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# Venture Capital Contracting in the Information Age

D. Gordon Smith

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# VENTURE CAPITAL CONTRACTING IN THE INFORMATION AGE

by  
D. Gordon Smith\*

*Entrepreneurs encounter moral hazard and adverse selection risks when “hiring” venture capitalists to invest money and perform value-added services. The explicit terms of venture capital contracts do not fully protect entrepreneurs against these risks, but venture capitalist reputation may assist the entrepreneur by serving as a nonlegal sanction against moral hazard problems and as a sorting device countering adverse selection problems. This Article describes the market for reputation among the venture capitalists and examines the effect of the World Wide Web on that market. This Article suggests that the increased accessibility of information about venture capital firms will improve the efficiency of the market for reputation, thus enhancing the ability of entrepreneurs to reduce the risks of moral hazard and adverse selection. This Article concludes with speculations about the effect of this improved market for reputation on venture capital contracts.*

I. INTRODUCTION .....	134
II. AGENCY COSTS IN VENTURE CAPITAL INVESTING .....	136
A. <i>Principal-Agent Theory in Venture Capital Investing</i> .....	137
B. <i>Venture Capital Investing as a Cooperative Relationship</i> .....	138
C. <i>The Entrepreneur’s Moral Hazard Problem</i> .....	140
D. <i>The Entrepreneur’s Adverse Selection Problem</i> .....	143
III. MITIGATING AGENCY COSTS THROUGH VENTURE CAPITAL CONTRACTS .....	144
A. <i>Forms of Venture Capital Contracts</i> .....	144
B. <i>Protecting Entrepreneurs Through Venture Capital Contracts</i> ...	150
1. <i>Addressing Moral Hazard</i> .....	150
2. <i>Addressing Adverse Selection</i> .....	152
C. <i>Lawsuits Over Venture Capital Contracts</i> .....	153
D. <i>The “Gambler’s Mentality” in Venture Capital Contracts</i> .....	155
IV. VENTURE CAPITALIST REPUTATION IN THE INFORMATION AGE .....	156
A. <i>The Market for Venture Capitalist Reputation</i> .....	158

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B.	<i>Venture Capital on the Web</i> .....	162
1.	<i>General Information</i> .....	163
2.	<i>Venture Capital Firms</i> .....	164
3.	<i>News Publications</i> .....	165
C.	<i>The Future of Venture Capital Contracting</i> .....	170
V.	CONCLUSION .....	174
	APPENDIX .....	175

## I. INTRODUCTION

Money is the primary product offering of venture capitalists. Money is a commodity. In an effort to distinguish themselves, most venture capitalists provide services to their portfolio companies beyond capital investment.<sup>1</sup> These "value-added" services include "identifying and evaluating business opportunities, including management, entry, or growth strategies; negotiating and closing the investment; tracking and coaching the company; providing technical and management assistance; and attracting additional capital, directors, management, suppliers, and other key stakeholders and resources."<sup>2</sup> Although these services form an important part of the bargain between the venture capitalists and the entrepreneur, they are rarely specified—or even capable of specification—in venture capital contracts. This Article examines the risks facing entrepreneurs who "hire" venture capitalists to provide value-added services and considers whether technology—specifically, the World Wide Web (the Web)—will change the relationship between venture capitalists and entrepreneurs with respect to such services.

Entrepreneurs face three risks in their quest to obtain value-added services from venture capitalists. First, venture capitalists sometimes promise to perform value-added services but simply fail to follow through. This is the problem of "shirking," which does not appear to be significant in the venture capital community. Second, venture capitalists sometimes promise to perform value-added services but later attempt to renegotiate this promise at a stage in the company's development when

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<sup>1</sup> The level of venture capitalist involvement varies dramatically among investments. Ian C. MacMillan, David M. Kulow and Roubina Khoynian place venture capitalists along a spectrum ranging from "laissez faire" to "close trackers." Ian C. MacMillan et al., *Venture Capitalists' Involvement in Their Investments: Extent and Performance*, 4 J. BUS. VENTURING 27, 27 (1989).

<sup>2</sup> WILLIAM D. BYGRAVE & JEFFRY A. TIMMONS, *VENTURE CAPITAL AT THE CROSSROADS* 13 (1992). Whether these services actually add value and the extent of any added value have been a matter of debate in the economics literature. See, e.g., Harry J. Sapienza, *When Do Venture Capitalists Add Value?*, 7 J. BUS. VENTURING 9, 10-12 (1992).

the entrepreneur has reduced bargaining power.<sup>3</sup> This is the problem of "opportunism,"<sup>4</sup> and it may be significant in the venture capital community. Third, venture capitalists sometimes promise to perform value-added services but fail to perform up to the entrepreneur's standards. This is the problem of "incompetence," and it may be significant in the venture capital community.

All of these problems can be addressed, to some extent, through appropriate provisions in the venture capital contracts. Shirking and opportunism are both incentive problems that can be mitigated by providing venture capitalists with proper incentives to act on behalf of the entrepreneur. Most venture capital contracts address shirking and opportunism by providing ample incentives for the venture capitalist to maximize the value of the entrepreneur's company. Nevertheless, those contracts sometimes allow venture capitalists to benefit by acting in an opportunistic fashion.

Incompetence is rarely addressed by the explicit terms of venture capital contracts. Unlike shirking and opportunism, incompetence cannot be cured by providing proper incentives and is best avoided at the relationship's outset. If evidence of incompetence surfaces only after the parties have entered a contractual relationship, the costs it imposes on the entrepreneur can be mitigated only by terminating the venture capitalist's services. Most venture capital contracts do not provide the most obvious method of terminating a venture capitalist's relationship with a firm—the power of discretionary stock redemption.

The failure to fully address opportunism and incompetence through the explicit terms of venture capital contracts may be intentional: entrepreneurs may agree to assume the risk of opportunism and incompetence in exchange for a reduced cost of capital. Entrepreneurs can mitigate some of the risk by relying on reputation as a nonlegal sanction (in the case of opportunism) or as a sorting device (in the case of incompetence). Whether reputation can function effectively as a nonlegal sanction or as a sorting device depends on the efficiency of the market for reputation. Most venture capital scholars assume, either without reflection or using casual empiricism as their research methodology, that the market for reputation among venture capitalists is highly efficient.<sup>5</sup> This Article does not directly address the latent empirical question, but offers several reasons to doubt both the informational and fundamental efficiency of the market for reputation,<sup>6</sup> suggesting that entrepreneurs do

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<sup>3</sup> See Bernard Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets*, 47 J. FIN. ECON. 243 (1998).

<sup>4</sup> The definition of opportunism is far from fixed. The most commonly cited definition is Oliver Williamson's: opportunism is "self-interest seeking with guile." OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 47 (1985).

<sup>5</sup> See *infra* text accompanying notes 67, 110.

<sup>6</sup> The terms "informational efficiency" and "fundamental efficiency" are borrowed from the economics literature relating to the efficient capital markets hy-

not necessarily have timely access to accurate information about venture capitalists.

The focus of this Forum—the influence of technology in the development of finance—provokes consideration of the manner in which technology might assist entrepreneurs, assuming that they are subject to informational deficiencies. The Web is the most powerful information tool ever devised by humans, and information regarding venture capitalists is plentiful on the Web. The thesis of this Article is that the ready availability of information on the Web will improve the efficiency of the market for venture capitalist reputation, thus reducing agency costs for entrepreneurs and ultimately resulting in contractual innovations.

Part II describes the nature of agency costs in the venture capital relationship, with particular reference to shirking, opportunism, and incompetence. Part III describes how those agency costs are sometimes mitigated through appropriate contract provisions, but concludes that the explicit terms of venture capital contracts fall short of fully protecting most entrepreneurs. Part IV describes the market for venture capitalist reputation and speculates about the effect of the Web on the availability of information in venture capital contracting process.

## II. AGENCY COSTS IN VENTURE CAPITAL INVESTING

The venture capital process may be conveniently divided into three stages: fundraising, investing, and exiting. At each of these stages, two relationships exert powerful, often countervailing, pressure on the parties: the relationship between investors and venture capitalists, and the relationship between venture capitalists and entrepreneurs. Although the focus of this Article is the relationship between venture capitalists and entrepreneurs at the investing stage, the relationship between investors and venture capitalists influences the terms of the former relationship in significant ways.

Most academic writings on the relationship between venture capitalists and entrepreneurs rely on a principal-agent model under which the venture capitalists are principals and the entrepreneurs are agents. Under this view, the primary purpose of any contract between the two parties is “to align entrepreneurs’ incentives with venture capitalists’ goals.”<sup>7</sup> Less commonly addressed are issues raised by viewing entrepreneurs as

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pothesis. In that context, informational efficiency implies that capital markets process information quickly, almost instantaneously, so that no one may use the information to make excess profits. Fundamental efficiency implies that the capital markets process information accurately, so that prices reflect rational expectations about the future value of securities. For a more complete description of these terms with ample references to other sources, see Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611, 646-50 (1995).

<sup>7</sup> Paul A. Gompers, *An Examination of Convertible Securities in Venture Capital Investments* (Apr. 1997) (unpublished manuscript, on file with author) [hereinafter Gompers, *Convertible Securities*].

principals and venture capitalists as agents.<sup>8</sup> This omission leads to an incomplete understanding of venture capital contracting.

#### A. *Principal-Agent Theory in Venture Capital Investing*

The expansive literature on the theory of the firm relies heavily on a model of the firm in which investors contribute money and managers contribute services.<sup>9</sup> In this model, the investors are viewed as principals and the managers as agents in an agency relationship. That relationship is created by "a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent."<sup>10</sup>

This delegation of authority is the key attribute of the principal-agent relationship. The discretion that necessarily results from this delegation creates the possibility that the agent will act in a manner contrary to the best interests of the principal. The principal faces two distinct risks: (1) the risk, known as moral hazard, that the agent will intentionally act in a self-interested manner and contrary to the best interests of the principal<sup>11</sup> and (2) the risk, known as adverse selection, that the agent will be incapable of acting in the principal's best interests because of the agent's incompetence.<sup>12</sup> Moral hazard and adverse selection encourage principals and agents to establish control mechanisms to mitigate the costs associated with these risks.

The moral hazard problem is addressed by providing the agent with the proper incentives to act in the best interests of the principal. Contracts may include both monitoring and bonding mechanisms to align

<sup>8</sup> *But see* Manuel A. Utset, *Innovation & Governance: High-Powered Incentives, Opportunism, and Venture Capital Contracts* (Feb. 24, 1997) (unpublished manuscript, on file with author).

<sup>9</sup> *See, e.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

<sup>10</sup> *Id.* at 308.

<sup>11</sup> As prelude to their classic article on the theory of the firm, Jensen and Meckling quote Adam Smith's masterful description of moral hazard:

The directors of such [joint-stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.

*Id.* at 305 (quoting ADAM SMITH, *THE WEALTH OF NATIONS* 700 (1776)).

<sup>12</sup> As used here, the term "incompetence" is not necessarily derogatory. It refers only to the lack of adequate skill necessary to perform the assigned task and does not imply that the agent is incapable of performing any tasks at a high level of skill. For example, a venture capitalist may be highly competent to advise companies producing computer software but incompetent in the field of medical devices.

the agent's interests with the principal's interests.<sup>13</sup> Despite the principal's best efforts to provide the agent with proper incentives, the agent's actions will inevitably deviate from the best interests of the principal in some ways. Some of these deviations may be intentional, the result of moral hazard that has been inadequately addressed by the incentive scheme. Other deviations may be the result of the agent's incompetence, the agent's inherent inability to perform up to the principal's expectations. This is an adverse selection problem. The risk of loss to the principal from adverse selection cannot be mitigated by adjusting the agent's incentive structure. The principal can address the adverse selection problem either *ex ante* by improving the selection process or *ex post* by replacing the incompetent agent with a competent agent. The costs associated with providing proper incentives, including both monitoring and bonding costs, together with all residual costs incurred by the principal because of the agent's suboptimal behavior—whether caused by moral hazard or adverse selection—are the agency costs of the relationship.

