The Technology of Technology Investments

Law is a means of regulating society. It is a crystallization of that society’s value system. With respect to commercial or corporate law, it is most often the case that the law is structured or designed to best facilitate the successful accomplishment of the business being regulated. Today’s column will describe the structure of convertible preferred stock for private companies, how and why this instrument was developed and the manner in which this technology (the convertible preferred stock instrument) has successfully facilitated venture capital investment, management and exit in Silicon Valley.

Let me begin with a simple statement that the instrument that is the subject of this article, the convertible preferred stock instrument, is absolutely differentiable from what most of the readers know as preferred stock in Korea. Preferred stock in Korea is merely a dividend preference instrument. It is generally not convertible into common stock at the option of the holder, and it does not allow for customization (“bells & whistles”). Most people think of public company preferred stock in this context. Please do not make this mistake. What we are talking about here is “COMMON STOCK PLUS ALPHA.” Convertible preferred stock has everything that common stock has, plus alpha. We will get into what “alpha” means shortly.

Basically, these alpha terms allow the investor to better hedge or minimize his or her risk, to better tailor the investment to the investee’s profile, and to align the investee’s incentives with one particular goal in mind: EXIT. The financial investor is after one thing and one thing only: returns at exit. They are not in the business of underwriting the investee’s dreams of managing a company. The investor is in this game in order to make money, for himself and the investors in his FUND. This is not about social welfare or technology development or full employment per se… these are results that are derived from the successful functioning of the venture capital sector, which after all, is JUST ONE SECTOR of a broader economy. Venture capital is that sector that exists to fund high risk, high return investments, often in the technology area.

In the US, as in Korea, venture capital developed in order to fund high risk, high return ventures. These types of business enterprises had difficulties in obtaining funding, as bank debt or other types of asset-backed loans were unavailable to companies with little to zero revenue, and no hard assets to speak of. The only assets of a technology venture startup are its people and its technology. Given that involuntary servitude has been outlawed, with respect to its people, such assets are made “real” or the property of the corporation by using incentives such as stock options and restricted stock to capture the time and focus of both founders and employees. These instruments, along with the Proprietary Information and Assignment Agreement, the Employment Agreement and the Confidentiality Agreement, will be the subject of another column. Suffice it to say that it is necessary to “tie down” the people associated with a venture so that they are effectively converted into “assets” of the company.

With respect to the intellectual property of a startup, various types of legal technology, such as intellectual property law and non-competition agreements, are utilized in tying down these types of assets. Again, these will be discussed in detail in a forthcoming column.

Today, we are concerned with how the convertible preferred stock equity instrument was developed and why. One reason is that the traditional debt market, which relied on corporate assets as security and underlying value for the debt instrument, was often unavailable to the typical technology startup, at least until the aforementioned developments in securitizing people and IP were sufficiently evolved.

Another reason that the convertible preferred stock instrument was developed for the venture capital industry is that is became necessary to align the incentives of the “sweat equity” with the goals of the financial investor. Without such an instrument, the financial investor is limited to investing in the common stock of the company, with the same instrument held by the founders and often the employees. Without additional contractual terms governing their investment, the financial players are essentially treated as just another founder or employee. They, however, have risked capital for the enterprise.
Obviously, there is also an opportunity cost for the founders and employees with respect to their time, but in a capitalistic system, those who fund an enterprise are generally uncomfortable with simply underwriting the efforts of the employees and founders. The financial investor wants to minimize his or her risk and exercise if not control, then some veto power over how his or her money is being spent, particularly if it’s the case that the company being invested in is being managed by inexperienced and unseasoned decision makers.

How was this dealt with in the past? The investor bought common stock, and entered into side agreements, written and unwritten, with company and/or its founders, often both. These side agreements (or contracts) soon became unwieldy, both for the investors and the investees. In addition, this practice resulted in different investors in the same company being treated differently, even if they invested in that company at the same time. It was not uncommon, therefore, for two investors to receive differing prices for their investments at exit, even if they invested the same amount at the same time, because their side-deals were different. This is exactly what has been happening in Korea’s market. This is particularly true for smaller or outsider investors, who were treated differently as compared with the major, insider investors, even when they invested with the larger investors. Why? They didn’t have the benefit of the side agreement.

What kinds of terms and conditions were included in these side agreements? These include control or governance provisions, such as restrictions on management’s discretionary authority to use or borrow funds, hire or fire employees, enter into agreements with third parties as well as agreements concerning the composition of the board and the capital structure of the corporation. As a subset of these conditions, there were also terms that governed the liquidation, sale, disposition or pledging (as collateral or security) of corporate assets. The most significant of this type are the liquidation preference (or “who gets what in the vent of M&A?”) provisions. There were also contractual provisions governing the timing and manner of the initial public offering (IPO).

Finally, there were strategic and tactical provisions designed to better align sweat equity with financial equity. Deals were struck as to payments or bonuses for successful M&A and IPO events. Milestones were negotiated and memorialized in contracts. Each deal was different, and each company could be a party to multiple arrangements. It all became very complicated, unwieldy, and most importantly, difficult to enforce. Finally, as the existence and ubiquitous nature of such deals became apparent to the market, they eventually reduced interest in the sector, as it became clear that this was a game for insiders only. The lack of transparency had negative consequences. Given, however, that venture capital is by nature unregulated (directly, at least) by the disclosure regime of the US securities laws, these side deals continued to be used until market pressures forced the evolution of the convertible preferred stock instrument. It is particularly important to note that such efficiency initiatives (in fact, the technology of technology investments) are generally, if not always, developed in down markets, when money is tough to obtain and the leverage of the investors is strongest… as is currently the case in Korea.

So what exactly is convertible preferred stock? It is that instrument which “hard wires” these contractual “bells & whistles”, these side deals, this ALPHA, into the terms and conditions of the security itself, so that it is transparent as well as efficient to manage, both for the investor and for the investee. By “hard wiring”, I mean that these terms and conditions are made part and parcel of the convertible preferred stock itself, by defining the stock, in the articles of incorporation (the documents governing the existence and nature of the instruments that comprise the corporation itself).

What does this all mean for the Korean venture capital market? First, if we are ever to invest outside of Korea, it is incumbent on the venture capitalists to develop an understanding of global standard practices. In this field, we are talking about convertible preferred stock. I personally know of several instances in which Korean investors invested in the common stock of a US company that had either issued convertible preferred previously or was issuing convertible preferred to other investors. Under such a structure, what the Korean investor essentially did was to fund exit for the other investors, by putting in money at a
subordinated level. It’s just like giving someone money to pay off his or her other creditors, but doing so at terms that are beyond stupid… just simply insane.

Secondly, it is important that we quickly develop a domestic convertible preferred stock instrument. It is my understanding that Korea’s leading investor is using this form in its new investments, and I’m excited by this development.

There was a recent deal in which a sophisticated issuer (trained in the US) sought to issue convertible preferred for his Korean venture. The venture capitalists that he spoke to had no understanding of what this instrument was about, and why in fact this was a better deal for them… in the end the issuer went with a large, more sophisticated investor, one who understood this instrument. If you are in this industry, and don’t understand what convertible preferred stock is, and what it can do for you, I would suggest that you invest some of your valuable time in figuring it out. It makes “global sense.”