ten years between 2000 and 2010. See PAUL MILLER & KRISTEN BOUND, *THE STARTUP FACTORIES: THE RISE OF ACCELERATOR PROGRAMMES TO SUPPORT NEW TECHNOLOGY VENTURES* 21 (2011), https://media.nesta.org.uk/documents/the_startup_factories_0.pdf.

180. *Correlate* is used intentionally. It is beyond the scope of this Article to claim a causal account of startup contractual innovation.

investors) as well as the demand side (i.e., startups). Decline in capital intensity required to bring a product to market, for example, results in a lower size of average startup investment.¹⁸¹ Moreover, a larger fraction of the general population now invests in startups, spurred by crowdfunding technology, regulatory changes, and the more mature character of public equities.¹⁸² Notably, four new startup investment “institutions” that did not exist twenty years ago—accelerators, angel groups, micro VC funds, and equity crowdfunding—arose amid economic shifts and are now supply-side sources of startup financing.¹⁸³ Funders behind a fifth institutional form, cryptocurrency, injected as much as an estimated \$5.6 billion into new projects in 2017.¹⁸⁴ Each of these new investor entrants is now a viable source of startup financing.

New types of startup investment participants embraced novel legal instruments. Lower startup costs may partially explain some new instruments for two reasons. One, IT industry capital efficiency creates companies that “can generate revenues quickly,”¹⁸⁵ relative to startups launched twenty to thirty years ago. A new investment thesis—derisively dubbed “spray and pray”—emerged whereby investors provide small amounts of capital across a range

181. Shane & Nicolaou, *supra* note 177, at 3.

182. Public companies today are larger, more mature, and more profitable. This development changes the opportunity set for investors in terms of the types of companies available on public markets. Fewer emerging companies in the United States use the public markets. MAUBOUSSIN ET AL., *supra* note 6. In fact, there were fewer public companies in 2016 than in 1976. *Id.* This development alters the choices of investors and has led, for example, to mutual funds forays into private companies. See, e.g., Schwartz, *supra* note 1, at 1348 (mutual fund investment into “startups” including Uber and Airbnb).

183. Shane & Nicolaou, *supra* note 177.

184. Oscar Williams-Grut, *Only 48% of ICOs Were Successful Last Year – but Startups Still Managed to Raise \$5.6 Billion*, BUS. INSIDER (Jan. 31, 2018, 1:45 AM) <https://www.businessinsider.com/how-much-raised-icos-2017-token-data-2017-2018-1>. The underlying technology behind ICOs is blockchain. See generally Peterson, *supra* note 166. It remains to be seen what the lasting influence of funders of blockchain-enabled technologies will be. Cryptocurrency fundraising gained momentum in 2017; however, it is also plagued with concerns about fraud. One report estimates that about 10% of funds raised through Initial Coin Offerings (ICOs) have been stolen. Anna Irrera, *More than 10 Percent of \$3.7 Billion Raised in ICOs Has Been Stolen: Ernst & Young*, REUTERS (Jan. 22, 2018) <https://www.reuters.com/article/us-ico-ernst-young/more-than-10-percent-of-3-7-billion-raised-in-icos-has-been-stolen-ernst-young-idUSKBN1FB1MZ> [<https://perma.cc/T6J7-P3QQ>] (“[Ernst & Young] analyzed more than 372 ICOs, in which new digital currencies are distributed to buyers, and found that roughly \$400 million of the total \$3.7 billion funds raised to date had been stolen . . .”).

185. Cable, *supra* note 59, at 242.

of capital-efficient, software-based startups.¹⁸⁶ An investor is said to “spray” when she invests in a wide portfolio of IT-based companies, each of which puts a low amount of capital at risk while promising the potential of high returns. The investor is said to “pray” because she provides less intensive post-investment company monitoring and lower active engagement than a traditional VC investor.¹⁸⁷ Two, today’s startup landscape permits decoupling expert help from VC investment. Startups often require help from experienced individuals outside the company. Such assistance takes many forms, ranging from strategic advice to making industry connections. New institutions such as accelerators, co-working spaces, and other formal mentor networks, increase startups’ access to pools of expert mentors.¹⁸⁸ This allows a startup manager to pursue an a la carte approach—that is, a company may partition its finance needs from its needs for outside expert advice.

III. THE TRADITIONAL TYPOLOGY

Only relatively recently have there existed enough different forms for a startup finance categorization scheme to be useful. To the extent that scholars classify entrepreneurial finance instruments, as discussed in Part I *supra*, they default into a debt/equity typology.¹⁸⁹ But this approach to classification is a choice, not a

186. For an account about Ron Conway, a prominent angel investor who is well known for investing across many startups, see Miguel Helft, *Ron Conway Is a Silicon Valley Startup’s Best Friend*, FORTUNE (Feb. 10, 2012), <http://fortune.com/2012/02/10/ron-conway-is-a-silicon-valley-startups-best-friend/> [<https://perma.cc/W3HR-9KPA>] (noting that Conway takes an index approach to startup investing; quoting a venture capitalist who criticizes super angel Ron Conway’s promiscuous approach to investing in startups).

187. *Id.* VCs bundle expert help along with financial capital. DENNIS T. JAFFE & PASCAL N. LEVENSOHN, AFTER THE TERM SHEET: HOW VENTURE BOARDS INFLUENCE THE SUCCESS OR FAILURE OF TECHNOLOGY COMPANIES 1 (2003) (describing social capital and expertise of VCs).

188. See Brad Bernthal, *Who Needs Contracts? Generalized Exchange Within Investment Accelerators*, 100 MARQ. L. REV. 997, 1010–11 (2017) (“An increasingly common feature of the 21st Century startup world . . . is to assemble expert help in open information sharing environments.”).

189. See, e.g., Coyle & Green, *supra* note 4, at 137 (arguing that startup firm’s ability to select between equity or debt is an example of contractual innovation); Green & Coyle, *supra* note 14 (starting with debt/equity distinction, then creating a third category, a “contractual derivative instrument”); Heminway, *supra* note 59, at 335 (starting with debt/equity distinction, then creating a third category, “unequity”); *Debt as Venture Capital*, *supra* note 1 (offering an extended discussion of the classic capital structure approach); Andrew A.

necessity. This Part examines why classification of startup investment instruments is important. Section A briefly summarizes the indicia of a useful legal typology. Section B then details the inadequacies of classification based on the debt/equity capital structure paradigm.

A. Indicia of a Functional Typology and the Capital Structure Decision

Typologies are access points to better understanding. A typology is a working tool, generally less scientifically robust than a taxonomy, used to classify observations in empirical research.¹⁹⁰ Typologies improve understanding in three broad ways. One, categories structure information and facilitate comparison that uncovers similarities and differences.¹⁹¹ Two, typologies resolve problems of information overload.¹⁹² Typologies provide shorthand descriptors that efficiently connote information about broader sets of attributes and relationships.¹⁹³ Three, typologies provide a common framework for iteration between people through shared vocabulary and mutually understood concepts.¹⁹⁴ In short, effective

Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457 (2013) (predicting that startups will prefer debt over equity in crowdfunding efforts) [hereinafter *Crowdfunding Securities*]; Andrew A. Schwartz, *The Digital Shareholder*, 100 MINN. L. REV. 609 (2015).

190. Typologies serve as “working tools in the identification of artifacts as empirical research progresses.” SMIRAGLIA, *supra* note 19, at 53. In contrast to a taxonomy, a typology is generally viewed as “less robust scientifically than [a] taxonom[y].” *Id.*

191. The process of comparison enables a virtuous cycle that yields a more efficient and accurate typology by further distinguishing information. Arthur Allen Leff, *Contract as Thing*, 19 AM. U. L. REV. 131, 135 (1970).

192. Categories “promote intellectual and operational efficiency.” *Id.* at 134. Similar to how corporate law practitioners save on contracting costs by using standard, well-understood default rules, typologies shortcut learning by using terms and concepts people already know. FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 34 (1991); *see also* Roscoe Pound, *Classification of Law*, 37 HARV. L. REV. 933, 944 (1924). Classifying organizes the law so it is “(1) [s]tated effectively . . . (2) administered effectively, (3) taught effectively, and (4) developed effectively for new situations.” *Id.* (emphasis omitted).

193. For example, introducing new material via categories allows for faster conveyance and retention of our obligations, in addition to providing a more complete and accurate picture of our aims. Nicholas J. McBride, *The Classification of Obligations and Legal Education*, in *THE CLASSIFICATION OF OBLIGATIONS* 71 (Peter Birks ed., 1997).

194. Sherwin, *supra* note 18, at 42. Friedrich Hayek underscores the importance of decentralized contributions, since data and knowledge are fragmented and dispersed among individuals (i.e., no individual can observe and retain every fact). 1 F.A. VON HAYEK, *LAW, LEGISLATION AND LIBERTY* 14 (1973).

classification schemes provide tools to translate data (viz., unfiltered observations about the world) into wisdom (viz., understanding about the world).¹⁹⁵

Legal typologies, in particular, organize information in an “effort to understand a complex phenomenon through the interplay of its more general and particular aspects.”¹⁹⁶ Just as science identifies clusters of variables discerned from observable phenomena,¹⁹⁷ typologies categorize a range of legal artifacts, including ways to organize a body of law and regulations,¹⁹⁸ jurisprudential aesthetics,¹⁹⁹ and contracts.²⁰⁰ Typologies are most effective when

195. See generally ALEX WRIGHT, *GLUT: MASTERING INFORMATION THROUGH THE AGES* 10 (2007). Wright places information along a continuum ranging from data (unprocessed observations about the world) to wisdom (deep understanding). *Id.* at 10. Wright observes that “[i]nformation is the juxtaposition of data to create meaning[,]” and it lies after data but before knowledge and wisdom: “data > information > knowledge > wisdom.” *Id.* Wright’s book highlights historic developments in information categorization as ways in which humans move from “data” to “wisdom.” See generally *id.*

196. See Ernest J. Weinrib, *The Juridical Classification of Obligations*, in *THE CLASSIFICATION OF OBLIGATIONS* 37 (Peter Birks ed., 1997) (“Classification is necessarily instinct with theory, because the act of classifying is the effort to understand a complex phenomenon through the interplay of its more general and particular aspects.”). A legal typology may represent a “composite picture” or “checklist” generated by aggregating ordinary artifacts, like contracts, and can thus guide practitioners and laypeople alike in their everyday drafting and relations. See Nathan Isaacs, *Part I: Contracts, Torts and Trusts*, in 6 *LEGAL RELATIONS* 1, 34 (Roscoe Pound et al. eds., 1939).

If we could make an analysis and build up a composite picture of topics in many of the ordinary contracts of everyday life, we should have a check-list for the guidance of lawyers and laymen for the drawing of better contracts, for the guidance of legislators, and for the better social understanding of such relations, whether these be memberships in clubs, or domestic employment, or relations with professional advisers.

Id. at 35.

197. HAYEK, *supra* note 194, at 15–16.

198. See, e.g., Michael N. Tennison & Amanda C. Pustilnik, “*And If Your Friends Jumped Off a Bridge, Would You Do It Too?*”: How Developmental Neuroscience Can Inform Legal Regimes Governing Adolescents, 12 *IND. HEALTH L. REV.* 533, 546 (2015) (discussing typology of legal approaches concerning “Adolescent Autonomy and Responsibility”).

199. See, e.g., Pierre Schlag, *The Aesthetics of American Law*, 115 *HARV. L. REV.* 1047 (2002).

200. McBride, *supra* note 193, at 88–89 (“The classification of obligations is an integral part of the production of good lists of our obligations. The classification of obligations is therefore central to the work of any academic who is seriously concerned to teach others about what our obligations are.”).

they are limited in scope,²⁰¹ informed by experience, and capable of iteration and expansion.²⁰²

Scholars default to debt/equity categories in analysis of startup investment instruments.²⁰³ Pervasive use of the capital structure's debt/equity paradigm is neither surprising nor irrational. Entrepreneurial finance is a branch of corporate finance, which divides the world of investment instruments into debt and equity securities.²⁰⁴ Further, capital structure categories remain important because several regulatory and corporate law classifications embed

201. A typology's scope balances accessibility with specificity. Criteria for classification should be specific enough to account for essential information but not so comprehensive that it overloads the user. Stuart P. Green, *Prototype Theory and the Classification of Offenses in a Revised Model Penal Code: A General Approach to the Special Part*, 4 BUFF. CRIM. L. REV. 301, 307 (2000).