#### B. Venture Capital Investing as a Cooperative Relationship

Most recent scholarship analyzing venture capital contracting implicitly employs a "pure agency relationship" between venture capitalists and entrepreneurs as the model.<sup>14</sup> For example, in what is perhaps the most-cited economics article on venture capital, William Sahlman describes the contracts between venture capitalists and entrepreneurs as mechanisms for minimizing potential agency costs by vesting control rights in venture capitalists.<sup>15</sup> Most subsequent scholarship has followed Sahlman's lead, viewing venture capital contracts exclusively as mechanisms for reducing potential agency costs to venture capitalists.<sup>16</sup>

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<sup>13</sup> Jensen & Meckling, *supra* note 9, at 308.

<sup>14</sup> *Id.* at 309. Jensen and Meckling contrast the "pure agency relationship" with a "cooperative" relationship. Although they acknowledge the role of agency costs in cooperative relationships "even though there is no clear cut principal-agent relationship," *id.* at 309, they confine their paper "to only a small part of this general problem—the analysis of agency costs generated by the contractual arrangements between the owners and top management of the corporation." *Id.*

<sup>15</sup> William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473, 506-14 (1990).

<sup>16</sup> See, e.g., Gompers, *Convertible Securities*, *supra* note 7; Paul A. Gompers, *Optimal Investment, Monitoring, and the Staging of Venture Capital*, 50 J. FIN. 1461 (1995) [hereinafter Gompers, *Optional Investment*] (arguing that staged capital investments minimize agency costs). Reduction of agency costs also may be important in aspects of venture capital investing beyond the contract between the venture capitalists and entrepreneurs. For example, Josh Lerner argues that syndication of venture capital investments "may lead to a superior selection of investments." Joshua Lerner, *The Syndication of Venture Capital Investments*, 23 FIN. MGMT. 16, 17 (1994). In short, syndication may address the adverse selection problem.

In a pure agency relationship—the usual example here is the relationship between shareholders and managers in a publicly traded corporation<sup>17</sup>—the agent does not face the same risks as the principal because the principal's only obligation is to pay money, an act that is accomplished at the agency relationship's inception and thus not subject to opportunistic behavior or dependent on the competence of the principal. The relationship between venture capitalists and entrepreneurs is not a pure agency relationship, but rather a more complex interaction characterized by give-and-take on both sides. It might be viewed as a relationship with reciprocal agency obligations and thus be more akin to a partnership than to the shareholders-manager relationship in a modern public corporation.<sup>18</sup> For purposes of this Article, this relationship will be referred to as a "cooperative relationship."<sup>19</sup>

At the outset of the relationship, venture capitalists and entrepreneurs typically have a common goal: build the company to the point where its stock may be sold to the public. Returns to venture capitalists from initial public offerings (IPOs) far outdistance returns from other exit options, including acquisitions, share repurchases by the company, secondary sales, and liquidations.<sup>20</sup> Reaching the IPO stage usually requires more than money from the venture capitalists; it requires substantial nonfinancial contributions to the firm. The following description written by venture capitalists suggests the extent of potential nonfinancial contributions:

[L]eading venture capitalists now typically have multi-disciplined external contact networks or sometimes professional staff that can provide portfolio companies with technical and marketing guidance; assist in strategy, financing and recruiting issues; and provide contacts with key potential customers, vendors and financial institutions. Venture capitalists with investment banking capabilities can assist companies directly with private or public equity financings, secured asset financing, joint ventures or acquisitions. When appropriate, a venture capitalist can assist a young company to ally with a larger established corporate partner through technology exchanges, OEM or other customer agreements, and minority equity investments. These services, combined with direct involvement by venture capital-

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<sup>17</sup> Jensen & Meckling, *supra* note 9, at 309.

<sup>18</sup> Jensen and Meckling note that "the relationship between the stockholders and manager of a corporation fit[s] the definition of a pure agency relationship." *Id.*

<sup>19</sup> This terminology is common in the economics literature. See *id.* Alchian and Demsetz use the similar concept of "team production" to describe production with the following attributes: (1) several types of resources are used, (2) the product is not the sum of separate outputs of each cooperating resource, and (3) not all resources used in team production belong to one person. Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 779 (1972).

<sup>20</sup> See Bygrave & Timmons, *supra* note 2, at 167-83 (discussing IPOs, or "The Golden Harvest").



ists in portfolio companies, such as serving on the board of directors, typically result in leading venture capital firms making substantial investments in experienced personnel to help make investments successful.<sup>21</sup>

Michael Gorman and William Sahlman surveyed venture capitalists and found that, although a venture capitalist is rarely involved in the daily management of its portfolio companies, it performs many services in addition to providing money.<sup>22</sup> The most important of these nonfinancial contributions were the following: (1) assisting the firm in obtaining additional financing, (2) strategic planning, and (3) recruiting additional members of the management team.<sup>23</sup> In a survey of venture capitalists and entrepreneurs, Harry Sapienza found evidence to suggest that value-added services were most important to highly innovative firms.<sup>24</sup>

Focusing on the nonfinancial contributions of venture capitalists places venture capital contracting in a new light. Instead of viewing venture capital contracts exclusively as mechanisms for reducing potential agency costs to venture capitalists, this analysis suggests that they might also serve as mechanisms for reducing the potential agency costs to the entrepreneur. This view invites analysis of the potential moral hazard and adverse selection problems facing the entrepreneur as principal in a relationship in which the venture capitalist is also an agent. Each of these problems is discussed in turn below.

### C. *The Entrepreneur's Moral Hazard Problem*

Bengt Holmström has described the moral hazard problem as "an asymmetry of information among individuals that results because indi-

<sup>21</sup> Daniel H. Case III & Standish H. O'Grady, *An Overview of Venture Capital, in START-UP COMPANIES: PLANNING, FINANCING AND OPERATING THE SUCCESSFUL BUSINESS* § 6.02[3] (Richard D. Harroch ed., 1996).

<sup>22</sup> Michael Gorman & William A. Sahlman, *What Do Venture Capitalists Do?*, 4 J. BUS. VENTURING 231 (1989). Venture capitalists perform more value-added services than other private equity investors. Sanford B. Ehrlich et al., *After the Cash Arrives: A Comparative Study of Venture Capital and Private Investor Involvement in Entrepreneurial Firms*, 9 J. BUS. VENTURING 67, 75-77 (1994).

<sup>23</sup> Gorman & Sahlman, *supra* note 22, at 237. Harry Sapienza, Sophie Manigart, and Wim Vermeir found that venture capitalists in four countries viewed strategic assistance as their most valuable role, and interpersonal relations (as a mentor or friend) as next in importance, followed by networking. Harry J. Sapienza et al., *Venture Capitalist Governance and Value Added in Four Countries*, 11 J. BUS. VENTURING 439, 439-40 (1996). The most influential venture capitalists add value beyond these company-specific measures by creating networks of related companies. See Alex Gove, *American Keiretsu*, RED HERRING, Feb. 1998, at 52 (describing the "keiretsu" of Internet-product companies financed by Kleiner Perkins Caufield & Byers in Silicon Valley); Zina Moukheiber, *Kleiner's Web: Think of Kleiner Perkins as Bankers to the Net*, FORBES, Mar. 25, 1996, at 40.

<sup>24</sup> Sapienza et al., *supra* note 23, at 20.

vidual actions cannot be observed and hence contracted upon.<sup>25</sup> When information about an agent's actions is improved, principals are better able to monitor agents and agents' incentives to perform improve. If the parties do not provide for constraints on the agent's behavior, they open the door to opportunism. As noted above, scholars have written extensively about moral hazard from the standpoint of venture capitalists, but little from the standpoint of the entrepreneur.

Shirking is a common moral hazard problem in many agency relationships, but it does not appear to be a significant problem in venture capital relationships, for reasons explained below. The most prominent risk to entrepreneurs is opportunism.<sup>26</sup> In this context, the potential for opportunism arises from the possibility that the venture capitalist will attempt to renegotiate with the entrepreneur at a point in the relationship when the entrepreneur has diminished bargaining power.

Venture capitalists exert substantial control over the entrepreneur because of the staged financing that characterizes most venture capital relationships.<sup>27</sup> Venture capitalists usually provide money to entrepreneurs in stages to give entrepreneurs an incentive to advance the company. At each stage, venture capitalists typically have preemptive rights to participate by purchasing sufficient new shares to retain their ownership interests in the company.<sup>28</sup> But venture capitalists are not required to provide financing at any stage in the process. Moreover, the refusal by one venture capitalist to provide subsequent financing may be viewed as a signal to other venture capitalists that the company is unworthy of capital.<sup>29</sup> This combination of rights and incentives opens the door to venture capitalist opportunism.

Opportunism may take several forms. For example, venture capitalists may attempt to renegotiate the entrepreneur's employment contract to force the entrepreneur from the business. The power to fire entrepreneurs in their roles as officers of the companies they founded is often granted by the explicit terms of venture capital contracts and when combined with the commonly awarded right to buy out the shares owned by the entrepreneurs, it allows venture capitalists to force entrepreneurs completely out of the business.<sup>30</sup> Thomas Hellman has argued that entrepreneurs open themselves to this type of action to lower the cost of capital.<sup>31</sup> In this negotiated context, the entrepreneur's termina-

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<sup>25</sup> Bengt Holmström, *Moral Hazard and Observability*, 10 BELL J. ECON. 74, 74 (1979).

<sup>26</sup> See *supra* note 4 (defining opportunism).

<sup>27</sup> See Sahlman, *supra* note 15, at 505.

<sup>28</sup> *Id.*

<sup>29</sup> *Id.* at 507.

<sup>30</sup> Venture capitalists usually have the right to repurchase shares at book value from managers who have been dismissed. See Sahlman, *supra* note 15, at 507.

<sup>31</sup> Thomas Hellman, *The Allocation of Control Rights in Venture Capital Contracts* (Nov. 19, 1995) (unpublished manuscript, on file with author).

tion is not properly viewed as opportunistic because it is part of the bargain. When an entrepreneur is terminated opportunistically, however, the entrepreneur does not obtain the benefit of reduced capital costs. Bernard Black and Ronald Gilson suggest that reputation is a check against this sort of opportunism.<sup>32</sup> Manuel Utset is unconvinced, arguing that overly optimistic entrepreneurs will not be dissuaded from dealing with a venture capitalist on these grounds.<sup>33</sup>

Another form of opportunism relates to the decision to sell the company. Venture capitalists typically strive to preserve a menu of potential exit strategies. Although power to determine the firm's fate is constrained by contract, venture capitalists (as a result of staged financing) often have substantial control over the timing of various exit strategies and may make decisions contrary to the entrepreneur's interests. For example, Paul Gompers has explored the phenomenon known as "grandstanding," whereby a venture capitalist elects to pursue a premature IPO in the hopes of enhancing its own reputation.<sup>34</sup> Similarly, companies known as the living dead<sup>35</sup>—firms that are profitable, but not so profitable as to be candidates for IPOs—are routinely liquidated by venture capitalists hoping to turn to more promising ventures.<sup>36</sup> Christopher Barry describes the problem as follows:

The entrepreneur brings in the venture capitalist as a financial partner and consultant. The venture capitalist may have incentives to offer bad consulting advice to the entrepreneur, i.e., advice that suggests a course of action contrary to the interests of the entrepreneur, up to and including the abandonment of an investment that has economic value. . . . Premature abandonment may come about because the venture capitalist has a diversified portfolio of opportunities and a high opportunity cost of time, whereas the entrepreneur is fully committed to the venture and in fact may choose to overinvest other people's money.<sup>37</sup>

These forms of opportunism are possible under most venture capital contracts, and the only apparent check on such behavior is the venture capitalists' fear of reputational backlash.

