Risk-Seeking Governance

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Oxford 2023

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Two Facts About VC

Portfolio payoff structure

- Risk management is less important than identifying / fostering "grand slams"
- "Power law"

Access to investment opportunities

- Complex bargaining dynamic between investors and entrepreneurs

The Paper

VCs objective: induce risk taking on the part of (risk averse) founder at the lowest cost

Two key ingredients:

- Ex ante: Preferred stock
  - Option-like payoff for founder $\Rightarrow$ induces risk taking
- Ex post: Founder friendly terms
  - Provides insurance to founder $\Rightarrow$ reduces cost to VCs

Model Setup

The authors model a 5 period setup:

1. Parties negotiate the series A contract; VC invests
2. Founder chooses low-risk or high-risk
3. First piece of uncertainty is resolved
4. Parties negotiate the series B contract; monitor VC can intervene in management; founder-friendly VC can arrange secondary sale
5. Second piece of uncertainty is resolved; liquidation

Limitations of the Model

The model has **many** free parameters

- Model is unwieldy
- Closed form solution is impractical
- Relationship between the parameters is outside the scope of the model

Founder makes no substantive decisions after t=2

- The results become somewhat mechanical

Whether midstream "governance changes" are value enhancing is independent of founder's actions

- Value of governance changes is untethered to the effect of the founder's decisions on value

An Alternative Approach

Tie the two sets of probabilities together

- Model the progression as gradually learning about the quality of the founder / project

Tie the value of governance changes to the risk choice

- Model governance change as a decision to de-risk the project

Simplify the ex post company value

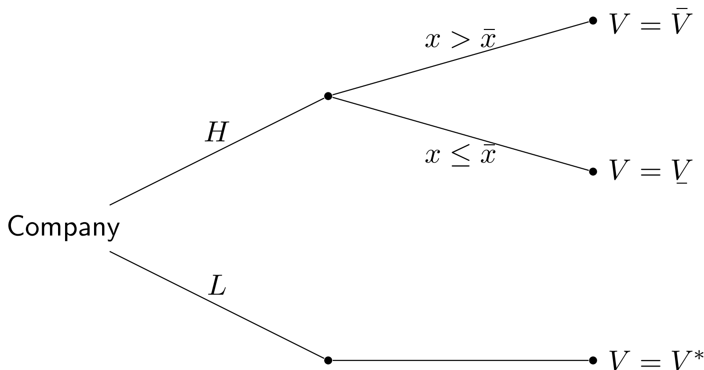
- Two possibilities: (1) company that does well with a high risk strategy; (2) company that does well with a low risk strategy

Streamline the timeline & actions

- Second contracting stage add unnecessary complexity

For Example

The company has the following payoff structure:



Where $E_0[V_H] > V^*$; $x \sim U[0, \delta]$ and $\delta = \begin{cases} \bar{\delta} & \text{w/ prob.} \quad \pi \\ \underline{\delta} & \text{w/ prob.} \quad (1-\pi) \end{cases}$

Timeline and Action Set

$t = 0$: The parties form a contract

- Specifies security type (common/preferred), share to the founder (α), founder premium (B) if FF VC, control right (if Monitor VC)

$t = 1$: The parties learn something about the company

- Observe a signal about the upside of the project (δ)

$t = 2$: Series B investment

- Monitor VC can change course if the signal is bad ($E[x|\delta] \leq \bar{x}$)

$t = 3$: Uncertainty is resolved

- Payoffs are realized; Everything is liquidated

Benefits of this Approach

Tractability

- You can actually solve it!

Pins down the mechanism much more clearly

- Fewer free parameters $\Rightarrow$ much more analytical clarity
  - What can the model tell you?
  - What do we have to assume for the results to hold?
- Less concern about mechanical results

Zooms in on the tradeoff you're after (maybe?)

- Incentive compatibility for risk averse founder
- Higher share $(1-\alpha)$ for the VC $\Rightarrow$ more upside
  - VC business model!

Conclusion

Interesting paper with an intuitively appealing punchline

Model has some challenges

- Suggestion: revise it to improve tractability and analytical payoff
- Alternative: maybe just take it out?

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