202. Classification should have a "purposive aim" since, fundamentally, the act of categorizing is an instrumental endeavor. Leff, *supra* note 191, at 134; *see also* Pound, *supra* note 192, at 939 ("Much must depend upon the connection in which a classification is desired and the end for which it is set up."). As Leff notes, for example, "if you're interested in heat, you separate the coal . . . from the rocks . . ." Leff, *supra* note 191, at 134. In creating typologies, humans drew on collective experiences and pooled data, allowing them to surpass together what they could not accomplish individually. WRIGHT, *supra* note 195, at 12-13. Three purposes attend development of a legal typology. One, facilitate use and discussion of law—that is, enhance legal understanding. Two, support critical evaluation—that is, promote legal critique and change (where appropriate). And three, influence outcomes associated with legal decisions. *See* Sherwin, *supra* note 18, at 39 ("At least three possible purposes emerge: facilitating use and discussion of law, supporting critical evaluation of law, and influencing the outcomes of legal decision-making."); *see also* Isaacs, *supra* note 196, at 34-35 ("If we could make an analysis and build up a composite picture of topics in many of the ordinary contracts of everyday life, we should have a check-list for the guidance of lawyers and laymen for the drawing of better contracts, for the guidance of legislators, and for the better social understanding of such relations, whether these be memberships in clubs, or domestic employment, or relations with professional advisers.").

203. *See supra* Part I.

204. Traditional lenders may be reluctant to provide debt to startups, given that many have negative cash flows and few hard assets available to secure the loan. Many startups issue equity which, in contrast to debt, provides an ownership interest in a firm. ROSS ET AL., *supra* note 33, at 475. If a company's value increases, notably, lenders do not participate beyond their contractual rights. Stockholders, on the other hand, have an ownership stake with uncapped value. Investors purchase either common or preferred stock, which provides rights superior to common. *Shintom Co. v. Audiovox Corp.*, 888 A.2d 225, 227 (Del. 2005); Ben Walther, *The Peril and Promise of Preferred Stock*, 39 DEL. J. CORP. L. 161, 163-64 (2014). Preferred stock may technically have a cap in value, known as a liquidation preference cap. But the holders of preferred stock may elect to convert into common in order to avoid the cap. FELD & MENDELSON, *supra* note 7. Of course, lenders trump stockholders—preferred or common—upon company liquidation. ROSS ET AL., *supra* note 33.

the debt/equity distinction.²⁰⁵ Tax determinations, for example, turn on which regulatory bucket—debt or equity—outside financing fits into.²⁰⁶ Corporate law considerations, such as fiduciary duties and information rights, also hinge on the debt/equity characterization.²⁰⁷ For example, debt holders are outsiders to the corporation, with rights and obligations determined by contract, while equity holders are insiders entitled to fiduciary rights and benefit from other company-related obligations provided by state law.²⁰⁸ Instruments categorized as equity include the right to inspect a company's books and records.²⁰⁹ Control rights also turn on the equity/debt categorization.²¹⁰

205. The ability to manipulate form despite similar functions gives rise to regulatory arbitrage opportunities. Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227 (2010). The aesthetic nature of the debt/equity distinction means that regulatory arbitrage opportunities abound through “creative drafting” of instruments to fit one category over another. Joan MacLeod Heminway, *To Be or Not to Be (a Security): Funding for-Profit Social Enterprises*, 25 REGENT U. L. REV. 299, 321 (2012) (discussing inter alia why tax related considerations may drive nonprofit entities to issue debt rather than equity); *Crowdfunding Securities*, *supra* note 189, at 1489; *see also* Coyle & Green, *supra* note 4, at 153–54 (answering “[i]f bridge notes were really more appropriately considered deferred equity, why didn’t these firms just issue more equity instead?”).

206. Interest is a business expense that a corporation may deduct for purposes of corporate tax liability. Borrowers receive preferential tax treatment for their debt. ROSS ET AL., *supra* note 33, at 507–08. Most importantly, a “corporation can deduct interest paid or accrued on the debt it issues but cannot deduct the dividends it pays on the shares it issues.” Pratt, *supra* note 16, at 1061, 1075. This is because shareholders are deemed to “own” a company while creditors do not. *Id.* As a result, “the interest on corporate debt is deductible as a cost of the corporation earning income.” *Id.* at 1066, 1075 (“traditional debtor-creditor model still dominating state corporate law”).

207. *See infra* Part V.

208. Charles R. Korsmo, *Venture Capital and Preferred Stock*, 78 BROOK. L. REV. 1163, 1165 (2013) (“Equity-holders are traditionally treated as corporate insiders, with any contractual rights and obligations they might bargain for augmented—or even supplanted—by fiduciary rights and obligations.”).

209. DEL. CODE ANN. tit. 8, § 220 (West 2011); *Crowdfunding Securities*, *supra* note 189, at 1482.

210. Instruments categorized as debt, for example, provide a creditor de facto control rights as a matter of law. Lenders can sue for missed payments; if not met, creditors may push a firm toward bankruptcy and financial distress. ROSS ET AL., *supra* note 33, at 523. Andrew Schwartz also argues that debt classification, from the issuer’s vantage point, “much better protects the founder from personal liability. Selling even a single share of equity to a stranger creates a real risk that shareholders will sue the founder in her personal capacity.” *Crowdfunding Securities*, *supra* note 189, at 1482. Debtholders are limited to suing the corporation. Lenders are creditors that receive preferential treatment ahead of firm shareholders in the event of liquidation or bankruptcy. Control provisions associated with debt restrict a borrowing firm’s ability to take actions that affect creditworthiness. *Debt as Venture Capital*, *supra* note 1, at 1203. Characteristics of debt and equity led one author to

*B. The Capital Structure Paradigm Falls Short in Promoting
Analysis of Startup Finance Instruments*

While the debt/equity classification scheme is embedded within corporate law,²¹¹ as a matter of contractual analysis, the debt/equity distinction is impoverished. It is unnecessary – and it would be ill advised – for law and entrepreneurship scholars to make debt/equity the centerpiece of startup finance classification. *Figure [2]* shows classification of startup instruments through a debt/equity lens.

Figure [2]

Debt (Mostly, Albeit with Equity Aspects)	Cannot Classify as Debt or Equity	Equity (Mostly, Albeit with Debt Aspects)
<ul style="list-style-type: none"> • Revenue-based financing (RBF) • Convertible debt • Demand dividend • Venture debt 	<ul style="list-style-type: none"> • Simple Agreement for Future Tokens (SAFT, associated with Initial Coin Offerings) • Simple Agreement for Future Equity (Safe) • Prepayment 	<ul style="list-style-type: none"> • Common equity • Preferred equity • Light preferred equity

Two deficiencies render the debt/equity paradigm a crude tool for instrument categorization: (1) most startup finance instruments are actually hybrids that blend debt and equity characteristics and

write, “Equity is soft; debt is hard. Equity is forgiving; debt is insistent. Equity is a pillow; debt is a dagger.” G. BENNETT STEWART, III, *THE QUEST FOR VALUE: A GUIDE FOR SENIOR MANAGERS* 580 (1991).

211. Delaware law is the most significant voice in corporate law. William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815, 1821 (2013) (“The Delaware courts have emerged as the dominant arbiters of preferred stock disputes.”). Capital providers that do not qualify as corporate shareholders are deemed creditors or another contract-specific holder. “Stockholders are corporate, lenders are contractual, and a well-understood wall separates their legal treatments.” *Id.* at 1819. Delaware law rules for equity are set forth in Delaware Code Annotated title 8, section 151 (West 2011) (setting the parameters of stock issuance under Delaware law and permitting preferred stock).

(2) certain novel instruments entirely defy debt/equity classification.²¹² Each weakness is discussed below.

First, high-risk capital instruments routinely blend elements of debt and equity within a single contractual structure.²¹³ Debt versus equity presents a binary classification—that is, an instrument is either one or the other. In practice, however, debt versus equity is an aesthetic—not analytic—distinction. As Katherine Pratt writes, “Prototypic equity and prototypic debt are end points on a conceptual continuum with most real securities falling in the middle of that continuum.”²¹⁴ Categorizing mixed instruments as one or the other—while necessary for regulatory classifications—contributes to misunderstanding of how contractual instruments actually function.²¹⁵

Deficiencies associated with the debt/equity distinction are not limited to entrepreneurial finance. A well-developed scholarly critique highlights shortcomings.²¹⁶ Financial innovation in recent decades, for example, produced instruments that “slice and dice risk and reallocate it in just about any way imaginable.”²¹⁷ Financial engineering makes an “attempt to pigeonhole investments as one type or another nearly meaningless.”²¹⁸ New instruments render

212. Debt and equity may also be criticized as deriving from evolutionary history—common descent—which Emily Sherwin notes often fails as a useful typology because it’s prone to functional overlap. (Sherwin notes the modern trend is to deemphasize the origins of rules.) See Sherwin, *supra* note 18, at 32.

213. Many scholars comment on the hybrid nature of startup instruments. See, e.g., GOMPERS & LERNER, *supra* note 7; Coyle & Green, *supra* note 4; Gilson, *supra* note 7; Reiser & Dean, *supra* note 89, at 799.

214. Pratt, *supra* note 16, at 1067; Triantis & Triantis, *supra* note 13, at 1246.

215. That is, categorizing an instrument as one or the other inevitably overstates the selected category’s characteristics while understating the other category’s elements. See, e.g., Carman & Bender, *supra* note 13, at 17 (“Under a binary analysis, an investment along the borders of one or the other classification gets pushed completely into one of the two baskets, disguising the hybrid nature of the investment.”).

216. “Few aspects of U.S. tax law have received greater criticism—and attracted fewer defenders—than the long-standing distinction between debt and equity.” Hutchison, *supra* note 16, at 96.

217. “The problems associated with the debt-equity distinction have gotten worse in recent years.” Pratt, *supra* note 16, at 1056–57; see also Carman & Bender, *supra* note 13, at 17 (arguing the debt/equity categorization is “far too limited in light of the use of guaranteed payments in partnerships, synthetic leases, annuities, and the almost endless variety of notional principal contracts”).

218. Baird & Henderson, *supra* note 13, at 1312 n.15 (“Modern financial engineering enables investors to parse capital structures—cash flow rights, voting, and so on—in ways

traditional categories of investors who provide capital—such as shareholder or creditor—a “misleading” matter of form over function.²¹⁹ In a world of complex instruments that mingle debt and equity characteristics, a risk-based approach fails to divine debt from equity.²²⁰ This gives rise to regulatory arbitrage opportunities where, for example, tax practitioners alter the form of a deal, even as the underlying substance remains the same.²²¹ To address this problem, granular clarifications in banking, tax, and accounting²²² try to draw the debt/equity line. Each of these areas, tellingly, spells out different criteria, such that “equity” for corporate law purposes may be booked as “debt” for accounting purposes.²²³

Entrepreneurial finance instruments, while not as complex²²⁴ and exotic as contracts in other capital markets, commonly mix debt- and equity-like aspects. For example, an investor in a convertible preferred financing ostensibly takes equity. Yet the equity

that make any attempt to pigeonhole investments as one type or another nearly meaningless.”).

219. *Id.* at 1311 (“As financial innovation has accelerated over the past two decades, the terms ‘shareholder’ and ‘debtholder’ or ‘creditor’ have become less meaningful. Identifying only shareholders as investors, as opposed to all providers of capital, is misleading.” (citation omitted)).