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<sup>32</sup> Black & Gilson, *supra* note 3, at 254.

<sup>33</sup> See Utset, *supra* note 8, at 28 n.93.

<sup>34</sup> Paul A. Gompers, *Grandstanding in the venture capital industry*, 42 J. FIN. ECON. 133 (1996) [hereinafter Gompers, *Grandstanding*].

<sup>35</sup> See John C. Ruhnka et al., *The "Living Dead" Phenomenon in Venture Capital Investments*, 7 J. BUS. VENTURING 137, 137-38 (1992).

<sup>36</sup> See *id.* at 147-48 (stating that "the most-often-used strategy (used in more than 75% of living dead situations) was an attempt to sell or merge the company—typically to a larger company with a related product line or technology").

<sup>37</sup> Christopher B. Barry, *New Directions in Research on Venture Capital Finance*, 23 FIN. MGMT. 3, 7-8 (Autumn 1994).

#### D. *The Entrepreneur's Adverse Selection Problem*

The entrepreneur's adverse selection problem is less complex than the multifaceted moral hazard problem just described. Paul Milgrom and John Roberts define adverse selection as:

the kind of *precontractual opportunism* that arises when one party to a bargain has private information about . . . something that affects the other's net benefit from the contract and when only those whose private information implies that the contract will be especially disadvantageous for the other party agree to a contract.<sup>38</sup>

Adverse selection has the potential to produce the well-known "market for lemons"<sup>39</sup> because a principal who cannot distinguish good products from bad products will discount the price they are willing to pay for all products (paying equally for both), causing sellers of bad products to flood the market and sellers of good products to exit.

One method of mitigating the costs of adverse selection is to improve the quality of information at the contracting stage, enabling the buyer to better distinguish among the relative quality levels of available products. For example, in a market for products (such as used cars), brand names provide reputational signals of quality. In addition, contractual innovations may serve to protect buyers from the costs of adverse selection. For example, warranties ensure that products meet certain quality standards.<sup>40</sup>

Most venture capitalists rely heavily on reputation ("brand name") to assure entrepreneurs regarding the quality of future services they are "purchasing." If the entrepreneur nevertheless chooses poorly, the costs of adverse selection accumulate over time because the relationship is ongoing. The only method of abating such cumulating costs is to allow the entrepreneur to end the relationship. This is the venture capital analog to a warranty. From the entrepreneur's perspective, the adverse selection problem in a venture capital relationship centers around the venture capitalist's competence at providing nonfinancial contributions to the firm. As noted above, no amount of monitoring by the entrepreneur will correct for venture capitalist incompetence, and once incompetence is revealed, the only solution is to replace the venture capitalist.

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<sup>38</sup> PAUL MILGROM & JOHN ROBERTS, *ECONOMICS, ORGANIZATION & MANAGEMENT* 595 (1992).

<sup>39</sup> George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

<sup>40</sup> *Id.* at 489.

### III. MITIGATING AGENCY COSTS THROUGH VENTURE CAPITAL CONTRACTS

When venture capitalists invest in a company, the transaction is typically accomplished through a set of contracts, including a stock purchase agreement, a certificate of designations (or restated certificate of incorporation), a shareholders agreement, and a registration rights agreement (collectively referred to as "venture capital contracts").<sup>41</sup> The venture capital contracts describe in great detail the relationship between venture capitalists and entrepreneurs. Unfortunately, because these contracts are not publicly available, analysis of the terms typically used in venture capital contracts usually rests on a description of such contracts in secondary sources. The first subpart below relies on Mark Suchman's pathbreaking study of venture capital in Silicon Valley to describe various contractual forms used in venture capital financing. The second subpart then discusses common terms in venture capital contracts that have the potential to address the moral hazard and adverse selection problems of the entrepreneur and concludes that the explicit terms of most venture capital contracts do not adequately protect entrepreneurs.

Beyond these explicit contractual protections, it is conceivable that courts could impose extra-contractual duties on venture capitalists to constrain agency costs. Although reported cases involving disputes between venture capitalists and entrepreneurs are relatively rare, the third subpart below describes two recent cases that illustrate the approach that most courts could be expected to take in response to such claims. In short, courts are unlikely to be inclined to impose extra-contractual duties on venture capitalists. The common law, therefore, does not address the entrepreneur's moral hazard and adverse selection problems.

If the explicit terms of venture capital contracts and the common law do not protect entrepreneurs against the problems of moral hazard and adverse selection, why are entrepreneurs so willing to enter venture capital relationships? The fourth subpart below considers the "gambler's mentality" as a possible explanation. Although this theory might explain some venture capital transactions, it is imprudent to assume such rampant irrationality among entrepreneurs. A more likely answer to the question—and one less derogatory toward entrepreneurs—is that entrepreneurs rely on the market for reputation to select and monitor venture capitalists. This explanation is explored in Part III.

#### A. *Forms of Venture Capital Contracts*

As noted above, venture capital contracts are private documents. Scholars examining venture capital contracting, therefore, often rely on

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<sup>41</sup> See, e.g., Michael J. Halloran et al., *Making Portfolio Company Investments*, in VENTURE CAPITAL AND PUBLIC OFFERING NEGOTIATION 6-1 (Lee F. Benton et al. section eds., 1998).

a few stylized descriptions of the terms of venture capital contracts as the starting point for analysis. The most often-cited description of venture capital contracts was written by William Sahlman, who studied approximately forty stock purchase agreements and found them "similar in many ways."<sup>42</sup> Sahlman's search for commonality among the agreements he studied was part of his attempt to demonstrate that venture capital contracts shift risk from the venture capitalists to the entrepreneur.<sup>43</sup> Sahlman's characterization of the venture capital relationship has exerted tremendous influence on subsequent scholars.<sup>44</sup>

The tendency of scholars to rely on stylized descriptions of venture capital contracts is understandable as part of an effort to make meaningful generalizations about the nature of venture capital investing. Indeed, this effort has produced many useful insights about venture capital investing, at least insofar as that investing conforms to the stylized contracts being analyzed. Nevertheless, generalization has obscured an important fact about venture capital contracting: not all deals are alike.

Some entrepreneurs are powerful because they have demonstrated their abilities to start and build successful companies. Other entrepreneurs, especially first-timers, have weak bargaining positions. Similarly, some venture capitalists have established track records and a substantial stable of portfolio companies, whereas other venture capitalists are young and eager to fund companies with any reasonable prospect of hitting a home run. It stands to reason that, in such a market, the contracts would exhibit some variation.

In an important study of the impact of lawyers in Silicon Valley, Mark Suchman attempted to describe such variation.<sup>45</sup> Suchman ana-

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<sup>42</sup> Sahlman, *supra* note 15, at 503.

<sup>43</sup> *Id.* at 510.

<sup>44</sup> See, e.g., Anat R. Admati & Paul Pfleiderer, *Robust Financial Contracting and the Role of Venture Capitalists*, 49 J. FIN. 371, 374 (1994) (constructing a model that is consistent with "the stylized facts about the venture capital industry" found in Sahlman's article and elsewhere); Barry, *supra* note 37, at 8-9 (relying on Sahlman for description of venture capital contracts); Black & Gilson, *supra* note 3, at 250, 259 (citing Sahlman and referring to provisions "typically" found in venture capital contracts); Gompers, *Convertible Securities*, *supra* note 7, at 2 (stating that Sahlman "gives an excellent summary of the common governance structures that typify the venture capital industry"); Joshua Lerner, *Venture capitalists and the decision to go public*, 35 J. FIN. 293, 294 (1994) (citing Sahlman for the proposition that "[v]enture [capitalists] usually have several board seats and powerful control rights"). *But see* George W. Dent, Jr., *Venture Capital and the Future of Corporate Finance*, 70 WASH. U. L.Q. 1029, 1036 (1992) ("Although contracts are quite standardized in many areas, the varied business contexts of venture capital discourage uniformity.").

<sup>45</sup> Mark C. Suchman, *On Advice of Counsel: Law Firms and Venture Capital Funds as Information Intermediaries in the Structuration of Silicon Valley* (1994) (unpublished Ph.D. dissertation, Stanford University) (on file with the author). Suchman's dissertation focuses on the role of lawyers in developing contractual forms in Silicon Valley. *Id.* His work in this area continues to garner attention. See, e.g., Ian Ayres, *Never Confuse Efficiency With a Liver Complaint*, 97 WIS. L. REV. 503, 508 (1997) (citing Suchman's methodology analysis with approval); Lisa Bernstein, *The*

lyzed seventy-eight "financing agreements" having some connection to California.<sup>46</sup> Using the technique of multi-dimensional scaling<sup>47</sup> and data derived from eleven types of contract provisions,<sup>48</sup> Suchman found that venture capital contracts tend to cluster into six distinctive "neighborhoods."

The first neighborhood contains the "idiosyncratic contracts." These contracts were idiosyncratic because they omitted terms common to other contracts or contained nonstandard terms, "such as a disproportionate tendency to involve common-stock-only financings and a significantly elevated likelihood of including restrictions on the private transfer of stock-ownership."<sup>49</sup>

The second neighborhood contains "weak contracts." These contracts were "weakly-specified, short-term agreements, with only limited protections for investors. . . . Investors benefit from relatively stringent 'cumulative' dividends, but they sacrifice items such as anti-dilution protections and rights of first refusal."<sup>50</sup> These contracts frequently contained discretionary stock redemption provisions, allowing successful entrepreneurs to repurchase the shares of venture capitalists at predetermined prices, "usually at a premium over the initial investment price but at a discount from the stock's market value."<sup>51</sup>

The third neighborhood contains "pre-programmed contracts." These contracts are "relatively conventional, but [they] exhibit a marked preference for establishing *a priori* timetables, milestones and bench-

*Silicon Valley Lawyer as Transaction Cost Engineer?*, 74 OR. L. REV. 239, 241 (1995) (discussing Suchman's analysis of Silicon Valley lawyers). Venture capital scholars, however, have largely ignored the work.

<sup>46</sup> Since the forms of documentation in venture capital financings can be idiosyncratic, Suchman uses the term "financing agreements" generically to refer to all of the contracts that comprise the relationship between venture capitalists and entrepreneurs, including stock purchase agreements, warrant agreements, registration rights agreements, and the like. Suchman, *supra* note 45, at 238.

<sup>47</sup> Suchman says that multi-dimensional scaling (MDS) "examines a matrix of 'similarities' between data objects (contracts, in the present context), in order to calculate a set of N-dimensional coordinates for each object." *Id.* at 191. By plotting each data object according to its coordinates and then performing a regression analysis, a researcher using MDS can reveal the fundamental dimensions and proximities of the objects. Suchman employs a variation on traditional MDS called Individual Differences Scaling (INDSCAL), which allows the researcher to input multiple matrices of similarities, rather than just one. The result of his INDSCAL analysis is a "map" of venture capital financing agreements. *Id.* at 191-93.

<sup>48</sup> The eleven groups were: (1) dividend provisions, (2) liquidation and merger provisions, (3) stock redemption requirements, (4) mandatory conversion clauses, (5) anti-dilution protections, (6) class-voting requirements, (7) affirmative and negative covenants, (8) representations and warranties, (9) financial reporting requirements, (10) sale restrictions and rights of first refusal, and (11) stock registration rights. *Id.* at 194.

<sup>49</sup> *Id.* at 219.

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

marks" relating to merger rights, anti-dilution rights, and redemption rights.<sup>52</sup> The common theme underlying these provisions is tight control by the venture capitalist at the outset with the potential for loosening the venture capitalist's grip if the company is successful. Suchman concludes that these contracts "conjure an image of the venture capital relationship as an 'indentured servitude'—a limited period of reduced autonomy, during which the start-up faces various carefully-delineated opportunities to earn its freedom from initially-burdensome obligations to its financial backers."<sup>53</sup>

The fourth neighborhood contains "legalistic contracts." These contracts are legalistic because they contain expansive provisions detailing the relationship between venture capitalists and entrepreneurs. These contracts guard the upside interests of the start-up through mandatory conversion provisions, discretionary stock redemption clauses and complexly contingent merger treatments; at the same time, these agreements address the downside concerns of investors through cumulative dividend provisions, abundant covenants, through representations and warranties, and nearly-universal anti-dilution protection. Between these performance extremes, [these contracts seem] to embrace a relatively long-term view of the venture capital relationship, with virtually all agreements granting rights of first refusal to investors who wish to join in future financing rounds.<sup>54</sup>

The fifth neighborhood contains "close contracts." These contracts are designed to forge long-term relationships between venture capitalists and entrepreneurs, offering "few easy exits, eschewing discretionary stock redemption and placing stringent conditions on investors' powers to register their holdings for public sale."<sup>55</sup> These contracts also erect barriers to entry, including "harsh anti-dilution protections, nearly-universal rights of first refusal, and numerous protective covenants."<sup>56</sup> Suchman suggests that the "overall image here is of a 'jealous marriage'—a long-term, close and exclusive relationship structured so as to forestall potential infidelities."<sup>57</sup>

The sixth neighborhood contains "flexible contracts." Like the idiosyncratic contracts and weak contracts, these contracts frequently do not specify certain common terms, but Suchman suggests that the omission is an intentional effort to build "adaptive relationships."<sup>58</sup> Unlike those other contracts, these contain some fairly extensive provisions—numerous representations, warranties, and covenants; financial reporting obligations; rights of first refusal; and stock registration rights—

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<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> *Id.* at 219-20.

<sup>55</sup> *Id.* at 220.

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

<sup>58</sup> *Id.*



suggesting that the parties were willing and able to specify their respective obligations in contracts, but chose to leave many details out.<sup>59</sup>

Suchman's typology of venture capital financing agreements provides a richer and more realistic account of the relationship between venture capitalists and entrepreneurs than normally appears in the academic literature on venture capital. Certain of the contract forms mentioned above might fit easily into the stylized facts employed by scholars. For example, Suchman suggests that pre-programmed contracts adhere closely to entrepreneurs' descriptions of "vulture capital" and that close contracts comport with William Bygrave and Jeffry Timmons' conception of classic venture capital.<sup>60</sup> Nevertheless, Suchman's analysis powerfully demonstrates that no set of stylized facts attempting to pigeonhole all venture capital contracts into a single contract form is sufficient.

Suchman's typology also suggests that venture capital contracts are more balanced than traditionally perceived. The traditional view is exemplified by William Sahlman, who identified four ways in which venture capital contracts addressed moral hazard and adverse selection problems facing venture capitalists. First, the structure of venture capital investments, particularly the staging of such investments, provides performance incentives to entrepreneurs and allows venture capitalists to abandon investments that are failing.<sup>61</sup> Second, compensation schemes involving lower-than-market cash salaries combined with substantial common stock and stock options, which are subject to vesting schedules and repurchase rights, provide strong incentives for entrepreneurs to perform.<sup>62</sup> Third, venture capitalist involvement in managing the firm serves a monitoring function and ensures that performance (at least in those areas in which the venture capitalist is active) meets with the venture capitalist's expectations.<sup>63</sup> Fourth, the use of convertible securities allows a venture capitalist to salvage some value from failing ventures and usually specifies that the venture capitalist may sell its shares at the same time and on the same terms as the entrepreneurs.<sup>64</sup> Each of these aspects of the venture capital relationship mitigates agency costs to the venture capitalists.

In summarizing the effects of the contract on the relationship between venture capitalists and entrepreneurs, Sahlman emphasized the benefits to venture capitalists: "A key feature of the contracts and operating procedures is that risk is shifted from the venture capitalists to the entrepreneur[s]. . . . It would be foolish for the entrepreneur[s] to ac-

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<sup>59</sup> *Id.*

<sup>60</sup> *Id.* at 222.

<sup>61</sup> Sahlman, *supra* note 15, at 506-07.

<sup>62</sup> *Id.* at 508.

<sup>63</sup> *Id.* at 508-09.

<sup>64</sup> *Id.* at 509.

cept such contract terms if they were not truly confident of their own abilities and deeply committed to the venture."<sup>65</sup>

Of course, it would be equally foolish for the entrepreneur to enter into such a contract without some assurance regarding the venture capitalist's commitment. As Sahlman observes, the cost of venture capital is high and cannot be justified by the money alone.<sup>66</sup> Sahlman suggests that the primary brake on venture capitalist opportunism is fear of diminishment of reputational capital:

Although it seems that venture capitalists retain much of the power in the relationship with entrepreneurial ventures, there are checks and balances in the system. Venture capitalists who abuse their power will find it hard to attract the best entrepreneurs, who have the option of approaching other venture capitalists or sources other than venture capital. In this regard, the decision to accept money from a venture capitalist can be seen as a conscious present-value-maximizing choice by the entrepreneur.<sup>67</sup>

While Sahlman's account of venture capital contracts portrays a lopsided agreement favoring venture capitalists—thus enabling venture capitalists to act opportunistically—Suchman concludes that each contract form provides benefits to and places burdens on both sides of the deal. On this point Suchman argues:

Although the trade press often frames discussions of venture capital transactions as debates between pro-company positions and pro-investor alternatives, the configuration of actual Silicon Valley financings displays little evidence of this distinction. Admittedly, individual contractual provisions often benefit one side at the expense of the other; however, such a provision-by-provision analysis may miss the larger picture. Taken as a whole,

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<sup>65</sup> *Id.* at 510. Sahlman also notes that the collective weight of the contracts on entrepreneurs assists in mitigating adverse selection: "[T]he entrepreneurs typically hold undiversified portfolios. Much of their wealth is invested in securities of the company they manage. The entrepreneur's willingness to bear diversifiable risk also conveys useful information to the venture capitalists." *Id.* at 511.

<sup>66</sup> *Id.* at 512-13. One venture capitalist company addressed the valuation concern on its Web site. Responding to one of the "Top Ten Myths About Venture Capital" which read, "Venture capitalists give me a lower valuation than a private placement," the firm wrote:

Sometimes. Keep in mind that a venture capitalist—especially an early-stage investor like ATV—will spend a significant amount of time with entrepreneurs. We participate in business planning, sales strategy, even key hiring decisions. In addition, we represent an important link to larger capital markets when the time comes for additional venture investment, or for an IPO.

Participants in a private placement are usually individual investors, who tend to be less involved. You may get a higher valuation for your shares today, but a venture investment can add far more value in the long run.

Alliance Technology Ventures, *Top Ten Myths About Venture Capital* (visited Mar. 21, 1998) <<http://www.atv.com/links/library/topten.html>>.

<sup>67</sup> Sahlman, *supra* note 15, at 513.

each of the contractual archetypes uncovered here appears to conjoin countervailing sets of terms into a coherent, relatively balanced bundle. Thus, “weak” contracts couple stringent dividends with substantial operational autonomy and limited duration; “pre-programmed” contracts link burdensome initial obligations with carefully specified release trajectories; “legalistic” contracts mix upside assurances for founders with downside guarantees for investors; “close” contracts pair bilateral barriers to exit with bilateral barriers to entry; and “flexible” contracts meld lax financial obligations with extensive assurances regarding supervision rights, exit paths, and conflicting commitments. None of this, of course, implies that individual contracts are immune to the effects of bargaining power and negotiating skill; however, these findings do suggest that the Silicon Valley community’s dominant contractual *models* reflect different ways of *reconciling* competing interests, rather than total victories for one side or the other.<sup>68</sup>

Suchman’s conclusion that venture capital agreements contain protective provisions favorable to both sides makes good sense, but may overstate the case. It is not obvious, for example, how entrepreneurs ensure that venture capitalists actually provide nonfinancial support to the enterprise because venture capital contracts rarely specify the nonfinancial obligations of venture capitalists. The following subpart examines this issue.

### *B. Protecting Entrepreneurs Through Venture Capital Contracts*

Venture capital contracts have the potential to protect entrepreneurs against both moral hazard and adverse selection problems. Nevertheless, most venture capital contracts fall far short of offering full protection; therefore, the analysis below suggests an important role for the market for reputation, which is analyzed in more detail in Part IV.

#### *1. Addressing Moral Hazard*

The structure of most venture capital relationships provides powerful incentives to mitigate shirking by the venture capitalist. 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. Collectively, various provisions of the venture capital contracts provide strong incentives to venture capitalists to maximize the value of the firm.

In most venture capital transactions, venture capitalists purchase preferred stock that does not require the company to pay cash dividends, at least during the first years of the company’s life. As explained by Michael Halloran, “corporations being financed with venture capital money are rarely in a position to pay dividends to their venture capital investors.

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<sup>68</sup> Suchman, *supra* note 45, at 223-24.

As a result, most dividend provisions do not make dividends either mandatory or cumulative."<sup>69</sup> Such provisions reflect the fact that a venture capitalist usually expects to earn its money through sale of the company—either through a public offering or an acquisition—rather than through a fixed return. Viewed another way, restricting the payment of dividends places added pressure on the venture capitalist to assist the company in achieving success because, without a public offering or acquisition, the venture capitalist is unlikely to profit from the investment.

Venture capitalists profit if the company executes a successful public offering because almost every venture capital contract provides for conversion of the preferred stock into common stock upon the completion of a public offering meeting certain requirements.<sup>70</sup> The venture capitalists, therefore, will hold shares of common stock that likely have a substantially higher value than the price paid by the venture capitalist.<sup>71</sup> To ensure that the shares owned by the venture capitalist are liquid, most venture capital agreements provide for registration rights. Demand registration rights, which allow the venture capitalists to determine the nature and timing of registration, are rarely used, but venture capitalists often receive "piggyback" registration rights, allowing them to register their shares at the same time as the company.<sup>72</sup> Registration is a precursor to a public sale of securities and is a sign of success. Granting venture capitalists registration rights, therefore, provides venture capitalists with the proper incentives to work on behalf of the company and thus mitigates the costs associated with shirking.<sup>73</sup>

If the company fails, the venture capitalist faces the prospect of receiving only a liquidation preference. Traditionally, liquidation preferences for the preferred stock were valued at the original issue prices, but more recent contracts often allow the venture capitalists to participate with the common stock in any gains.<sup>74</sup> Nevertheless, liquidation is clearly a less desirable exit option than the IPO.

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<sup>69</sup> Halloran et al., *supra* note 41, at 8-7 to 8-8.

<sup>70</sup> *Id.* at 8-31.

<sup>71</sup> The venture capital contracts usually provide for a minimum price per share as a conversion condition. Michael Halloran notes that "[t]he minimum price per share represents an agreed-upon measure of success. If the Company's valuation meets or exceeds that price per share, the venture capitalists are willing to give up their seniority." *Id.*

<sup>72</sup> *Id.* at 9-5; Sahlman, *supra* note 15, at 504.

<sup>73</sup> Venture capitalists are likewise encouraged to prepare the company for sale, usually as a second-best option to a public offering, by certain preferences granted in the context of a merger, consolidation, or sale of all, or substantially all, of the corporation's assets. *See* Halloran et al., *supra* note 41, at 8-15.

<sup>74</sup> The reason for this development is explained by Michael Halloran:

Previously, the various series of Preferred Stock were given a liquidation preference over the Common Stock equal to the original issue prices (i.e., the per share prices the investors paid). If the investors desired to participate in any gain on their investment, they were compelled to convert their Preferred Stock into Common Stock.