220. Such complex instruments include derivatives, partnership agreements, synthetic leases, annuities, and notional principal contracts. Carman & Bender, *supra* note 13, at 17. “The problems associated with the debt-equity distinction have gotten worse in recent years.” Pratt, *supra* note 16, at 1056, 1068. A sixteen-factor test, set forth by the Third Circuit Court of Appeals, illustrates the struggle to distinguish debt from equity. *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968).

221. Carman & Bender, *supra* note 13; Fleischer, *supra* note 205; Hutchison, *supra* note 16, at 96 (claiming problems distinguishing debt and equity “invite . . . tax avoidance strategies”); Pratt, *supra* note 16, at 1071–72 (“[I]nvestment banks have begun to fashion innovative types of traded securities that are treated like debt for tax purposes, but are treated like equity for accounting, regulatory, and credit rating purposes.”).

222. Banking regulations divide capital instruments into tiers to determine compliance with minimum capital requirements and leverage ratios. For bank rules, see *Bank Capital Rules: Federal Reserve Approves Final Rules Addressing Basel III Implementation and, for All Banks, Substantial Revisions to Basel I-Based Rules*, SULLIVAN & CROMWELL LLP 1–3 (July 3, 2012), https://www.sullcrom.com/Bank_Capital_Rules_Basel_III_7_3_13/ [<https://perma.cc/7FX4-NSUH>].

223. Bank rules, tax rules, GAAP rules, and corporate law each have their own criteria to separate debt from equity. Bratton & Wachter, *supra* note 211, at 1820–21 (noting that “bank capital rules treat preferred as equity (sometimes, on par with common)[.]” while Generally Accepted Accounting Principles (GAAP) “require some preferred to be booked as debt, even though formally it is stock, while other preferred is booked as equity” (footnote omitted)).

224. See Partnoy, *supra* note 13, at 812 (describing “evolution of some of the most complex forms of hybrids that are not well understood today”).

class's rights include debt-like features, such as the right to receive proceeds ahead of other shareholders (i.e., a liquidation preference).²²⁵ This "hybrid character" of preferred stock results in legal treatment that "straddle[s] the dividing line between corporate law and contract law."²²⁶ Discussing the blurry line ostensibly partitioning equity and debt, one prominent business school finance textbook asks whether preferred stock really is debt,²²⁷ while a legal scholar observes that "[f]inancially, preferred stock resembles debt," but legally, preferred stock "is much more like common equity."²²⁸ Meanwhile, a convertible note is explicitly styled as debt. But its terms include equity-like features—namely, the opportunity upon conversion to enjoy uncapped upside participation in company value—such that a convertible note "only marginally qualif[ies]" as debt.²²⁹

An extensive body of literature provides theories defending the classic capital structure's utility with respect to private contracts. Such theories examine which type of financing—debt or equity—is

225. As Charles Pouncy aptly observed, "If preferred shares can be viewed as debt-like equity, then convertible bonds can be seen as equity-like debt." See Coyle & Green, *supra* note 4, at 153 n.105 (quoting Charles R.P. Pouncy, *Contemporary Financial Innovation: Orthodoxy and Alternatives*, 51 SMU L. REV. 505, 522 n.101 (1998)); see also Christopher K. Aidun & Ernest Ceberio, *Current Trends in Venture Capital Financing: 2002*, 7 CYBERSPACE L. 2, 4 (2002) ("Bridge notes generally carry . . . an opportunity to convert to equity.").

226. Korsmo, *supra* note 208, at 1165. A prominent scholarly article asks, "So is preferred stock equity or debt? . . . Is it an incomplete contract filled out by fiduciary duty or a complete contract with the drafting burden on the party asserting the right? These are the central questions of the law of preferred stock." Bratton & Wachter, *supra* note 211; see also Reiser & Dean, *supra* note 89, at 799 (discussing hybrid nature of entrepreneurial contracts). Another textbook's overview provides one section on common stock and another lumping debt, preferred stock, and convertibles, although it notes that preferred stock is considered an equity security for legal purposes. RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 353–60 (5th ed. 1996).

227. ROSS ET AL., *supra* note 33, at 475.

228. Walther, *supra* note 204 ("Financially, preferred stock resembles debt, in that it has limited upside and its return comes in the form of periodic coupon payments. Legally, though, it is much more like common equity: preferred shareholders, unlike creditors, cannot sue in contract to recoup either their principal investment or unpaid coupons, and the terms of a preferred stock investment, unlike those of a debt contract, can be altered unilaterally by the firm.").

229. As Jack Wroldsen aptly observes, "convertible debt securities only marginally qualify as debt securities because their ultimate purpose is to provide investors with an equity interest in the company." Wroldsen, *supra* note 174, at 582.

least costly for a firm.²³⁰ At least in principal, this framework would give scholars and practitioners useful tools to critically evaluate—and predict—a firm’s capital structure decisions. In function, however, the hybrid nature of most early-stage investment instruments confounds meaningful use of capital structure theory.²³¹ Indeed, an instrument does not necessarily have different economic attributes just because it is styled as debt or equity. Alexander Triantis and George Triantis, in comparing puttable stock and convertible debt, show how equity and debt contractual features create identical economic effects in the absence of regulation.²³²

Second, another defense of the classic dichotomy is that, while financial instruments may blend elements of debt and equity, hybrid instruments could nonetheless fit into a spectrum—that is, a debt/equity continuum. But this approach fails with respect to several novel instruments. Specifically, Safes, SAFTs, and prepayment do not create contingent rights arising from a company’s cash flows, nor do they create residual rights in company value.²³³ These instruments entirely defy categorization—namely, they are neither equity nor debt.

This difficulty leads scholars to search for third-way alternatives to describe new instruments. For example, Safes structure investment so that a startup can use an investor’s funding; however, the investor acquires few present rights other than the right to future equity upon a financing event or a return upon liquidation of the company. Coyle and Green, accordingly, describe

230. For example, a firm will generally rely more on debt if it has a high taxable income, as firms can deduct interest for tax purposes. ROSS ET AL., *supra* note 33, at 547. And a firm may rely more on equity if it holds mostly intangible assets or if its operating income is uncertain, as assets secure the loan and lenders demand regular interest payments. *Id.*

231. Ibrahim’s otherwise excellent description of venture debt is accompanied by an Olympian effort to apply traditional capital structure theory to private company financing. *Debt as Venture Capital*, *supra* note 1, at 1198–205. The resulting intellectual contortions, while impressive, do not convincingly square capital structure theory with startup finance practice. *Id.*

232. Puttable stock involves shares that provide an investor the right to sell stock back to the company. Triantis & Triantis, *supra* note 13, at 1233, 1244–48 (showing identical economic effects of convertible debt and puttable stock).

233. A Safe provides an investor a right to future equity. A SAFT provides an investor a right to future tokens. And prepayment provides an investor a right to a future good or service. *See, e.g.*, Green & Coyle, *supra* note 14, at 172 (describing Safe as a “contractual derivative instrument”); Heminway, *supra* note 59, at 360–61.

the Safe as a “contractual derivative instrument” rather than debt or equity.²³⁴ Heminway similarly creates a third category, “unequity,” to describe novel crowdfunding instruments that provide an investor a short-term profit or revenue-sharing interest without governance or ownership rights in a startup.²³⁵ Categories fail their essential purpose when their boundaries do not sort phenomena in useful and accurate ways. Practitioners benefit, moreover, when typologies are rooted in the practical realities of legal and business practices.²³⁶ Novel instruments that defy categorization further call into question the utility of the debt/equity typology for purposes of classification and analysis of private agreements.

In sum, the debt/equity distinction falls short as an analytic framework to enhance understanding of instruments. Indeed, Triantis and Triantis anticipated the need for a new taxonomy almost twenty-five years ago.²³⁷ The old debt/equity dichotomy affords limited insight about how an instrument constrains opportunity and allocates risk and reward. Further, with respect to contractual considerations, the capital structure does not help practitioners to choose the appropriate form of instrument for their circumstances. In short, the capital structure paradigm is inade-

234. Green & Coyle, *supra* note 14, at 172 (“[Safe] is a deferred equity investment that will prove valuable to the holder if, and only if, the company that issues it raises a subsequent round of financing, is sold, or goes public.”).

235. Heminway, *supra* note 59, at 360–61 (“This type of interest is a security, but it is neither debt (because the funded business or project has no obligation to repay the funder) nor traditional equity (which typically combines, based on statutory mandate or contractual provisions, financial and governance rights); it is properly classified as a form of investment contract.”). Along these lines, the SEC recognized a third type of instrument used in crowdfunding. See SEC, *Crowdfunding, Exchange Act Release Nos. 33-9974; 34-76324; File No. S7-09-13*, (May 16, 2016), <https://www.sec.gov/rules/final/2015/33-9974.pdf>. As discussed further in section II.A, crowdfunding investments may include any type of security, whether equity securities (e.g., stock), debt securities (e.g., promissory notes), or hybrid securities (e.g., “unequity” and convertible debt). *Id.*

236. See David Campbell, *Classification and the Crisis of the Common Law*, 26 J.L. & SOC’Y 369 (1999). Campbell criticizes classifications derived from “what one might get up to in the library with a lot of reports as more or less one’s only resource.” *Id.*

237. Triantis & Triantis, *supra* note 13, at 1231–32 (“[A] superior taxonomy for understanding capital structure may be one that abandons the debt-equity dichotomy and refers directly to the various financial and governance features that may be embodied in any given financial instrument.”).

quate as a way to promote contractual analysis of investment instruments.²³⁸ Part IV proposes a new approach.

IV. A NEW TYPOLOGY OF ENTREPRENEURIAL INVESTMENT INSTRUMENTS

The objective of a typology is not perfect categorization.²³⁹ The objective of a well-functioning typology, rather, is to provide a useful way to categorize phenomena. A typology should classify instruments based upon the functional aspects of economics, control, time, and regulatory implications.²⁴⁰ With this in mind, I propose a new typology comprised of three instrument categories: Lock-in, Park-n-ride, and Payouts.²⁴¹ Each category in the typology is detailed in the sections below.

238. See Sherwin, *supra* note 18, at 39 (“At least three possible purposes emerge: facilitating use and discussion of law, supporting critical evaluation of law, and influencing the outcomes of legal decision-making.”); see also Isaacs, *supra* note 196, at 35 (“If we could make an analysis and build up a composite picture of topics in many of the ordinary contracts of everyday life, we should have a check-list for the guidance of lawyers and laymen for the drawing of better contracts, for the guidance of legislators, and for the better social understanding of such relations, whether these be memberships in clubs, or domestic employment, or relations with professional advisers.”).

239. Instrument classification entails edge cases and conceptual challenges. Some scholars express a skepticism that speaks to any undertaking to classify instruments. “Modern financial engineering enables investors to parse capital structures . . . in ways that make any attempt to pigeonhole investments as one type or another nearly meaningless.” Baird & Henderson, *supra* note 13, at 1312 n.15; see also Partnoy, *supra* note 13, at 802 (asserting that financial innovation in general makes the traditional legal notions of how investors should be characterized “contradictory and meaningless”). Certainly the project is not worth the candle if any classification attempts are more misleading than helpful. Yet useful typologies improve understanding. Moreover, some degree of categorization is likely inevitable. A thoughtful scheme to sort financial instruments is likely to be better than the default categories used without critical reflection. “[F]requently . . . one will discover . . . that objects with one thing in common have other things in common too, and that these other things are more practically useful identifying criteria than the ones first used.” Leff, *supra* note 191, at 135.

240. As discussed in Part II *supra*, analysis of instruments should be multidimensional. A single aspect of an instrument (for example, whether an investor is a shareholder, or where the investor fits within a company’s liquidation waterfall) is not dispositive for classification.

241. This Article argues that the new typology improves upon the classic debt/equity dichotomy. The new typology certainly does not provide the only classifications imaginable, and going forward, other approaches should be considered.