These built-in incentives to avoid shirking seem to be effective because shirking is rarely cited as a concern in venture capital relationships. But other forms of moral hazard—specifically, those associated with opportunism—are not usually addressed by venture capital contracts. Indeed, venture capital contracts often provide the mechanism (staged financing) that allows for opportunism. Even though venture capitalists often do not contract for outright control of a portfolio company, either through majority share ownership or control of the board of directors, venture capitalists exert tremendous power over the entrepreneur because of staged financing. As noted by Paul Gompers, “The role of staged capital infusion is analogous to that of debt in highly leveraged transactions, keeping the owner/manager on a ‘tight leash’ and reducing potential losses from bad decisions.”<sup>75</sup>

Entrepreneurs have no effective contractual counterweight to staged financing. Even if they have nominal control of their company, challenging a venture capitalist will not only ensure that the entrepreneur does not receive funding from that venture capitalist but may doom the entrepreneur with other venture capitalists. The fact that entrepreneurs are willing to cede such power to venture capitalists suggests either that they are irrational<sup>76</sup> or that they are protected by some mechanism beyond the explicit terms of the contract. The most likely source of such extra-contractual protection is the market for reputation, which is discussed in Part IV.

## 2. Addressing Adverse Selection

The entrepreneur’s only effective contractual protection against adverse selection (which can be combated after entering a venture capital contract only by terminating the relationship) is discretionary stock redemption. Discretionary stock redemption provisions allow entrepreneurs to repurchase the stock sold to venture capitalists at a predetermined price. Mark Suchman found that discretionary stock redemption provisions were common in weak, pre-programmed, and legalistic contracts, but they are not usually found in close or flexible contracts—the most common modern forms of venture capital agreements.<sup>77</sup> Indeed, discretionary stock redemption provisions are sufficiently rare in modern venture capital contracts that many venture capitalists claim never to have seen them.<sup>78</sup>

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Basically, this system allocated all financial gain to the holders of Common Stock until they “caught up” with the holders of Preferred Stock. The consideration for this was their “sweat equity,” the amount of time they worked for the corporation before they “earned” their shares under the typical vesting system.

*Id.* at 8-11.

<sup>75</sup> See Gompers, *Optional Investment*, *supra* note 16, at 1462.

<sup>76</sup> See *infra* Part III.D (discussing the “gambler’s mentality”).

<sup>77</sup> See Suchman, *supra* note 45, at 219-20.

<sup>78</sup> At a recent conference on venture capital in Portland, Oregon, Gerard H. Langelier of Olympic Venture Partners observed: “You can divorce your spouse. You

Even if a discretionary stock redemption provision was proposed, venture capitalists would be unenthusiastic. Such provisions limit a venture capitalist's ability to decide the form of its investment.<sup>79</sup> For example, if a company were contemplating the exercise of a discretionary right of redemption, it is safe to assume that the value of the company had risen and the venture capitalist would convert preferred shares into common shares to preserve an interest in the company.<sup>80</sup> Although the venture capitalist would remain interested in the company, many of the control mechanisms previously awarded to the venture capitalist would evaporate upon conversion.

The absence of discretionary stock redemption provisions from most modern venture capital contracts suggests that the cost to the entrepreneur of protecting against adverse selection through contract are greater than the risks. This in turn suggests that entrepreneurs have other methods of protecting against adverse selection. The most likely candidate for such protection is the market for reputation, discussed in Part IV.

### C. *Lawsuits Over Venture Capital Contracts*

Conventional wisdom has it that lawsuits in the venture capital community are rare.<sup>81</sup> According to this view, entrepreneurs are loath to sue their venture capitalists for fear of gaining a reputation for recalcitrance and never receiving venture funding. On the other hand, venture capitalists are reluctant to sue entrepreneurs because they fear acquiring

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cannot divorce your investors." Gerald H. Langelier, Remarks at the Venture Oregon '97 conference sponsored by Oregon Entrepreneurs Forum (Oct. 14, 1997).

<sup>79</sup> Venture capitalists are more favorably disposed toward mandatory redemption provisions, but even these are rare in venture capital agreements because the provisions are "not viewed as a realistic alternative" for a company with little or no cash inflow. See Halloran et al., *supra* note 41, at 8-16. For other arguments against mandatory redemption from the venture capitalist's view, see *id.* at 8-17.

<sup>80</sup> See *id.* at 8-17 (observing that "corporations prefer redemption provisions exercisable at their option so that they can force the Preferred Stock to convert into Common Stock (and surrender its privileges) at some time in the future, even if the conditions for automatic conversions are not met"). George W. Dent, Jr. states that:

It is misleading . . . to assume that the investor gambles that the company's fortune will not improve, because if the company's fortune does improve, the investor's conversion right appreciates. Consequently, in venture capital deals, the corporation's option to redeem works primarily to force an investor conversion that will relieve the company of the burdens of interest (or dividend) payments and restrictive covenants.

Dent, *supra* note 44, at 1063.

<sup>81</sup> See, e.g., Jan Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 571 (1991) ("The sophisticated investors in private placements (usually venture capitalists or established companies) do not generally sue if things turn out badly, in the absence of strong evidence of common-law fraud."); Mark C. Suchman & Mia L. Cahill, *The Hired Gun as Facilitator: Lawyers and the Suppression of Business Disputes in Silicon Valley*, 21 L. & SOC. INQUIRY 679 (1996).

a reputation for abusiveness that will drive away future entrepreneurs. Regardless of whether conventional wisdom is correct,<sup>82</sup> the general flow of such cases should not provide much comfort to entrepreneurs because the courts typically treat these disputes as entirely contractual. Venture capitalists do not owe any special fiduciary duties to entrepreneurs. Two recent cases decided by Chancellor Allen of the Delaware Court of Chancery are illustrative.

In *Orban v. Field*,<sup>83</sup> the founder (Orban) of Office Mart Holdings Corp. sued the venture capitalists who had come to control the company.<sup>84</sup> The source of the dispute was a stock-for-stock merger between Office Mart and Staples, Inc. Under the terms of the merger agreement, each class of Office Mart stock was required to approve the merger by a ninety percent vote so that Staples could account for the merger as a pooling of interests. Orban, Office Mart's largest holder of common stock, opposed the merger because the common stockholders of Office Mart were to receive no payment for their shares; the liquidation preferences of the preferred stockholders consumed the entire purchase price. Although the holders of preferred stock owned sufficient shares of common stock and warrants to control ninety percent of the vote, the company needed to amend the certificate of incorporation (by increasing the number of authorized shares) and take other actions (including the non-pro-rata redemption of preferred shares to provide funds for the exercise of the warrants) to facilitate the exercise of the warrants. As a result of these actions, Orban's share of common stock was diluted below ten percent, and all classes of stock of Office Mart approved the merger.

Orban claimed that the directors of Office Mart breached their fiduciary duties to the holders of Office Mart common stock by facilitating the exercise of the warrants. Chancellor Allen held that the directors did not breach a duty by honoring a contractual right of the preferred stockholders, even if that right injured the common stockholders:

Whereas the preferred stockholders had existing legal preferences, the common stockholders had no legal right to a portion of the merger consideration under Delaware law or the corpo-

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<sup>82</sup> It is far from obvious that the reputational constraints on venture capitalists and entrepreneurs are much greater than other potential litigants in American society. Perhaps the relatively modest appeal to litigation results from the moderating role of venture capital lawyers. See generally Suchman & Cahill, *supra* note 81.

<sup>83</sup> No. CIV.A.12820, 1997 WL 153831 (Del. Ch. Apr. 1, 1997).

<sup>84</sup> Of the five defendants, two were venture capitalists. William Field was the Chairman of Prudential Equity Investments Corp., which is the corporate general partner of Prudential Venture Partners II, and Jay McGoodwin was the Senior Vice President of Security Pacific Venture Capital Group, which held shares of preferred stock in Office Mart through First Small Business Investment Company. *Id.* at \*7 n.19. One of the other defendants was Stephen T. Westerfield, an experienced retail executive who replaced the founder of Office Mart as CEO. *Id.* at \*2 n.3. The remaining two defendants were the two companies involved in the merger, Office Mart and Staples. Ironically, the founder of the company describes himself as a "venture capitalist." *Id.* at \*2.

rate charter. The Staples' transaction appeared reasonably to be the best available transaction. Mr. Orban's threat to impede the realization of that transaction by the corporation was thwarted by legally permissible action that was measured and appropriate in the circumstances.<sup>85</sup>

In *Orban* the contract favored the venture capitalists, but that is not always the case. In *Equity-Linked Investors, L.P. v. Adams*,<sup>86</sup> Chancellor Allen again addressed a breach of fiduciary duty claim in the context of a venture capital contract. In *Adams*, however, the claim was made by the venture capitalists, not the entrepreneur. The focus of attention in *Adams* was Genta Incorporated, a bio-pharmaceutical company that owned several promising technologies but had never turned a profit. The company was running out of operating funds and sought new sources of capital. The venture capitalists, who owned preferred stock with a liquidation preference, wanted to liquidate the company. The entrepreneurs, on the other hand, owned common stock, and wanted to continue the business in the hope of someday obtaining a return. Because the terms of the preferred stock did not provide for the right to force liquidation, the holders of preferred stock were forced to argue that the directors breached a fiduciary duty by pursuing additional financing. Chancellor Allen rejected this claim:

While the board in these circumstances could have made a different business judgment, in my opinion, it violated no duty owed to the preferred in not doing so. The special protections offered to the preferred are contractual in nature. The corporation is, of course, required to respect those legal rights. But, aside from the insolvency point just alluded to, generally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of the common stock—as the good faith judgment of the board sees them to be—to the interests created by the special rights, preferences, etc., of preferred stock, where there is a conflict.<sup>87</sup>

The lesson of *Orban* and *Adams* is that courts are inclined to enforce the bargain between venture capitalists and entrepreneurs.<sup>88</sup>

#### D. The "Gambler's Mentality" in Venture Capital Contracts

The foregoing subparts have attempted to explain the structure of venture capital contracting from the standpoint of a rational, value-

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<sup>85</sup> *Id.* at \*9.

<sup>86</sup> No. CIV.A.15513, 1997 WL 225708 (Del. Ch. Apr. 25, 1997).

<sup>87</sup> *Id.* at \*2 (citation omitted).

<sup>88</sup> See also *Macksey v. Egan*, 633 N.E.2d 408 (Mass. App. Ct. 1994) (holding that venture capitalists had exercised "best efforts" as required by contract); *Capital Investments, Inc. v. Whitehall Packing Co., Inc.*, 280 N.W.2d 254 (Wis. 1979) (holding that an ambiguous financing agreement would be construed against the venture capitalists who drafted it).



maximizing entrepreneur. Another view of venture capital financing is that entrepreneurs are not rational, but are overly optimistic. Joseph Bankman, in attempting to explain the failure of Silicon Valley startups to maximize tax benefits through organizational structure, considered the possibility that investors and venture capitalists did not concern themselves with foregone tax benefits because they had a "gambler's mentality."<sup>89</sup> In other words, they expected the success of every new venture to dwarf any adverse tax consequences, so they simply did not concern themselves with the issues.

This view does not carry much water for the particular problem raised by Bankman,<sup>90</sup> but it may offer some guidance to the current problem. Manuel Utset, for example, relies heavily on this view of entrepreneurs as overly optimistic to explain supposed shortfalls in venture capital contracts.<sup>91</sup> Even if this sort of irrationality can explain some venture capital contracts, however, it seems unlikely to explain the fact that almost all venture capital contracts fall short of fully protecting the entrepreneur. Jokes regarding engineers notwithstanding,<sup>92</sup> the idea that entrepreneurs would consistently enter contracts that are facially so lopsided strains credulity.

A more plausible account of venture capital contracts is offered by the theory that the market for reputation among venture capitalists provides protection to entrepreneurs beyond the explicit terms of the contracts. That theory is examined in more detail in the next Part.

#### IV. VENTURE CAPITALIST REPUTATION IN THE INFORMATION AGE

The Web will change the world. One commentator recently wrote that:

[T]he transformations brought forth by the technology industry over the past 20 years, exemplified by the invention of the microprocessor, the advent of the personal computer, the rise of

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<sup>89</sup> Joseph Bankman, *The Structure of Silicon Valley Start-ups*, 41 UCLA L. REV. 1737, 1764-65 (1994).

<sup>90</sup> Bankman writes:

The difficulty with the explanation lies in the assumption that maximizing tax benefits is inconsistent with a preference for high-risk, high-return investments. . . . [A] given limited partnership investment fund may finance scores of start-ups. Whatever their level of optimism, venture capitalists know, statistically, that . . . all of these start-ups will show early tax losses. All else equal, better utilization of tax benefits should enable venture capitalists to increase their investors' after-tax return without increasing the level of risk. Alternatively, venture capitalists could reduce the before-tax risk level (and hence return) of investments and use the additional (risk-free) tax benefits to produce a portfolio that provides investors with their current after-tax return with less risk.

*Id.* at 1765.

<sup>91</sup> See Utset, *supra* note 8, at 55-59.

<sup>92</sup> See generally SCOTT ADAMS, *THE DILBERT PRINCIPLE* (1996).

Microsoft and fall of IBM, are mere gusts of wind compared to the tornado, the hurricane, and the tsunami wave of the Internet.<sup>93</sup>

This view is widely held, but few people pretend to have a solid grasp of *how* the world will change. Venture capital contracting has been in a constant state of flux over the past four decades, and it seems likely that it will not be immune from the effects of the Web. This final part of the Article addresses the question: How (if at all) will the Web change venture capital contracting?

The answer to that question begins with an examination of the market for reputation among venture capitalists. Moral hazard and adverse selection are both caused by informational asymmetries between the entrepreneur and venture capitalist.<sup>94</sup> Although these problems may be mitigated to some extent by the venture capital contracts, those contracts routinely fall short of fully protecting entrepreneurs. The market for reputation can assist in filling the gap. For moral hazard, reputational concerns provide incentives to venture capitalists to refrain from opportunistic behavior.<sup>95</sup> With respect to adverse selection, on the other hand, reputation is employed as a sorting device.<sup>96</sup>

The market for reputation will perform its gap-filling function, however, only to the extent that it is informationally and fundamentally efficient. In other words, it must provide information to entrepreneurs quickly (informational efficiency) and accurately (fundamental efficiency). The Web has the potential to make the market for reputation more efficient.

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<sup>93</sup> J. Neil Weintraut, *Introduction*, in ROBERT H. REID, *ARCHITECTS OF THE WEB: 1,000 DAYS THAT BUILT THE FUTURE OF BUSINESS* xiii-iv (1997).

<sup>94</sup> See *supra* Part II.C-D.

<sup>95</sup> See *infra* Part IV.A.

<sup>96</sup> Reputation is not the only nonlegal sanction that encourages performance of the venture capital contracts. David Charny describes "relationship-specific prospective advantage" and "psychic and social goods" as other forms of nonlegal sanction. David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 373, 393 (1990). With respect to the former, Charny observes:

A particularly important and common form of relationship-specific prospective advantage is the opportunity to deal again with the same transactor—the "repeat deal." The asset posted is the value of future dealings; if one party breaches, the other party will terminate the relationship and refuse to deal with the breacher again, destroying the asset.

*Id.* Although the repeat deal may arise in a venture capital context, it appears to be much less important in the venture capital community than in some other settings. Likewise, "psychic and social goods"—such as "loss of opportunities for important or pleasurable associations with others, loss of self-esteem, feelings of guilt, or an unfulfilled desire to think of himself as trustworthy and competent"—also may play some role in the venture capital relationship. *Id.* at 393-94. Nevertheless, both of these nonlegal sanctions seem less important than reputation and, therefore, will not be analyzed in detail here.

### A. *The Market for Venture Capitalist Reputation*

A venture capitalist's ability to provide effective nonfinancial assistance to its portfolio companies is highly dependent on its store of "reputational capital."<sup>97</sup> Indeed, several scholars have argued that only the most prestigious venture capital firms truly add value to portfolio companies.<sup>98</sup> Bernard Black and Ronald Gilson describe the importance of reputation as follows:

Talented managers are more likely to invest their human capital in a company financed by a respected venture capital fund, because the venture capitalist's participation provides a credible signal about the company's likelihood of success. Suppliers will be more willing to risk committing capacity and extending trade credit to a company with respected venture capital backers. Customers will take more seriously the company's promise of future product delivery if a venture capitalist both vouches for and monitors its management and technical process.... Later on, the venture capitalist's reputation helps to attract a high quality underwriter for an initial public offering of the portfolio company's stock (Lerner, 1994a; Megginson and Weiss, 1991).<sup>99</sup>

The reputation of the venture capitalists probably matters most in the most important area: going public. Empirical studies suggest that firms backed by well-respected venture capitalists are able to sell shares to the public at higher prices than other firms.<sup>100</sup>

The argument that the market for reputation curbs opportunism and incompetence relies on the assumption that the actions of venture capitalists are observable to future entrepreneurs or those who counsel future entrepreneurs regarding their choice of venture capitalists. In short, the argument relies on the efficiency of the market for reputation. Although the analogy to the efficient capital markets hypothesis might easily be carried too far, it does not seem an exaggeration to state that the market for reputation compiles information about venture capitalists and summarizes that information in a measure called "reputation" in a manner similar to that in which capital markets assemble information about companies and summarize that information in a measure called "price."<sup>101</sup> Obviously, stock prices are more transparent than reputations,

<sup>97</sup> Black & Gilson, *supra* note 3, at 254.

<sup>98</sup> See, e.g., Joseph Rosenstein et al., *The CEO, Venture Capitalists and the Board*, 8 J. BUS. VENTURING 99 (1993).

<sup>99</sup> Black & Gilson, *supra* note 3, at 254.

<sup>100</sup> Christopher B. Barry et al., *The Role of Venture Capital in the Creation of Public Companies: Evidence From the Going Public Process*, 27 J. FIN. ECON. 447, 464 (1990); William L. Megginson & Kathleen A. Weiss, *Venture Capitalist Certification in Initial Public Offerings*, 46 J. FIN. 879 (1991).

<sup>101</sup> The fact that reputation is not quantified does not diminish the power of the analogy—as far as it goes—because the end measure (whether it is reputation or price) is not the inquiry's focus. Instead, the inquiry is designed to provide a coher-

not only because stock prices are quantified but also because they are displayed for all of the world to see in a single, centralized location (either an exchange or, in the case of the over-the-counter market, a computer screen). Still, the analogy is useful because it focuses attention on the various components of the process by which reputations are made. Indeed, in their influential work describing the mechanisms of capital market efficiency, Ronald Gilson and Reinier Kraakman recognized the aptness of the analogy between capital markets and other markets:

[T]he extent of informational efficiency is surely a central determinant of the pricing behavior and institutional underpinnings of all markets, and not merely of the securities markets. Our analysis, then, is only part of a broader inquiry into the functioning of markets in general. That inquiry, stated generically, examines the joint interaction of product or service markets and the associated markets in information about the product or service.<sup>102</sup>

Following Gilson and Kraakman, a thorough understanding of venture capitalist reputation would require an examination of two markets: the market for information about venture capitalists and the associated market for venture capitalist reputation. The market for information "determines how information is initially distributed,"<sup>103</sup> while the market for reputation determines "how (and how much) efficiency is achieved given the initial distribution of information."<sup>104</sup> This Article will not fully describe these two markets, but rather will sketch the outlines of those markets as a means of defining a future role for the Web.

Unlike capital markets, reputational markets have rarely been the subject of direct analysis.<sup>105</sup> One notable exception, because of its close relationship to this Article, is Paul Gompers' work on grandstanding in the venture capital industry.<sup>106</sup> Gompers argues convincingly that "young venture capital firms have incentives to grandstand, *i.e.*, they take actions that signal their ability to potential investors. Specifically, young venture

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ent theory of the process by which information is reflected in a summary measure. The fact that one summary measure is stated in terms of dollars and another is unquantified should not obscure the fact that each must be generated by a similar process.

<sup>102</sup> Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 643 (1984).

<sup>103</sup> *Id.* at 593.

<sup>104</sup> *Id.*

<sup>105</sup> This is the most obvious difference in the academic literature between markets for reputation and capital markets. While capital markets have been the object of numerous empirical and theoretical studies, markets for reputation are rarely studied in any fashion. *But see* Charny, *supra* note 96 (discussing nonlegal sanctions, including reputation, that assist in the enforcement of commercial transactions); Louis A. Kornhauser, *Reliance, Reputation, and Breach of Contract*, 26 J.L. & ECON. 691 (1983) (analyzing reputational markets via contract).

<sup>106</sup> *See* Gompers, *Grandstanding*, *supra* note 34.

capital firms bring companies public earlier than older venture capital firms in an effort to establish a reputation and successfully raise capital for new funds.<sup>107</sup> Although Gompers focuses on the effect of reputation in venture capital fundraising, his findings raise questions about venture capital investing.<sup>108</sup> For example, why do entrepreneurs accept investments from young venture capital firms that grandstand? It is still unclear whether grandstanding has negative long-term effects on venture-backed companies, but Gompers' data suggests that investors in venture capital funds may bear much of the cost of grandstanding through lower equity stakes in the portfolio companies.<sup>109</sup>

In the context of venture capital investing, most commentators acknowledge a role for reputation, but the analysis tends to be anecdotal. For example, Bernard Black and Ronald Gilson claim that the market for reputation is efficient based on the following attributes of the venture capital community: (1) there are relatively few venture capitalists, (2) venture capitalists are geographically concentrated, (3) venture capitalists often specialize in companies that are geographically proximate to the offices of the venture capitalists, and (4) venture capitalists are repeat players, both in investing and fundraising.<sup>110</sup> Although Black and Gilson assume that information is transmitted efficiently in such a tight-knit community—a claim that seems to comport with anecdotal accounts of Silicon Valley—they do not attempt to describe in detail “how information is initially distributed”<sup>111</sup> or “how (and how much) efficiency is achieved given the initial distribution of information.”<sup>112</sup> In short, they do not offer a theory about how entrepreneurs obtain information regarding venture capitalist reputation and whether the information that they obtain is credible.

The debate over the role of reputation in venture capital contracting must ultimately be informed by empirical evidence about the processes used by entrepreneurs to locate and evaluate venture capitalists. Nevertheless, the study of capital markets suggests two principles that will advance the understanding of the market for venture capitalist reputation.

First, “[t]he lower the cost of particular information, the wider will be its distribution, the more effective will be the . . . market mechanism operating to reflect it in [reputation], and the more efficient will be the market with respect to it.”<sup>113</sup> Gilson and Kraakman identify three categories of information costs: acquisition, processing, and verification.<sup>114</sup>

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<sup>107</sup> *Id.* at 134.

<sup>108</sup> Gompers acknowledges this connection. *See id.* at 155.

<sup>109</sup> *Id.* at 150-53.

<sup>110</sup> Black & Gilson, *supra* note 3, at 256-57.

<sup>111</sup> Gilson & Kraakman, *supra* note 102, at 593.

<sup>112</sup> *Id.*

<sup>113</sup> *Id.* at 593.

<sup>114</sup> *Id.* at 594.