A. Lock-in

A Lock-in instrument is an ownership interest where an equity holder's return (1) is uncertain as to timing; (2) would not be realistically expected for a minimum of two to three years, and up to five to eight years, from initial investment; and (3) is a function of the underlying valuation of the company. Each type of Lock-in instrument, which includes common, preferred, and light preferred stock, is summarized in *Figure [3]*.²⁴²

Legal scholars carefully parse preferred convertible equity structures, which remain the most important form of VC investment. This Article need not rehash preferred stock characteristics in depth.²⁴³ The most striking aspect across Lock-in instruments, however, is the amount that each of these instruments has in common, especially in time and regulatory dimensions. The most important differences between preferred and common Lock-in instruments relate to liquidation preferences and control rights. Preferred shareholders have a right to take proceeds upon liquidation ahead of common shareholders. Further, as Gilson observed, with respect to control, preferred stock turns the Berle-Means problem²⁴⁴ on its head. Preferred shareholders secure an outsized level of control relative to their (often minority) ownership stake in the company.²⁴⁵ *Figure [3]* provides a summary comparison of Lock-in instruments.

242. A startup's founders and employees also typically hold a Lock-in instrument: common stock. Founders may contribute financial capital, intellectual property, or some other form of valuable work in exchange for common shares. Employees receive options for common stock.

243. Ronald Gilson describes how convertible preferred equity arrangements between VC funds and startup companies dovetail with VC limited partnership agreements. Gilson, *supra* note 7, at 1070-71. Gordon Smith examines how greater visibility about VC firm reputation affects entrepreneurial managers' ability to solve for problems of moral hazard and adverse selection. *Exit Structure of VC*, *supra* note 43, at 315; *VC Contracting*, *supra* note 7, at 140-42. More recently, John Coyle and Joseph Green have discussed the emergence of a stripped-down preferred equity round. See Coyle & Green, *supra* note 4, at 168-72.

244. The Berle-Means problem refers to the concern that, as a company's shareholder base becomes large and dispersed, management dominates control of the company. Directors become beholden to management, allowing managers to act in ways that are not responsive to owners' interests. The so-called Berle-Means problem arises from insight from Berle and Means's well-known work: Adolf A. Berle, Jr., & Gardiner C. Means, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

245. Gilson, *supra* note 7, at 1073-74.

Figure [3]: Lock-in instruments

	Common Stock	Full Preferred (NVCA)	Light Preferred (Series Seed)
Economics	<ul style="list-style-type: none"> • common shareholders are residual claimants (i.e., the last to get paid upon company liquidation) • if shareholder is an officer or employee, startup wealth can be channeled through salaries to common shareholders • upon sale of company, a portion of proceeds may be allocated to officers (i.e., a “carve out”) 	<ul style="list-style-type: none"> • a liquidation preference provides that preferred shareholders get paid before common shareholders 	<ul style="list-style-type: none"> • a liquidation preference provides that preferred shareholders get paid before common shareholders
Time	<ul style="list-style-type: none"> • 5–8 years • founders and key employees may be able to sell limited number of shares on secondary market in mid- or expansion-stage financing 	<ul style="list-style-type: none"> • 5–8 years • investors secure rights to participate in future financing rounds • key founders and executives enter into vesting agreements • early-stage investors may be able to sell limited number of shares on secondary market in mid- or expansion-stage financing 	<ul style="list-style-type: none"> • 5–8 years • investors secure rights to participate in future financing rounds • key founders and executives enter into vesting agreements • early-stage investors may be able to sell limited number of shares on secondary market in mid- or expansion-stage financing

Control	<ul style="list-style-type: none"> • voting rights • board of director representation • if shareholder is an officer or executive, then control may be exercised in that capacity 	<ul style="list-style-type: none"> • anti-dilution protection • board of director representation • extensive protective provisions • voting rights • reputational protections and constraints 	<ul style="list-style-type: none"> • stripped down protective provisions • board of director representation • voting rights • reputational protections and constraints
Regulatory Status	<ul style="list-style-type: none"> • security • equity for tax purposes 	<ul style="list-style-type: none"> • security • equity for tax purposes 	<ul style="list-style-type: none"> • security • equity for tax purposes

B. Park-n-ride

The typology's second category of investment structure is the Park-n-ride. In contrast to a Lock-in holder's *present* ownership interest, a Park-n-ride structure contemplates a *future* ownership interest in a company.²⁴⁶ A Park-n-ride structure exists where an investor (1) invests capital into a company, (2) lacks ownership for an indefinite post-investment period, and (3) agrees to take ownership on unknown terms led by an unknown future investor upon occurrence of a financing that involves issuance of preferred equity.²⁴⁷ I use the term *Park-n-ride* to highlight the two-step process prescribed by these instruments. Step one is that an investor "parks" money with a startup. The startup puts capital to use during an indefinite period in which the investor lacks ownership. Step two is triggered by a financing associated with issuance of preferred stock. Upon the financing, the investor's money converts automatically into equity and "rides" alongside a new investment on the terms negotiated by the new investor(s). Typically, a Park-n-ride investor does not lead the qualified financing round.

246. Green & Coyle, *supra* note 14, at 169 (discussing the simple agreement for future equity (Safe), an equity derivative).

247. *Id.*; see also Burns E-mail, *supra* note 24.

Legal scholars document two instruments that the new typology classifies as a Park-n-ride: (1) convertible debt and (2) equity derivative instruments—most notably the Simple Agreement for Future Equity (Safe).²⁴⁸ These instruments are summarized in *Figure [4]*.

Figure [4]: Types of Park-n-ride instruments

Convertible Debt	<ul style="list-style-type: none"> • Note for convertible debt
Future Equity Derivative	<ul style="list-style-type: none"> • Simple Agreement for Future Equity (Safe) • Keep It Simple Security (KISS)²⁴⁹ • Techstars Foreign Instrument (Fixed Percentage Convertible Equity Agreement)

Three economic characteristics are common to Park-n-ride instruments. First, absent a qualified financing or successful sale of a startup, Park-n-ride investors are unlikely to see a meaningful economic return.²⁵⁰ The lack of a current return, prior to a company-wide liquidity event or secondary sale, distinguishes Park-n-ride and Lock-in instruments from a Payout instrument (discussed in section IV.C *infra*). This underscores that Park-n-ride holders typically require two conditions for a successful investment: (1) a preferred financing and (2) a successful company-wide liquidity event, such as a sale or IPO. Of course, future financing risk—that is, the possibility that a company will run out of money and will be unable to raise more capital—is not unique to Park-n-ride instruments. Future financing risk attends any early-stage company

248. See generally Coyle & Green, *supra* note 4; Foreign Instrument Documents, Techstars (on file with author).

249. See *500 Startups KISS Convertible Debt & Equity Financing Documents*, COOLEY GO, <https://www.cooleygo.com/documents/kiss-convertible-debt-equity-agreements/> [https://perma.cc/V5AU-EV8U].

250. One exception to this is that a convertible noteholder may receive loan payments prescribed postmaturity. But, in practice, a company unable to obtain financing often lacks cash sufficient to service a loan. A convertible noteholder, once the note matures, may have a right to convert to equity at its own election. This could be attractive if a startup is profitable and does not raise a qualified financing round.

investment where a startup will require additional rounds of capital to bring a successful product to market. But future contractual derivative holders, such as Safe investors, face a heightened risk because a Safe holder lacks a way to force exit in a struggling company and, additionally, lacks a way to force conversion of investment into equity when a company thrives without a qualified financing.²⁵¹ Additionally, the terms of the Park-n-ride instrument may limit the form of future financings, which could deter possible future investors.²⁵²

A second economic provision common to Park-n-rides is the discount. A Park-n-ride investor commonly negotiates a “discount.” Upon equity conversion triggered by a qualified financing, a discount reduces the price that the holder pays for equity relative to the “new” equity investors.²⁵³ In practice, a discount ultimately benefits a Park-n-ride holder at the direct expense of common shareholders. Despite the economic benefit of the discount, some investors are skeptical that the discount adequately compensates a Park-n-ride investor, who provides capital at a time of high uncertainty and significant information asymmetries between company and investor.²⁵⁴

251. See generally Coyle & Green, *supra* note 4.

252. See, e.g., Gheen E-mail, *supra* note 105 (“[Park-n-rides] are interesting instruments because they sometimes dictate what the next round needs to look like (which is annoying when you’re trying to get a deal done). I’ve seen good RBF investors be unable to invest in good tech companies where the previous [Park-n-Ride] investors couldn’t decide whether or not RBF investment triggered their follow-on terms. In other words, it can cause an unnecessarily complex capital strategy.”).

253. Typical discount ranges are 10–30%. The discount rewards the Park-n-ride holder’s willingness to invest at the earliest stages of a company’s lifecycle. See *supra* Section II.A.

254. The Park-n-ride structure is widely viewed as an “entrepreneur friendly” form of high-risk capital. Many well-known investors, including Ron Conway and Seth Levine, are skeptical that a discount and conversion cap adequately compensates investors for the risk of early investment, perils which range from the company’s uncertain prospects to whether future investors will try to recut the terms of the deal at a later time. See Seth Levine, *Has Convertible Debt Won? And If It Has, Is That a Good Thing?*, VCADVENTURE (Aug. 30, 2010), <http://www.sethlevine.com/archives/2010/08/has-convertible-debt-won-and-if-it-has-is-that-a-good-thing.html> [<https://perma.cc/Y93W-3246>]. Levine writes that use of convertible debt is “clearly *not* a positive trend for early-stage investors” for two reasons. *Id.* One, an investor that does not purchase equity is more exposed to “an easier renegotiation of their terms by a later investor (who, almost by definition, wields more power at that time than the original angels, assuming the company actually needs to raise capital).” *Id.* Two, convertible debt “has the effect of raising prices for early stage investing.” *Id.* This is due in part to the

One might expect early investors to simply take a steeper discount, even if out of line with market norms, in order to adequately compensate for the uncertainty of the early investment in a company. Yet two practical constraints limit such arrangements. One challenge is that a larger discount, if deemed outside market norms, risks deterring future qualified investors. This is not a trivial concern: future capital rounds are the oxygen required to keep a company alive. Moreover, a large discount also invites agency problems—namely, opportunistic behavior by entrepreneurs at the expense of a Park-n-ride holder. For example, entrepreneurs may encourage subsequent investors to condition their investment on Park-n-ride holders' acceptance of a renegotiated, reduced discount.²⁵⁵ The entrepreneur's impetus for such behavior is that a discount, in economic terms, acts as a ratchet against common shareholders. Founders, often including the CEO who typically drives a deal for the company, hold common stock. So a VC may condition a round of financing upon a startup's renegotiation of the nonmarket discount.²⁵⁶ This gambit aims to benefit common shareholders at the expense of Park-n-ride holders.

A third shared economic attribute common among Park-n-ride instruments is that, while appearing to avoid company valuation, the instruments nevertheless set what amounts to a shadow valuation. The valuation cap prescribes a ceiling on the price at which a

conversion cap set to a "premium to the current fair market value of the business." *Id.* Mark Suster, quoting Ron Conway, sizes up the problems for investors.

Ron said he never likes to do convertible debt deals and always insists on pricing his investments. His rationale was clear, "If I invest in a company I open my Rolodex for them. I help them with business development introductions. I introduce employees. I give them credibility in the fund raising process. Let's say the company was worth \$1 million when I met them and I've helped them with both my Rolodex and my cash and they can now raise a round of venture capital at a valuation of \$6 million. I would be hurting my own interests. A \$500,000 investment at a 30% discount to a \$6 million round is still priced and [sic] more than \$4 million and is certainly worth much less than my investing at a \$1 million pre-money where I could own 33% of the company."

Mark Suster, *Raising Angel Money*, BOTH SIDES OF THE TABLE (July 19, 2009), <https://both.sidesofthetable.com/raising-angel-money-cc9f8ab923b6> [<https://perma.cc/YXL5-RW94>].