Without delving into the nuances of each category, it is reasonable to assume that entrepreneurs face substantial information costs and that reducing such costs will improve the efficiency of the market for venture capitalist reputation.

Second, if the market for venture capitalist reputation is to operate efficiently, mechanisms must exist to convey information about reputation to entrepreneurs. Information about venture capitalist reputation comes primarily from three sources: venture capitalists (self promotion), intermediaries (*i.e.*, lawyers, accountants, other entrepreneurs, and friends), and the media (particularly those publications such as *Entrepreneur*, *The Red Herring*, and *Inc.*, which focus a great deal of attention on the venture capital community). Like the mechanisms of capital market efficiency described by Gilson and Kraakman, these mechanisms “facilitate the eventual ‘reflection’ of information into” reputation.<sup>115</sup> Moreover, like the information necessary to determine price in capital markets, the information that must be incorporated in reputation includes not only information that is well known to members of the venture capital community but also information that is known to only a few people.

Despite these similarities between capital markets and the market for venture capitalist reputation, other factors call the efficiency of the market for venture capitalist reputation into question. The most apparent reason to suspect inefficiency in this market is the absence of a centralized location—like a stock exchange—where various assessments of venture capitalist reputation can be “traded.” Gilson and Kraakman identify four “general forms of mechanisms” that transmit information in capital markets: universally informed trading, professionally informed trading, derivatively informed trading, and uninformed trading.<sup>116</sup> The emphasis on trading is not coincidental. Only by trading is information from disparate sources gathered and evaluated. By trading in a centralized location, capital markets assemble all relevant information into a single measure. Venture capital markets lack this feature. Thus, one would expect much different measures of venture capitalist reputation from transaction to transaction.

Other, less obvious, differences between capital markets and the reputational markets point toward inefficiencies in the market for venture capitalist reputation. For example, people who have information regarding a venture capitalist—including, most importantly, entrepreneurs who have dealt with the venture capitalist—will not necessarily have an incentive to convey that information to future entrepreneurs. This is in a stark contrast to the capital markets, where people who have private information regarding stock prices may profit by bringing that information to the market. In addition, a venture capitalist is under no

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<sup>115</sup> *Id.* at 588-89.

<sup>116</sup> *Id.* at 566.

obligation—comparable to the disclosure provisions of the federal securities law—to provide information to the public regarding its reputation. Finally, intermediaries such as lawyers, accountants, and other entrepreneurs may have varied reasons (including self-interested reasons) for recommending one venture capitalist over another, and those reasons may bear no relationship to the “fundamentals” of the venture capitalist. In short, it seems likely that even in a close community such as Silicon Valley, other structural features of the market for venture capitalist reputation inhibit the efficiency of that market.

### *B. Venture Capital on the Web*

The Web promises to improve the efficiency of both the market for reputation and the related market for information. The efficiency of the market for reputation should be improved by partially centralizing the source of information, and the efficiency of the market for information should be improved by lowering the cost of information. To facilitate consideration of the Web's effect on venture capital contracting, the following sections employ the services of a hypothetical entrepreneur named Kim, a software engineer who has worked for several years for an established technology firm in Silicon Valley. Pursuing a longtime dream, she left her employer on good terms several months ago to develop her own revolutionary ideas for Internet applications. She is now the chief executive officer of a new technology company, which she founded with the assistance of three associates from her former employer.

She has been working with an attorney at the Venture Law Group, a prominent law firm located in Menlo Park, California.<sup>117</sup> Although her attorney has been very helpful in shepherding her through the initial stages of company formation, she feels compelled to educate herself generally about the legal and business issues that lie ahead. But a steady diet of fourteen- to twenty-hour days building her new firm leaves no time for formal education and little time to explore the stacks at the local public library. Nevertheless, she knows that a virtual library sits on

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<sup>117</sup> The firm's home page announces:

Venture Law Group is a 70+ lawyer law firm which specializes in representing deal-intensive technology companies, both public and private, and the venture capital funds and investment banking firms that finance them.

Our headquarters are located in Menlo Park, California, with more than 50 venture capital funds within a half mile or so of our building.

Founded by groups of senior technology lawyers from three of Silicon Valley's leading law firms (Wilson, Sonsini, Goodrich & Rosati, Brobeck, Phleger & Harrison, and Morrison & Foerster), VLG concentrates on helping technology companies get started, find financing, and structure and grow their businesses.

*Venture Law Group* (visited Mar. 21, 1998) <<http://www.venlaw.com>>.

top of her desk, and she decides to explore the world of venture capital by searching the Web.

Searching the Web for information can be an epiphany. Through the popular Alta Vista Search Network<sup>118</sup> using the words "venture capital," Kim retrieves over 23,000 documents! She finds that Excite,<sup>119</sup> Infoseek,<sup>120</sup> and Yahoo!<sup>121</sup> all have pages dedicated to links to venture capital firms and other resources on venture capital. She quickly realizes that anyone seeking a crash course in venture capital could hardly do better than a few hours on the Web.

### 1. General Information

As a first-time entrepreneur, Kim wants to begin at the beginning. She quickly locates several organizations that provide information about the venture capital process generally. These materials serve as a useful introduction to the unique world of venture capital. Similar materials are sometimes provided on the Web by venture capital firms, discussed below. Although Kim realizes that she will want more tailored advice once the process begins in earnest, these Web sites provide many of the tools necessary for a more informed and detailed search for venture capital.

The Capital Venture Web site attempts to answer the question "what is venture capital?" with helpful materials under the *Venture Capital 101* link.<sup>122</sup> The materials include additional links entitled *Overview of the Financial Industry*,<sup>123</sup> *Buy-Side of the Financial Industry*,<sup>124</sup> *Stages of Venture Capital Investment*,<sup>125</sup> and *Understanding Venture Capital*.<sup>126</sup> The Venture Capital Resource Library (VCRL) links users to venture capital firms (organized both alphabetically and by industry sector), law firms, accounting firms, and other service providers; a business plan template that entrepreneurs

<sup>118</sup> See Alta Vista, *A Digital Internet Service* (visited Mar. 21, 1998) <<http://altavista.digital.com>>.

<sup>119</sup> See *Excite Business & Investing* (visited Mar. 21, 1998) <[http://quicken.excite.com/small\\_business/answers/?channel=0&topic=1&subtopic=22#8](http://quicken.excite.com/small_business/answers/?channel=0&topic=1&subtopic=22#8)>.

<sup>120</sup> See *Infoseek Business Channel* (visited Mar. 21, 1998) <[http://www.infoseek.com/Business/Small\\_Business/Finance\\_a\\_business/Venture\\_capital?tid=451](http://www.infoseek.com/Business/Small_Business/Finance_a_business/Venture_capital?tid=451)>.

<sup>121</sup> See *Yahoo!* (visited Mar. 21, 1998) <[http://www.yahoo.com/Business\\_and\\_Economy/Finance\\_and\\_Investment/Financing/Corporate\\_Financing/Venture\\_Capital](http://www.yahoo.com/Business_and_Economy/Finance_and_Investment/Financing/Corporate_Financing/Venture_Capital)>.

<sup>122</sup> *Capital Venture* (visited Mar. 21, 1998) <<http://www.capitalventure.com/cvindustry.htm>>.

<sup>123</sup> (visited Mar. 21, 1998) <[http://www.capitalventure.com/cvindustry.htm#Overview\\_Financial](http://www.capitalventure.com/cvindustry.htm#Overview_Financial)>.

<sup>124</sup> (visited Mar. 21, 1998) <[http://www.capitalventure.com/cvindustry.htm#Buy\\_Side](http://www.capitalventure.com/cvindustry.htm#Buy_Side)>.

<sup>125</sup> (visited Mar. 21, 1998) <<http://www.capitalventure.com/cvindustry.htm#Stages>>.

<sup>126</sup> (visited Mar. 21, 1998) <<http://www.capitalventure.com/cvindustry.htm#UnderstandingVC>>.



can use to write a business plan; securities and tax laws; and financial market information.<sup>127</sup>

In addition to obtaining information online, Kim finds that she can use the Web to contact other entrepreneurs or industry groups that may lend assistance. For example, American Entrepreneurs for Economic Growth—which boasts over 10,000 emerging growth companies as members—hosts a Web site with information about the group's activities, including a newsletter containing recent developments of interest to emerging growth companies.<sup>128</sup> Many other sites promote interaction among entrepreneurs.<sup>129</sup>

## 2. Venture Capital Firms

It doesn't take Kim long to find a host of Web sites featuring venture capital firms. All of the sites contain basic information about the firms: physical locations, investment specializations, and investment strategies. In addition, many of the sites contain extensive information about partners in the firm and the firm's portfolio companies. Finally, all of the sites contain contact information, often in the form of an e-mail address accessible by clicking a link available on the site. Some even outline criteria for submission of a business plan.

Kim observes that most of the Web sites seem to be directed at entrepreneurs, and she wonders whether the venture capital firms really expect to attract clients through a Web page.<sup>130</sup> Her attorney is busy contacting venture capitalists on her behalf, and she had the impression that most successful entrepreneurs met venture capitalists through such an intermediary.

Many of the Web sites constructed by venture capital firms provide more than information about the firms. They also attempt to educate

<sup>127</sup> *Venture Capital Resource Library* (visited Mar. 21, 1998) <<http://www.vfinance.com>>.

<sup>128</sup> The Web site proclaims: "AEEG's mission is to serve as a united voice for entrepreneurs on public policy issues that affect emerging growth companies and to strengthen public policy support through education about the critical role emerging growth companies play in the U.S. economy—i.e., job creation, technology development, innovation and global competitiveness." AEEG, *General Information* (visited Feb. 11, 1998) <<http://www.aeeg.org/fact.html>>.

<sup>129</sup> See, e.g., *The Entrepreneur Network* (visited Mar. 21, 1998) <<http://TENonline.org>>; *MIT Entrepreneurs Club* (last modified Nov. 1, 1995) <<http://www.mit.edu:8001/activities/e-club/e-club-home.html>>; *The Vine, Venture Information Network for Entrepreneurs* (visited Mar. 21, 1998) <<http://www.thevine.com>>.

<sup>130</sup> The answer to this question seems to be a resounding "Yes." In an informal survey of venture capital firms on the Web, which appears in the Appendix, the firms were asked, "Why did your firm construct a Web page?" Given several nonexclusive options, over 80% responded, "We expect entrepreneurs to locate our firm through the Web page." In addition, over 90% checked, "We expect entrepreneurs who have contacted our firm through other means to use the Web page as a source of additional information about our firm." Moreover, over 97% of the responding firms indicated that entrepreneurs had contacted the firm through the Web page. See *infra* Appendix.

entrepreneurs about the venture capital process. Kim is especially impressed by a site hosted by Accel Partners,<sup>131</sup> which provides helpful information on *Advice for First Time Entrepreneurs*,<sup>132</sup> *How to Win a Venture Capitalist—the five characteristics we look for in entrepreneurs*,<sup>133</sup> *Challenges in Building World Class Technology Companies*,<sup>134</sup> and *CommunicationsWeek and InternetWeek Columns*.<sup>135</sup> In addition to these materials, the Accel site provide links to other sites containing information about venture capital.<sup>136</sup> Alliance Technology Ventures provides links to articles,<sup>137</sup> books,<sup>138</sup> and other information about venture capital, as well as detailing the “Top Ten Myths About Venture Capital”<sup>139</sup> Kim locates many sites hosted by venture capital firms that provide resource links for entrepreneurs.<sup>140</sup>

### 3. News Publications

Once Kim’s attorney succeeds in setting up a meeting with a partner at Sequoia Capital—a prominent venture capital firm located in Menlo Park—Kim begins her search in earnest. Of course, she knows all about Sequoia’s biggest success, Cisco Systems. Everyone in Silicon Valley knows about Cisco Systems, which has had an average annual return of 177% since 1987!<sup>141</sup> But Kim wants more detailed information.