255. See Levine, *supra* note 254. Levine writes that an investor that does not purchase equity is more exposed to "an easier renegotiation of their terms by a later investor (who, almost by definition, wields more power at that time than the original angels, assuming the company actually needs to raise capital)." *Id.*

256. See *id.*

Park-n-ride instrument converts.²⁵⁷ If a company's valuation exceeds the cap at a qualified financing, for example, the valuation cap retroactively acts as a de facto valuation. Future investors, moreover, may use the Park-n-ride's valuation cap as a reference point when negotiating valuation with a startup.²⁵⁸

Park-n-ride instruments share two notable aspects with respect to time. One, a Park-n-ride investor's time horizon for return is even longer than a Lock-in holder who invests in preferred stock subsequent to a Park-n-ride round. Park-n-ride instruments are often used at the earliest stages of a company's lifecycle. Moreover, a Park-n-ride instrument features extreme investor lock-in, and return is unlikely until a company-wide liquidity event. From initial investment to expected return, accordingly, a reasonable expectation is at least five to eight years. Two, a Park-n-ride holder is in a relational limbo with a company during the "park" period.²⁵⁹ A key difference between Park-n-ride and Lock-in instruments is whether key terms of investment are specified at the time of investment or whether key terms are de facto indefinitely deferred until some future event. The Park-n-ride investor takes a leap of faith about the future—namely, an investor agrees to take later-in-time ownership on yet-unknown terms negotiated by a yet-to-be-determined party (if a future financing occurs at all).

Park-n-ride instruments share a common dimension as it relates to control. Post-conversion, during the "ride" period, the control rights of Park-n-ride holders are muted. This may seem counter-intuitive since Park-n-ride instruments convert into a class of stock with identical control characteristics available to other—often sophisticated—investors in a qualified financing. But conversion occurs alongside other investors in a large, qualified round. Investors in a qualified financing usually invest amounts well in excess of the amount of capital involved in the Park-n-ride. Many

257. For example, say an investor makes a \$100,000 investment that uses a Park-n-ride instrument that includes a \$1 million valuation cap. The company flourishes and, a year later, raises a qualified financing round with a \$5 million pre-money valuation. Upon conversion, excluding any interest, the Park-n-ride holder is entitled to 10% of the company under the cap.

258. FELD & MENDELSON, *supra* note 7, at 109.

259. The investor's relationship with the founder/company is put in a "[s]uspended state as to whether we are really partners in this or not." Interview with Chris Marks, Attorney with Boulder-based private investment company (Aug. 8, 2017).

control provisions, such as protective provisions, may be exercised only by the majority-in-interest of the preferred shareholder class. Unless a Park-n-ride holder leads the qualified financing, the Park-n-ride holder lacks power to unilaterally exercise control provisions post-conversion.

A drawback of the new typology's Park-n-ride category is that equity derivatives and convertible debt have divergent control characteristics. A holder of convertible debt may "call" a note. In contrast, an equity derivative holder—such as a Safe holder—lacks meaningful control protections. In this way, widespread adoption of the Safe illustrates a new manifestation of the angel paradox—that is, the earliest investors who take the most risk often receive less favorable terms than later-in-time investors.²⁶⁰ One explanation for this is what Gilson refers to as the "conservation of discretion"—namely, a concern that an early investor, especially if reputational constraints are low, may be more likely than an entrepreneurial manager to act opportunistically.²⁶¹ On this view, a Park-n-ride investor cannot be trusted with powerful control rights.

Finally, Park-n-ride instruments have two common regulatory elements. One, Park-n-ride instruments are securities. Two, prior to equity conversion, Park-n-ride holders lack shareholder rights and protections such as fiduciary duties and statutory information rights. Tax-related treatment of Park-n-ride instruments, however, may vary. For example, Illinois provided a tax credit for angel investors, yet investments in a Safe initially did not qualify for the tax credit. Illinois subsequently changed its approach. Further, a Safe and convertible debt may be treated differently for federal tax purposes, with a Safe categorized as a prepaid forward contract and convertible debt categorized as debt.²⁶²

Figure [5] summarizes notable characteristics of Park-n-ride instruments, as seen through the prism of economic, time, control,

260. See *supra* Section II.A; *Puzzling Behavior*, *supra* note 7, at 1420-22 (discussing angel paradox).

261. Gilson, *supra* note 7, at 1081 ("[S]hifting discretion from the entrepreneur to the fund does not eliminate the potential for agency costs; it merely shifts the chance to act opportunistically to the fund.").

262. When examining Safes under federal tax law, "in most cases, the usual treatment should be as a prepaid forward contract." Lesley P. Adamo, *Client Alert, Tax Treatment of SAFES*, LOWENSTEIN SANDLER (July 12, 2018), <https://www.lowenstein.com/news-insights/client-alerts/tax-treatment-of-safes-tax> (discussing federal tax criteria for debt classification and explaining that Safes typically do not qualify).

and regulatory aspects. One column, *Common Characteristics*, describes functional elements shared by Park-n-ride instruments. Another column, *Variations and Exceptions*, highlights instances where certain Park-n-ride instruments diverge.

Figure [5]: Notable characteristics of Park-n-ride instruments

	Common Characteristics	Variations and Exceptions
Economics	<ul style="list-style-type: none"> • absent subsequent qualified financing or sale of a company, a meaningful return for investor is unlikely • Park-n-ride holder receives “discount” into subsequent equity round • valuation cap rewards Park-n-ride holder in event that subsequent equity round is priced at high valuation; valuation cap effectively sets a shadow price for the company 	<ul style="list-style-type: none"> • convertible debt accrues interest so long as note is outstanding
Time	<ul style="list-style-type: none"> • long hold period expected between initial investment and ultimate exit • relationship between investor and founder is in limbo during the “park” period (i.e., after initial investment but before qualified financing) • key founders and executives typically not required to enter into new vesting agreements 	<ul style="list-style-type: none"> • super pro rata rights may be used to give Park-n-ride holder the option to purchase an outsized ownership stake, relative to the size of initial investment, in subsequent equity round
Control	<ul style="list-style-type: none"> • upon qualified financing, control rights attach to preferred equity; but it is unlikely that Park-n-ride investor will have majority-in-interest of preferred equity, which diminishes controls 	<ul style="list-style-type: none"> • there is significant difference between control rights of Safe and convertible debt instruments; holder of convertible debt may “call” note after maturity; Safe has few control rights for investor prior to qualified financing

Regulatory Status	<ul style="list-style-type: none"> • Park-n-ride instruments are a security • Park-n-ride holders lack shareholder rights and protections such as fiduciary duties and statutory information rights 	<ul style="list-style-type: none"> • state laws favoring investment (e.g., tax credits for angel investors) vary as to whether Park-n-ride instruments qualify (e.g., Illinois and Safes) • convertible debt is debt for federal tax purposes
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C. Payouts

A Payout is where an investor's return is not based upon sale of company equity and, instead, an investor's return primarily flows from startup revenues, profits, or provision of goods or services. Payouts avoid extreme investor lock-in.²⁶³ Ibrahim details problems associated with "investor lock-in," which refers to circumstances where a shareholder does not receive a return on investment until a company-wide liquidity event. Lock-in is described as "extreme" because a shareholder cannot (1) redeem shares for cash directly from a company, nor can a shareholder (2) readily sell shares to other purchasers on a secondary market. Where investor lock-in attends investment, a drawback is that investors require an "illiquidity premium" that raises the cost of capital for startups.²⁶⁴ Much of the promise of secondary markets to relax investor lock-in has not come to pass due to startups' extensive use of transfer restrictions in recent years when issuing stock.²⁶⁵ Nonetheless,

263. *New Exit in VC*, *supra* note 25, at 8 (distinguishing capital lock-in—i.e., the inability of an investor to demand redemption from the company—from investor lock-in).

264. Secondary market sales, where an investor sells ownership to another investor, relieves problems of "extreme investor lock-in" for certain founders, long-term employees, and early investors. Secondary markets involve sales between investors, rather than a direct investment into a startup, so a secondary sale is not a separate "instrument" for purposes of this Article. Darian Ibrahim's examination of secondary markets provides careful discussion of investor lock-in for startups. *See id.* Further, Elizabeth Pollman's study of secondary markets addresses problems related to information disclosures and proposes "establishing a minimum information requirement for secondary trading." Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. PA. L. REV. 179, 179 (2012).

265. Importantly, secondary sales in early-stage companies have not proven as robust as many observers once envisioned. Since Ibrahim's 2012 article, for example, secondary sales from startup employees to new investors generated undesirable issues for startup managers, ranging from a new shareholder's information rights (mandated by corporate law) to an employee having less interest in long-term wealth creation of the startup. Startups responded by imposing transfer restrictions on stock which, essentially, prevent employee

relaxation of investor lock-in through Payout instruments is among the most notable developments associated with the proliferation of investment instrument forms.

Investor lock-in traditionally accompanies startup investment. In theory, a startup could declare and distribute dividends to shareholders. In practice, this is extremely rare because startup cash flows are minimal and, to the extent a startup generates profits, managers desire to reinvest profits with a goal of rapid company growth. An investor's stake in a company, as a result, remains highly illiquid, at least until a company-wide liquidity event occurs – that is, a sale of the company, an IPO, or a company wind down. Today not all high-risk capital providers, however, seek to invest within investor lock-in structures. Payouts secure a return for individual investors even in the absence of a company-wide liquidity event. *Figure [6]* shows three permutations of Payout instruments – variable paybacks, prepayments, and short-term loans. Each permutation and instrument is then described in turn below.

sales without company authorization. As of 2018, this Author's conversations with early-stage investors suggest that secondary markets are primarily used in two ways: (1) to provide an important pressure release for founders to sell limited amounts of stock (e.g., in order to pay for a child's college education) and (2) as a mechanism for late-stage and other investors outside the startup world to dip down and purchase pieces of highly valued private companies (e.g., a mutual fund that would like to purchase part of Uber). *See generally* Susan S. Muck & Michael S. Dicke, *Securities Enforcement Alert: SEC Increases Scrutiny of "Unicorns" and Other Private Companies and Secondary Market Trading of Pre-IPO Shares, Urges Private Companies to Adopt Enhanced Controls Long Before IPO*, FENWICK & WEST LLP (Apr. 4, 2016), <https://www.fenwick.com/publications/pages/sec-increases-scrutiny-of-unicorns-and-other-private-companies-and-secondary-market-trading-of-pre-ipo-shares.aspx> [<https://perma.cc/C2BD-C8F7>] (noting the SEC expressed concern that a "new [secondary sales] model has arisen because companies have restricted the transfer of shares, leading to employees and others retaining the shares themselves but selling an economic interest in the shares or promising to deliver shares after a liquidity event").

Figure [6]: Payout instrument permutations

Variable Paybacks	<ul style="list-style-type: none"> • Revenue-based financing (RBF) • Demand dividend • Unequity
Prepayments	<ul style="list-style-type: none"> • Prepayment fundraising (e.g., using Kickstarter or Indiegogo) • Simple Agreement for Future Tokens (SAFT, associated with Initial Coin Offerings)
Short-Term Loans	<ul style="list-style-type: none"> • Venture debt

The first Payout permutation, variable paybacks, is an instrument that arranges variable—not fixed—returns from company to investor. RBF, social impact investment instruments (including the demand dividend), and unequity each provide a variable, short-term profit- or revenue-sharing interest to an investor. A second Payout permutation, prepayment, attracts financing from backers in the anticipation of a “return” in the form of a future good or service. Further, a new prepayment variant, which emerged in 2017, is the SAFT. The SAFT structures a preliminary sale of tokens that presages creation of a digital product and, ultimately, anticipates an ICO in the form of cryptocurrency.²⁶⁶ Finally, short-term loans are a third Payout instrument permutation. Venture debt differs from variable paybacks insofar as the repayment schedule is fixed.²⁶⁷

Payout instruments share three notable economic characteristics. The first is that an investor’s return is “capped”—that is, even if a company is a rousing success, there is a ceiling on the amount that an investor receives as a return on investment. Such caps take different forms. Variable paybacks often cap returns at a multiple of the original investment. Companies pay back short-term loans, such as venture debt, based on principal plus interest. Prepayment does not promise any return beyond delivery of a company’s

266. See BATIZ-BENET ET AL., *supra* note 166; Peterson, *supra* note 166.

267. *Debt as Venture Capital*, *supra* note 1, at 1179.

product. Limited upside on returns means that, from an investor's portfolio perspective, longshot investments must be limited, since one outsized winner will not offset numerous losers. A second key economic feature is that, at the time of an investment, parties do not need to determine the value of the startup enterprise. Sale of startup equity requires that an investor and a company agree upon a startup's value in order to determine the "price" of equity. Early-stage private company valuation is a speculative endeavor that requires considerable guesswork.²⁶⁸ Return on a payback instrument is independent of company ownership and, as a result, valuation is not a prerequisite to investment. A third economic characteristic is that Payout instruments reduce illiquidity risk—namely, the risk that there is no ready buyer for company equity.²⁶⁹

From a time perspective, Payout instruments share three attributes. First, a Payout holder anticipates investment return (well) in advance of any company-wide liquidity event. For example, an RBF instrument generates returns shortly after the agreement is executed. This is in sharp contrast to the five-to-eight-year median time before Lock-in investors (i.e., investors who purchase common or preferred stock) will see returns.²⁷⁰ This shift in return time horizon is notable in view of the time value of money and, as noted above, reduces investor uncertainty associated with liquidity.

Second, Payout misaligns the return time horizons of investors and startup founders. Alignment of investor and founder interests is tricky when a Payout instrument is used. When an investor seeks to exit well in advance of founders and managers, agency concerns arise whereby one party may act to benefit itself at the expense of

268. FELD & MENDELSON, *supra* note 7, at 43 (“[Valuation] is not an exact science regardless of the number of spreadsheets involved.”); GOMPERS & LERNER, *supra* note 7.

269. *New Exit in VC*, *supra* note 25, at 8. Of course, risk remains insofar as returns are contingent upon a startup's revenues, profits, or other ability of a startup to pay monies to an investor. But payback instruments remove a notable risk factor since an investor need not wait until a company-wide liquidity event before receiving an investment return. RBF returns only require that a company generate revenues, rather than a sale of an entire enterprise. Uncertainty is reduced because the trigger for return on a Payback instrument is more likely to occur than a company-wide liquidity event.

270. PITCHBOOK, *supra* note 125, at 14 (finding a median time to exit of 6.8 years for an IPO, 5.1 years for an acquisition, and 7.6 years for a secondary buyout); *see also For Largest Venture-Backed Tech Exits*, *supra* note 125 (finding an average of 6.3 years); *New Exit in VC*, *supra* note 25, at 14 (citing an average of around 7 years).

another—that is, a company action that benefits investors may harm a founder, and vice versa.²⁷¹ Experienced early-stage investors who use preferred equity know that, because investor lock-in accompanies multiple rounds of financing during a startup’s lifecycle, over time the early investors’ equity interests will more closely align with startup founders than later-stage investors.²⁷² Founders and early-stage equity investors—for the most part—expect to receive a return at the same time in the same event (i.e., a sale, wind down, or company IPO). In contrast, Payout instruments generate agency concerns insofar as an investor’s return and a founder’s return occur at different times and are contingent upon different events.²⁷³

Third, a Payout holder is less likely to rely upon the time-based strategy of staging investments. Staging occurs where an investor holds back amounts that the investor intends to eventually invest, instead only providing a portion of the funds that a company will ultimately need to succeed. Future investment amounts are held back—in industry parlance, “reserved”—for future rounds of financing. If a company performs well, an investor infuses additional funds—often in progressively larger increments—into the startup over multiple stages. Staging allows early preferred equity investors to guard against opportunism by using time to

271. Gilson, *supra* note 7 (describing agency issues between VCs and portfolio company managers); see also Joseph Bankman & Marcus Cole, *The Venture Capital Investment Bust: Did Agency Costs Play A Role? Was It Something Lawyers Helped Structure?*, 77 CHI.-KENT L. REV. 211, 225 (2001) (discussing agency costs between VCs and their limited partner investors).

272. This is because, inter alia, additional funding rounds will entail larger amounts of investment from later-in-time investors with liquidation preferences. As a result, after multiple rounds of financing, an early-stage investor and a founder would typically benefit only upon a company liquidity event where proceeds are sufficient to pour over the later-stage investors (whose liquidation preferences entitle them to receive proceeds first) and reach the early-stage investors and common shareholders. To be clear, the incentives of early investors and a founder with common shares, while overlapping, are not coterminous. For example, a founder who is still an executive with a company may benefit from a sale of a company separate from the sale of her shares in an acquisition. For example, she may benefit from a management carveout or from an attractive post-acquisition salary by a purchaser.

273. For example, an investor’s returns may be pegged to profitability and revenues, while a founder’s return ultimately may be a function of company valuation at the time of a liquidity event.

create powerful performance incentives for managers.²⁷⁴ Moreover, since uncertainty and information asymmetry are reduced over time, staging generates information that provides an investor greater visibility about a company's prospects. Payout instruments do not eliminate staging. But they do limit reliance upon staging.

Payout instruments' control term characteristics, by which an investor protects its interests and guards against opportunism, are notable in two ways. One, a Payout holder lacks a strong incentive to push a company toward an exit and, therefore, does not contract for control terms that would force a startup exit event.²⁷⁵ Traditional VC-fund limited partnership agreements prescribe that a fund's monies must be returned to limited partners within a fixed (typically ten-to-twelve-year) time horizon.²⁷⁶ VC investment into a startup, accordingly, effectively puts a portfolio company on a shot clock to reach a company-wide liquidity event.²⁷⁷ VCs negotiate control provisions that enable the VC to pressure a company toward exit.²⁷⁸ Payout instrument holders, in contrast, need not seek control provisions that push a company to exit. This may be attractive to a startup manager, especially where the manager would like to avoid a "shot clock" that forces a company to sell to an acquirer or, less frequently, conduct an IPO.

Two, holders of Payout instruments prioritize short-term contractual controls over long-term involvement in a company. Payout holders generally do not insist upon critical governance rights, such as board-of-director participation. Payouts mark an important departure from a model of early-stage investment that bundles financial capital with other types of startup assistance,

274. Gilson, *supra* note 7, at 1079 ("The first respect in which staged financing creates, rather than merely transfers, value is its reduction of the *agency problems* associated with the entrepreneur's management of the portfolio company's operation.").

275. Some incentive to nudge for early exit may still exist. For example, an RBF investor may benefit upon the sale of a company because payoff of the loan is accelerated. So the RBF investor has at least a "secondary interest" in a company liquidity event. See Gheen E-mail, *supra* note 105.

276. Gilson, *supra* note 7, at 1071. The actual length of most VC funds exceeds the ten-year horizon. Most funds have two automatic one-year extensions. Beyond that, funds are extended with the permission of limited partners.

277. *See id.* at 1074.

278. *Id.*

such as social capital, expertise, and reputational capital.²⁷⁹ Specialized investor intermediaries, such as VCs, traditionally combine active provision of business help with monitoring of firm activities through participation in firm governance.²⁸⁰ The promise of uncapped returns following an extended investment hold period justifies an investor's lengthy ongoing involvement with a startup to work toward a favorable company-wide liquidity event.²⁸¹ In contrast, Payout instrument holders do not share a common mission with management to build the company over an extended period (i.e., five to eight years) until an exit event. The shorter time horizon militates that Payout instrument holders rely more on contractual provisions, such as more onerous reporting requirements and restrictive covenants known as protective provisions, rather than governance rights to manage agency costs.

Since many Payout instruments are relatively new to startup investment, it remains to be seen what effect this will have on net transaction costs. Returns predicated on revenues, for example, require controls such as greater financial reporting from company to investor. Such controls provide comfort that an investor receives what the investor is owed. But this may impose additional accounting costs upon a startup. Moreover, monitoring and enforcement of contractual rights are potentially costly. Enforcement of contractual rights may necessitate litigation, especially since governance rights (e.g., board control that would allow CEO replacement) are muted. Future investors may condition investment upon renegotiation of RBF arrangements, increasing transaction costs. From a control perspective, Payout instruments allow entrepreneurial managers, vis-à-vis investors, to retain more control of the board of directors and other governance aspects of a startup. But concomitantly an investor's nonmonetary assistance to a company is likely to be lower than an equity investor's nonmonetary help. A Payout investment structure is also likely to involve greater contractual restrictions on company actions.

279. JAFFE & LEVENSOHN, *supra* note 187 (discussing the ways in which board members provide startups with social, intellectual, and interpersonal capital).

280. *Id.*

281. In an equity investment, for example, a "lead" investor (i.e., the investor who negotiates the deal and often invests the most capital in a round) commonly exercises control through active governance participation that includes board representation as well as shareholder voting rights.

Finally, while the new typology highlights common economic, time, and control dimensions of Payouts, Payouts do not share uniform regulatory attributes. Notably, prepayment fundraising is unique in that it does not involve an investment contract under securities laws. The new typology highlights that, while RBF and venture debt instruments create debt for tax purposes, prepayment and SAFTs do not.²⁸²

Figure [7] summarizes notable characteristics of Payout instruments, as seen through the prism of economic, time, control, and regulatory aspects of an investment.

Figure [7]: Notable characteristics of Payout instruments

	Common Characteristics	Variations and Exceptions
Economics	<ul style="list-style-type: none"> • company valuation is not required at time of investment • investor's upside (i.e., profit) is capped or otherwise limited • investor's primary desired return is not pegged to underlying valuation of company 	<ul style="list-style-type: none"> • warrants sometimes provide a Payout investor an option to purchase stock with uncapped upside to share in residual proceeds upon liquidation
Time	<ul style="list-style-type: none"> • investor anticipates returns prior to company-wide liquidity event • staging is less frequent than in Lock-in structures • early-stage investor does not "look like a founder" over subsequent investment rounds 	<ul style="list-style-type: none"> • time horizon for a secondary sale is unpredictable

282. The intended tax treatment for SAFTs is that they are a forward contract; however, the IRS' willingness to respect this intention remains to be seen. See Lisa Zarlenga & John Cobb, *What ICO Issuers and Investors Need to Know About Taxes*, COINDESK (Apr. 16, 2018, 11:02 PM), <https://www.coindesk.com/ico-issuers-investors-need-know-taxes> (while "intended tax treatment of the SAFT is as a forward contract[,] tax treatment depends on "facts and circumstances[.]" and it is "obvious from this discussion that there is little guidance from the IRS on how to treat a token offering . . . [or a] SAFT . . . for tax purposes").

Control	<ul style="list-style-type: none"> contractual provisions, such as restrictive covenants and information requirements, relied upon more than governance rights 	<ul style="list-style-type: none"> there is a paucity of control terms typically associated with prepayment instruments
Regulatory Status	<ul style="list-style-type: none"> varies across instruments 	<ul style="list-style-type: none"> instrument may be debt or equity for tax purposes instrument may be investment contract or not for security purposes

D. Summary Overview:

Classifying Startup Financial Instruments with the New Typology

Figure [8] below classifies startup finance instruments within the new typology.

Figure [8]: New typology classifications of instruments

Park-n-ride	Lock-in	Payout
<ul style="list-style-type: none"> Convertible debt Simple Agreement for Future Equity (Safe) Keep It Simple Security (KISS) Fixed Percentage Convertible Equity Agreement 	<ul style="list-style-type: none"> Common equity Preferred equity Light preferred equity 	<ul style="list-style-type: none"> Revenue-based financing (RBF) Unequity Demand dividend Prepayment fundraising Simple Agreement for Future Tokens (SAFT) Venture debt

When comparing Figure [8], which classifies instruments under the new typology, with Figure [2], which classifies instruments under the debt/equity dichotomy, three advantages of the new typology merit elaboration. One, the new typology more definitively classifies instruments. The debt/equity scheme, in contrast, struggles to classify instruments that are hybrids. Further, the debt/equity binary results in neither-fish-nor-fowl difficulties.

Several emerging instruments—including the Safe, KISS, Fixed Percentage Convertible Equity Agreement, unequity, prepayment, and SAFT—fall outside of debt/equity boundaries.

Two, from a functional perspective, the new typology better sorts “like” with “like” instruments. The functional framework of the new typology helps surface “the economic and sociological realities” of a startup-investor relationship.²⁸³ This is because the typology’s analysis accounts for economic, control, time, and regulatory dimensions of a deal. For example, consider three different types of startup investment loans: venture debt, RBF, and convertible debt. Under a debt/equity scheme, reflected in *Figure [2]*, each of these instruments classifies as “debt” for purposes of corporate law. Two dimensions bind the holders of these instruments—namely, (1) upon company liquidation, each is entitled to payment before shareholders, and (2) each has control associated with the right to “call” a note where it is overdue. Despite these common elements, however, the debt classification obscures stark differences in how the instruments function.

In contrast, the new typology makes plain that creditors in venture debt, RBF, and convertible debt share little in common with respect to risk and reward associated with the economic and time characteristics of an instrument. A holder of convertible debt invests in an instrument that has economic and time aspects that are much more like a Safe than venture debt or RBF. The economics of convertible debt’s favorable return hinges on the value of enterprise over time. In contrast, the economics of venture debt’s return hinges on an ability to pay contractually predetermined amounts back to the venture bank lender, an event uniquely secured by implicit guarantees from a third-party VC. Meanwhile, an RBF investor, reliant upon company revenues associated with variable repayment, stands in contrast to a venture bank lender’s risk and reward profile. Convertible debt takes fewer contractual controls than RBF and venture debt.²⁸⁴ The new typology shows

283. Mitchell, *supra* note 26, at 447 (contending that we live in an era when we “attempt to ground legal doctrine in what we perceive to be the economic and sociological realities of various relationships”).

284. While convertible debt is secured by a startup’s assets, a startup’s most important asset, typically intellectual property, tends to have diminished value in contexts outside the

that whether an investor is labeled “shareholder,” “creditor,” or “derivative holder” is more a matter of formalistic choice than a fundamental reflection of the risk and reward associated with investment.²⁸⁵

A final advantage is that the new typology’s comparative structure across instruments, designed to enhance understanding, promotes more precise selection of an instrument tailored to the circumstances presented by a startup fundraising. Most important, the new typology’s analytic framework surfaces aspects of an investment that are relevant to determining whether the interests of managers and capital providers are aligned. In this way, the new typology helps entrepreneurs, investors, and practitioners to better understand efficient and inefficient uses of instruments.

Part V next examines implications of the new typology.

V. PUTTING THE NEW TYPOLOGY TO USE

So what? If the new typology is indeed a better way to analyze the expanded menu of startup investment instruments, what consequences flow from its use? This Part explores two implications. One, section A examines issues associated with different instruments that provide investors with disparate contingent and residual rights in a company. In particular, new types of horizontal conflicts among startup investors emerge when a startup uses diverse instruments to effect financings over its lifecycle. Two, a further implication involves the diminished role of corporate law as novel instruments gain traction. Startup investors are increasingly not shareholders for purposes of corporate law. Section B observes that this is a ripe time for legal scholars, judges, and

startup. In economic terms, the IP has “high asset specificity.” *Asset Specificity*, INVESTOPEDIA, <https://www.investopedia.com/terms/a/asset-specificity.asp> [<https://perma.cc/F7PV-VRQ8>] (“An asset with a high level of specificity has use in only certain situations or for certain purposes.”).

285. Coyle and Green come to a similar conclusion about formalism in instrument labels. See Green & Coyle, *supra* note 14, at 182 (“[A]ll of these instruments—SAFEs, convertible notes, common stock, preferred stock, etc.—are simply labels. It is not the *name* of the instrument that matters so much as the *terms* set forth within it, that is, the balance struck between issuer and investor. It is possible to issue ‘common stock’ that contains terms commonly used in ‘preferred stock’ financings. It is also possible to issue ‘SAFEs’ that contain terms that make them virtually indistinguishable from ‘convertible notes.’”)

policymakers to study and reevaluate the role of corporate law as it relates to entrepreneurial investment.

A. New Types of Horizontal Conflicts

One implication of the new typology is that new types of start-up investor conflicts become visible. A “horizontal conflict” refers to a divergence in interest between participants in a company’s capital structure.²⁸⁶ A horizontal conflict is in contradistinction to a “vertical conflict,” which arises between the sources of corporate power (e.g., corporate directors, officers, and the corporation itself) and other corporate constituent groups subject to exercise of that power (e.g., shareholders and others in the capital structure).²⁸⁷

The classic horizontal conflict is between common and preferred shareholders.²⁸⁸ Another significant type of horizontal conflict within startups, as Robert Bartlett documents, is between VC investors.²⁸⁹ Bartlett describes the “dynamic character of agency problems” generated by VC horizontal conflicts.²⁹⁰ Over a startup’s lifecycle, a viable company typically raises capital from more than one VC investor. VC investors within the same startup have divergent interests that drive different preferences about a company’s decisions (such as whether and when to exit). VC funds’ time duration and compensation structures drive differences in

286. Mitchell, *supra* note 26, at 449 (explaining that horizontal conflicts can be between shareholders and may also arise with “bondholders, employees, and other corporate constituencies”).

287. *Id.* at 449–50.

288. A simple hypothetical provides an example. StartupCo’s preferred shareholders two years ago invested \$2 million and have a 2x liquidation preference. StartupCo is now about to run out of money and, further, is having trouble finding an investor willing to provide more capital. BuyerCo offers to purchase StartupCo for \$3 million. The preferred shareholders would like to sell StartupCo. The preferred investors’ economic rights entitle them to the full \$3 million, and rather than the company going broke, they would receive a fine return on their investment. But the common shareholders, which include current and former founders and employees, as well as angel investors, oppose the sale. They stand to make nothing. The board of directors faces a dilemma: any decision will benefit one group at the expense of the other. A horizontal conflict results from distributional disparities that flow from disparate economic rights between the common and preferred shareholders. As a practical matter, under these circumstances, the preferred shareholders would likely carve out some of the proceeds for StartupCo’s management team, as both a reward and an inducement for the team to support the sale.

289. Bartlett, *supra* note 10, at 111.

290. *Id.*

investor preferences. Additionally, VC investors purchase preferred stock from a startup at different times, at different prices, and with different terms.²⁹¹ Sophisticated VC investors secure terms to protect against undesirable actions—whether such actions are initiated by management, the board, or other VC investors—that are contrary to their interests. “Paradoxically” the terms that VCs secure for their protection also generate conflicts between investors by providing the “means to engage in rent-seeking behavior vis-à-vis other investors.”²⁹²

The new typology highlights a new type of dynamic agency problem: conflicts between investors are not limited to divergent interests between shareholders.²⁹³ The time dimension of the new typology shows, for example, that Payout instruments that relax investor lock-in inherently misalign Payout investors with Lock-in investors. Conflicts also arise with Park-n-ride holders. The new typology surfaces two new permutations of horizontal conflicts involving non-shareholder investors: (1) anticipatory conflicts and (2) post-investment conflicts. These are each addressed in turn.

I define an *anticipatory conflict* as where a would-be investor declines to invest in a company due to a prospective misalignment with an existing investor (or investors). Speak with early-stage investors and lawyers today and you will hear versions of stories where an investor passes on an investment opportunity due to an anticipatory horizontal conflict.²⁹⁴ Of course, concerns of this flavor are not entirely new. The rights of preexisting shareholders in a company’s capitalization table, and where a prospective investor would fit within a payout waterfall, are a well-established part of a sophisticated investor’s calculus. But the expansion of novel non-shareholder startup investment instruments, which interact with other instruments through layers of investment rounds, generates new types of anticipatory conflicts.

An example shows how anticipatory conflicts arise from use of different types of instruments across startup fundraises. ScaleCo is

291. *Id.* at 42.

292. *Id.*

293. Baird & Henderson, *supra* note 13, at 1311 (“Others, such as lenders, bondholders, and preferred stockholders, also stand to gain or lose with right or wrong decisions.”).

294. Axelrad Interview, *supra* note 83. See generally FELD & MENDELSON, *supra* note 7, at 171-72.

a hypothetical startup that successfully launched a company without institutional investment. Previously, in lieu of taking VC, ScaleCo raised two rounds of financing from angel investors through a convertible note (a type of Park-n-ride instrument) that included a conversion cap and discount. Most recently, ScaleCo took capital through a Payout instrument, an RBF loan that ScaleCo pays back at up to two times the principal through 5% of its revenues. ScaleCo now recognizes a large market opportunity and needs an infusion of \$5 million and strategic guidance about its next steps. This is ideal for a venture capitalist and ScaleCo is soon in talks with VC1.

VC1 loves ScaleCo's team, product, and market opportunity. But the layers of previous investment, and the interests of non-shareholder Park-n-ride and Payout investors, present an anticipatory horizontal conflict. First, while the Park-n-ride creditors would convert to shareholders upon a VC financing, the conversion itself may result in excessive dilution to the common shareholders (including the management team). VC1 is concerned that this would result in a demotivated team or, alternatively, require issuance of new equity to the team (which would dilute VC1's ownership stake). Second, RBF investors would like ScaleCo to optimize for near-term revenues, an interest that would be cross-wise with VC1's interest in long-term growth. VC1 would prefer to reinvest all available funds into the company.²⁹⁵ Ultimately, due to concerns arising from the Payout and Park-n-ride instruments, VC1 decides not to invest in ScaleCo.

The second type of horizontal conflict, *post-investment conflict*, also comes into view through the new typology. Consider another hypothetical startup, JumpCo, which raises a pre-seed round of funding through a Safe instrument. JumpCo does well. So well, in fact, that JumpCo sees a path to solid profitability without additional financing. Common shareholders, including the management team, would like to move forward with the company as a profitable entity. The management team may take a high salary that reflects the company's rosy position. A Safe holder, meanwhile, would like to see a path to ownership conversion and, eventually,

295. One option is that VC1 could provide sufficient funds to "take out" the RBF investor by paying off the loan. But VCs are generally reluctant to see their capital used in this way.

a return through company-wide liquidation. Yet the Safe holder may be frozen in an investment purgatory without ability to force conversion or to exit the company.

The new typology highlights that horizontal conflicts will increasingly ensnare startup investors who are not shareholders. As next discussed in section B, the protections of corporate law will not extend to non-shareholder investors.

B. The Diminished Role of Corporate Law for Startup Investments

A second implication, made plain by the new typology, is an important but little discussed development: novel entrepreneurial financial instruments push more and more startup investors beyond the boundaries of corporate law. Traditional Lock-in instruments, such as preferred stock, structure investment such that investors are shareholders entitled to corporate law's protections, including fiduciary duties owed by directors to shareholders.²⁹⁶ Dual application of corporate law and contract law with respect to preferred stock generates difficult questions for courts and provides an attractive conceptual knot for scholars.²⁹⁷ VCs and their attorneys have learned—sometimes the hard way—through the *Benchmark* line of cases that preferred shareholders must expressly delineate any special rights in writing.²⁹⁸ From a corporate law perspective, nonetheless, the status of a preferred

296. "A board of directors, as Adam Smith observed long ago, is charged with taking care of other people's money, and it is usual in such cases for the law to impose special and unremitting duties." Baird & Henderson, *supra* note 13, at 1310 (footnote omitted).

297. "On the one hand, the corporate paradigm instructs that managing to the common stock, since stockholders are residual interest holders, maximizes value; on the other hand, the contract paradigm instructs that holding parties to contractual risk allocations maximizes value." Bratton & Wachter, *supra* note 211, at 1820–21 ("The Delaware courts have emerged as the dominant arbiters of preferred stock disputes."). Much hand-wringing concerns the extent of corporate protections owed by directors to preferred investors. "[A]ll is not well jurisprudentially with preferred stock." Mitchell, *supra* note 26, at 443. *See supra* note 33.

298. "[T]he special rights, powers, or preferences of preferred stock must be expressed clearly and will not be presumed . . ." C. Stephen Bigler & Jennifer Veet Barrett, *Words that Matter: Considerations in Drafting Preferred Stock Provisions*, BUS. L. TODAY, Jan. 23, 2012, at 2 (analyzing Delaware line of cases). *See also* *Benchmark Capital Partners IV, L.P. v. Vague*, 2002 WL 1732423 (Del. Ch. July 15, 2002), *aff'd*, 822 A.2d 396 (Del. 2003); *Greenmont Capital Partners I, L.P. v. Mary's Gone Crackers, Inc.*, 2012 WL 4479999 (Del. Ch. Sept. 28, 2012).

stock investor as a shareholder entitled to basic corporate law protections is not in dispute.²⁹⁹

A consequence of novel instruments is that many startup investors fall outside the boundaries of corporate law. For example, Safe investors who provide capital at the earliest stages of a startup's lifecycle, with the intention that a company will use the capital for an extended period of time, are not shareholders during the "park" period of investment.³⁰⁰ Many startup investors currently should be characterized as something other than a shareholder.³⁰¹ Convertible debt results in investor as creditor (at least prior to conversion). Prepayment results in investor as a consumer. And the SAFT results in investor as a future token holder. Indeed, the vast majority of emerging startup investment instruments, classified within the Payout and Park-n-ride categories, place investors outside the role of shareholder. These developments shift a burden to contract law to interpret and determine the relationship as set forth in an investment instrument between a startup and its non-shareholder investors.³⁰² Default corporate law rights are generally unavailable. Absent insolvency, directors do not owe fiduciary duties to creditors.³⁰³ Only shareholders, moreover, are entitled as

299. Preferred stockholders are a "statutorily recognized corporate constituency." Mitchell, *supra* note 26, at 445 (citing *In re Hawkeye Oil Co.*, 19 F.2d 151, 152 (D. Del. 1927) (preferred stockholders are stockholders, not creditors) and DEL. CODE ANN. tit. 8, § 151 (1989 & Supp. 1994)).

300. A Safe results in investor as a derivative holder (at least prior to conversion).

301. Baird and Henderson, observing a broader set of instruments than startup finance, make a similar observation. Baird & Henderson, *supra* note 13 at 1311 ("As financial innovation has accelerated over the past two decades, the terms 'shareholder' and 'debtholder' or 'creditor' have become less meaningful. Identifying only shareholders as investors, as opposed to all providers of capital, is misleading." (footnote omitted)).

302. "Stockholders are corporate, lenders are contractual, and a well-understood wall separates their legal treatments." Bratton & Wachter, *supra* note 211, at 1819.

303. Directors owe creditors fiduciary duties where a corporation is insolvent. *Quadrant Structured Prods. Co. v. Vertin*, 115 A.3d 535, 551 (Del. Ch. 2015) (stating that upon insolvency "the creditors replace the stockholders as the equitable owners of the firm's assets and the initial beneficiaries of any increases in value"); *In re Cent. Ice Cream Co.*, 836 F.2d 1068 (7th Cir. 1987). A "zone of insolvency" line of cases under Delaware law once complicated this picture. *See, e.g., Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, Civ. A. No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991) (explaining that directors owe duties to creditors and shareholders where company is in the "zone of insolvency"). But since *North American Catholic Education Programming Foundation, Inc. v. Gheewalla*, Delaware courts appear to have backed away from the zone of insolvency view. 930 A.2d 92 (Del. 2007); *see also* Kelli A. Alces & Larry E. Ribstein, *Directors' Duties in Failing*

a matter of corporate law to books and inspection rights under Delaware law.³⁰⁴ And only noncontrolling shareholders may assert claims due to officer and director violations of the corporate opportunity doctrine.³⁰⁵

Of course, contractual rights may fill gaps for non-shareholders. Indeed, scholars often assume that non-shareholder investors secure sophisticated contractual terms that protect their interests in the absence of fiduciary duties.³⁰⁶ But the new typology underscores that this depends upon the form of instrument. Often, as seen with the angel paradox, the result is surprising. The new typology identifies investors that are most vulnerable to opportunistic behavior by officers and directors. The Safe and SAFT, for example, feature few control protections. While non-shareholder investors certainly may negotiate for protections, it is uncommon for contractual terms to expressly make an officer or director a fiduciary to a non-shareholder investor. Perhaps extralegal protections such as reputation and relational norms might prevent

Firms, 3 J. BUS. & TECH. L. (2008) (zone of insolvency does not shift fiduciary duties; business judgment rule explains cases that suggest otherwise). The court in *Quadrant* held that, while directors owe creditors fiduciary duties once a corporation is insolvent, a “zone” of insolvency does not appear to trigger any shifting duties. 115 A.3d at 546.

304. DEL. CODE ANN. tit. 8, § 220 (West 2011).

305. The corporate opportunity doctrine is a legal principle that prohibits officers, directors, and controlling shareholders of a company from seizing business opportunities for themselves that may benefit the company. See generally Gabriel Rauterberg & Eric Talley, *Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, 117 COLUM. L. REV. 1075 (2017).

306. See, e.g., Baird & Henderson, *supra* note 13, at 1310 n.8 (“So-called ‘contract’ creditors, or ones who voluntarily enter into loan, bond or other debt agreements with the firm usually set out many obligations in the investment contract.”); see also Bratton & Wachter, *supra* note 211, at 1819 (“Lenders sit ‘outside’ of the corporation, and look to specific, bargained-for rights to protect their interests rather than the apparatuses of governance and fiduciary duty.”). Douglas Baird and Robert Rasmussen observe—at least in the public company context—how creditors may obtain outsized levels of control through loan covenants. “When a business trips one of the wires in a large loan, the lender is able to exercise de facto control rights—such as replacing the CEO of a company—that shareholders of a public company simply do not have.” Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1211 (2006).

opportunism.³⁰⁷ But at times the conditions for reputation markets to shield early-stage investors may not exist.³⁰⁸

A baseline theory about corporate law, including the purpose of the corporation and the role of fiduciary duties, goes a long way toward a view about whether the developments that move investors outside the boundaries of corporate law are problematic. Contractarians, who see investors as sophisticated parties that exercise equal power as company actors, are likely untroubled. In fact, contractarians may welcome a diminished role of corporate law vis-à-vis investors since contract and securities law may be up to the task.³⁰⁹ In contrast, if one's baseline theory is that corporate law crucially protects investors due to structural power and informational imbalances relative to company actors, then the trend toward a diminished role of corporate law is more worrisome.³¹⁰ Vertical and horizontal conflicts may be unsettling to markets, especially in instances where directors' decisions appropriate

307. High reputation is a "lure" insofar as entrepreneurs are more likely to select high-reputation VCs over others. The certification value of associating with high-reputation VCs lures entrepreneurs even when this decision entails less favorable economic terms for a company. "Offers made by VCs with a high reputation are three times more likely to be accepted, and high-reputation VCs acquire start-up equity at a 10 to 14% discount." David Hsu, *What Do Entrepreneurs Pay for Venture Capital Affiliation?*, 59 J. FIN. 1805, 1805-06 (2004).

308. Four conditions generally must exist for reputation markets to effectively function: "(i) repeat behavior must be anticipated by participants; (ii) there are shared expectations about appropriate behavior; (iii) a party's conduct is observable for those who consider doing business the party in the future; and (iv) consequences exist for social norm violations." Bernthal, *supra* note 1, at 175. In particular, repeat behavior with the angel investor may not be anticipated. Moreover, an aggrieved angel may have difficulty making bad conduct by a company observable for those who consider doing business with the company or its management team in the future.

309. See, e.g., EASTERBROOK & FISCHER, *supra* note 192. For a survey of contractarian theory, see Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779 (2006) (presented at Symposium, *Robert Clark's Corporate Law: Twenty Years of Change*).

310. Mitchell, *supra* note 26, at 457-58.

Fiduciary duty, by contrast, arises from a situation that is quite the opposite from the supposed free autonomy underlying contract. It is imposed in situations of significant power disparity, where one party is given responsibility and power over something that matters to another party and that vulnerable party is at the mercy of the power-holding party. Once the relationship has been established, the dominated party effectively loses any control over the subject of the relationship, while the power-holder remains autonomous.

Id. (footnote omitted).

wealth from non-shareholders to shareholders.³¹¹ Further, if the scope of “constituencies” that directors account for in decision-making should go beyond shareholders, then the questions about corporate law and startup investors become more complicated.³¹²

CONCLUSION

Startup investment instruments remain under-theorized despite a variety of structures. This Article shows the spike in the number of instruments used in entrepreneurial finance today as compared to twenty years ago. Scholars have yet to reflect upon a classification scheme to promote comparison and understanding of instrument forms. The debt/equity dichotomy is the default classification within law and entrepreneurship literature. Yet most startup investment instruments are hybrids that interleave elements of debt and equity. Still other instruments entirely defy categorization as debt or equity. A new way to analyze and classify startup instruments would be useful.

I propose a three-fold classification scheme: Payouts, Lock-in, and Park-n-ride. A useful typology would liberate contractual analysis from legacy categories to promote understanding of how instruments work. The new typology has two broad advantages, relative to the debt/equity distinction, that improve understanding. Most important, the new typology is multidimensional, providing a tool to examine economic, control, time, and regulatory aspects of instruments. In this way, the typology incorporates broadly accepted analytic tools from law and entrepreneurship. Second, the typology’s categories more accurately classify

311. *Id.* at 452 (“The difficult question arises, however, when the motivation for a transaction is not maximization but expropriation. That is, when directors, whose duty is to maximize common stockholder wealth, do so not by creating new wealth but by transferring existing corporate wealth from the preferreds to the commons, the character of the risk encountered by the preferred stockholders is different. Now, it is no longer the reasonable expectation that they might lose because a risky (but positive net present value) transaction fails. Instead, it is the risk that the directors will make an unanticipated zero-sum transfer. The loss in this case is not the unintended (although anticipated) consequence of wealth creation. It is, rather, the direct and intended consequence of directorial action.” (footnote omitted)).

312. See, e.g., Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 276–87, 314 n.178 (1999); Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1192–95 (2002).

instruments, including categorization of unfamiliar and novel instrument types.

This Article points toward three areas for further investigation. First, how does the expansion in startup instruments square with—and inform—theories of contractual innovation?³¹³ Theories of contractual innovation should be examined in view of the relatively sudden proliferation of instruments. What is the relative importance of path dependence, transaction costs, standardization, and the existence (or not) of a market-maker in adoption of new instruments? Why do some instruments survive while other instruments go away? Moreover, deeper study of emerging instruments is also warranted. Legal scholars, for example, have yet to carefully analyze structures such as RBFs and SAFTs. Scholars should ask “why now?” and “why is there a new instrument in this context but not in another?”

Second, many emerging instruments push investors outside the protections of corporate law. Principal-agent problems not managed by oversight or fiduciary obligations merit further investigation. Horizontal conflicts will also emerge between investors that are not shareholders. Now is a ripe time for law and entrepreneurship scholars to consider whether corporate law-type protections should extend to non-shareholder investors. Several specific questions emerge, such as whether directors should have any sort of obligation to think about non-shareholders? In some cases, reputational markets should constrain inefficient opportunism by firms at the expense of investors, but not necessarily in others. Under what circumstances will greater contractual protections be required? Current developments in startup investment instruments broadly raise issues about how modern entrepreneurial realities challenge the policy objectives of corporate law, as well as the structure of startup investment instruments.

Third, the focus of this investigation is upon startup financial contracts. Regulatory classifications that embed the debt/equity distinction properly influence decisions about which instrument is appropriate to structure a deal. Regulatory factors alone are not

313. See, e.g., Jennejohn, *supra* note 175, at 77 (providing a “preliminary empirical study of the process of contract innovation in the M&A market”). Coyle and Green start down the path of examination of new instruments through the prism of innovation theory. See, e.g., Coyle & Green, *supra* note 4, at 133.

dispositive about the nature of a contract, however, and should be contextualized within a broader analytic framework. The logic behind the need for a better way to classify instruments applies to financial instruments outside the startup world. This Article does not take a position on the utility of the new typology's categories for instruments in other sectors of finance. But this Article proposes a way to shed conceptual limitations inherent in the legacy of the debt/equity dichotomy. Further work may examine whether new frameworks to functionally analyze and classify instruments would be fruitful in other areas of law and finance.