<sup>131</sup> Accel Partners, *For Entrepreneurs* (visited Mar. 21, 1998) <<http://www.accel.com/entrepreneurs>>.

<sup>132</sup> (visited Mar. 21, 1998) <<http://www.accel.com/entrepreneurs/advice.html>>.

<sup>133</sup> (visited Mar. 21, 1998) <[http://www.accel.com/entrepreneurs/how\\_to\\_win.html](http://www.accel.com/entrepreneurs/how_to_win.html)>.

<sup>134</sup> (visited Mar. 21, 1998) <[http://www.accel.com/entrepreneurs/world\\_class.html](http://www.accel.com/entrepreneurs/world_class.html)>.

<sup>135</sup> (visited Mar. 21, 1998) <<http://www.accel.com/entrepreneurs/articles.html>>.

<sup>136</sup> *Id.*

<sup>137</sup> Alliance Technology Ventures, *ATV Library* (visited Mar. 21, 1998) <<http://www.atv.com/links/articles.html>>.

<sup>138</sup> Alliance Technology Ventures, *Good Books for Entrepreneurs* (visited Mar. 21, 1998) <<http://www.atv.com/links/books.html>>.

<sup>139</sup> Alliance Technology Ventures, *Top Ten Myths about Venture Capital* (visited Mar. 21, 1998) <<http://www.atv.com/links/library/topten.html>>. The myths are:

1. Venture capitalists want to take control of my company.
2. Venture capitalists load their deals with all sorts of unfair terms.
3. Venture capitalists are only interested in the numbers.
4. Venture capitalists have unrealistic performance expectations.
5. Venture capitalists are always harping on “exit strategy.”
6. Venture capitalists give me a lower valuation than a private placement.
7. Venture capitalists won’t invest in small deals like mine.
8. Venture capitalists are too quick to pull the plug when trouble starts.
9. Venture capitalists don’t like signing non-disclosure agreements.
10. Venture capitalists are impossible to get on the phone.

*Id.*

<sup>140</sup> See, e.g., Draper Fisher Jurvetson, *Resources for the Entrepreneur* (visited Mar. 21, 1998) <<http://www.DraperVC.com/Resources.html>> (listing various resources for the entrepreneur); *Venture Capital Online* (visited Mar. 21, 1998) <<http://www.vcapital.com>> (providing networking and an information exchange between investors and entrepreneurs).

<sup>141</sup> Anthony B. Perkins, *Don Valentine’s Next Big Bet Is on C-Cube Microsystems*, 11 RED HERRING ONLINE (June 1994) <<http://www.herring.com/mag/issue11/bet.html>>.

Her attorney has worked with the Sequoia partner before, and he provides useful pointers about the partner's style. He gives Kim detailed instructions about what to expect at the first meeting and mentions in passing that she will be on her own. Like many venture capitalists, this one does not like to have the attorney present at the first meeting. When Kim learns this news, her desire for information about Sequoia increases, and she turns back to the Web.

Sequoia's Web site is fairly predictable,<sup>142</sup> but through it Kim finds that Sequoia has financed two other firms where she has friends. She makes a note to call them and ask about their experiences. As expected, Sequoia provides no negative information (the type of information that might be most useful to her).<sup>143</sup> She is looking for a more objective view, and she realizes that Sequoia has probably attracted some attention over the years from the local financial press.

Several news publications follow the venture capital community closely. *The Red Herring* is a magazine that bills itself as "the premier provider of business information for the technology and entertainment industries." Naturally, many of its stories relate to the venture capital industry. The companion Web site, called *Herring.com*,<sup>144</sup> is searchable back to 1993 and contains articles about many venture-backed companies and the venture capital firms that financed them. Similar online services are provided by magazines such as *Upside*,<sup>145</sup> *Inc.*,<sup>146</sup> *Entrepreneurial Edge*,<sup>147</sup> *ZDNet*,<sup>148</sup> and *Worth*.<sup>149</sup>

Kim begins her search at *Herring.com*, where she locates an article describing the different policies of venture capitalists with respect to ownership by entrepreneurs.<sup>150</sup> The article warns that Jim Clark, the legendary founder of Silicon Graphics and Netscape, learned about venture capital in the school of hard knocks:

When you talk to Jim Clark it is clear that he still harbors some resentment for giving up 40% of his stock in Silicon Graphics to The Mayfield Fund and the other first-round VCs for only

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<sup>142</sup> See *Sequoia Capital* (visited Mar. 21, 1998) <<http://www.sequoiacap.com/index.shtml>>.

<sup>143</sup> For example, the Web site for the venture capital firm Burr, Egan, Deleage & Co. does not indicate that the firm provided financing for Discovery Toys. See *Burr, Egan, Deleage & Co.* (last modified May 21, 1997) <<http://www.bedco.com>>. The omission is understandable because the founder of Discovery Toys sued Burr Egan. See Nancy Rutter, *Greer v. Nemeth, INC.*, July 1990, at 76.

<sup>144</sup> *Welcome to Red Herring Online* (visited Mar. 21, 1998) <<http://www.herring.com>>.

<sup>145</sup> See *Upside* (visited Mar. 21, 1998) <<http://www.upside.com>>.

<sup>146</sup> See *Inc. Online: The Web Site for Growing Companies* (visited Mar. 21, 1998) <<http://www.inc.com>>.

<sup>147</sup> See *Entrepreneurial Edge Online* (visited Mar. 21, 1998) <<http://www.edgeonline.com>>.

<sup>148</sup> See *Zdnet* (visited Mar. 21, 1998) <<http://www.zdnet.com>>.

<sup>149</sup> See *WorthOnline-Financial Intelligence* (visited Mar. 21, 1998) <<http://www.worth.com>>.

<sup>150</sup> Anthony B. Perkins, *You Too Can Be a Winner!*, 32 RED HERRING ONLINE (June 1996) <<http://www.herring.com/mag/issue32/angler.html>>.

\$800,000. "By the time SGI went through a couple of public offerings, I ended up with only 1% of the company. In retrospect, that kind of hurts," Mr. Clark told *The Herring* last fall.<sup>151</sup>

Fortunately, Kim thinks to herself, she is not scheduled to meet with the Mayfield Fund. According to the article, she will be much happier with Sequoia Capital, which has a long track record, having financed Apple, Oracle, Cisco Systems, and Yahoo!, among others:

Sequoia still makes its money the old-fashioned way. Their goal, as Sequoia partner Mike Moritz is happy to remind us, is "to start wicked infernos with a single match rather than 10 million gallons of kerosene." Translation: Sequoia has a long history of launching huge companies with very little capital. . . . Sequoia accomplishes this feat by preaching frugality, building business plans that focus on profitability, and keeping their entrepreneurs honest.

Mr. Moritz admits that the timing of Sequoia's investments is also critical to their success strategy. "We tend to be more focused on market growth potential than most VCs," he says. "But we don't want to invest into a market until it has developed enough to support a profitable company." As we can see with Yahoo!, this approach has terrific benefits for the people who start companies, *and* the limited partners who invest in Sequoia. So there you have it, a way for everyone to win. Isn't entrepreneurial capitalism great. . . . if it's done right?<sup>152</sup>

Of course, just because it is written in *The Red Herring* doesn't make it true. But Kim feels comforted by these war stories, and she is gaining more sophistication about the issues that are likely arise in the venture capital process.

The initial report about Sequoia is encouraging. Kim moves on. Searching *Upside.com*, she finds a recent profile of Sequoia's founder and most prominent partner, Don Valentine.<sup>153</sup> Although she is not scheduled to meet with Valentine, she is intrigued and wants to know more. *Worth* magazine features another long story about Valentine. She reads:

A dense veil of mystique and folklore surrounds the seasoned venturers who helped create the entrepreneurial petri dish of Silicon Valley. Donald Valentine, the 63-year-old founder of Sequoia Capital, is particularly decorated by mythos. There are rich tales of his volcanic boardroom proclamations and of young entrepreneurs (sometimes the stories have a salesman or a journalist) becoming so intimidated by Valentine's exacting personal style that they pass out on the table (or throw up or burst into tears). This apocrypha is more than matched by the

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<sup>151</sup> *Id.*

<sup>152</sup> *Id.*

<sup>153</sup> Karen Southwick, *He Keeps on Ticking* (last modified July 18, 1997) <<http://www.upside.com/texis/mvm/story?id=34712c1b6c>>.

verifiable stories of Valentine making himself, his stable of young genius-entrepreneurs, and many investors in his VC funds extremely rich.<sup>154</sup>

Her attorney didn't mention anything about throwing up or passing out at the meeting! Of course, this is all "apocrypha," Kim assures herself, but after reading a bit further, she finds the following "testimonial" to Don Valentine:

"Don Valentine is one of the most influential people in my life," [Trip Hawkins, founder of video game machine company 3DO] says now. "He helped me grow up as a businessman. If you can't survive the hazing Don puts you through, then you certainly can't survive the crap that comes your way as a company CEO. Even now, I wear Don Valentine in my brain. Sometimes I sense that a new idea must be crushed and people must be sent away to get their shit together—so I simply turn into Don.

"At the beginning it isn't easy," Hawkins says. "When I was writing the Electronic Arts business plan at 3000 Sand Hill, Don took me to his golf club for lunch. 'If I wanted to run your company,' he said to me, 'why in the world would I need you?' He basically announced, We are about to start a relationship in which I will savagely beat you. If you roll over, Don teaches, you won't be successful. He's kind of like the professor in the movie *The Paper Chase*. But it's hard. Entrepreneurs come from optimism. Don does not come from optimism. He's the yang to the entrepreneur's yin."<sup>155</sup>

"Hazing"? "Savagely beat you"? Professor Kingsfield? The meeting with Sequoia is sounding a lot less enticing than it did just minutes ago. But she isn't meeting with Valentine, anyway. Is she? Kim makes a note to ask her attorney whether Valentine has a habit of appearing in meetings to which he was not invited.<sup>156</sup> She also wants to know whether the other Sequoia partners imitate Valentine.<sup>157</sup> Firm culture is a powerful thing.

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<sup>154</sup> Donald Katz, *Rise of Silicon Patriots* (last modified Jan. 1996) <<http://www.worth.com/articles/Z9601F02.html>>.

<sup>155</sup> *Id.*

<sup>156</sup> The article she is reading sends a flare:

The younger partners at Sequoia say that when news of a hot young company in need of funds comes into the office, Valentine is the first to hear the fire bells and hit the north-south racetrack of a highway that is Interstate 280. He still loves to punch holes in slick presentations offered by "guys in power suits, referring to their mothers and pastors and showing slides."

*Id.*

<sup>157</sup> Again, the article suggests an answer. Referring to Michael Moritz, a young Sequoia partner, the article states, "Moritz seems to have internalized Valentine's axioms." *Id.* But later in her search, Kim finds an interview with Moritz in which he describes his partners as follows:

Don [Valentine] is a cool and very rational thinker when it comes to analyzing companies and different situations, Pierre [LaMond] has a tremendous com-

Discouraged, but realizing that she is among the fortunate few entrepreneurs who will ever land an interview with Sequoia, Kim plows on. In *Herring.com*, she finds an interview with Jerry Yang, one of the founders of Yahoo!, describing his experience with Sequoia:

The first time we sat down with Sequoia, Mike asked "So, how much are you going to charge subscribers?" and Dave and I looked at each other and said, "Well, it's going to be a long conversation." But two hours later, we convinced them that Yahoo! should be free, and I think we're the only company Sequoia's funding that has a free product. Overall, the relationship with Sequoia has been a very light-hearted one. We had heard about the big conference room with thick padded chairs and posters all over the wall of all their IPOs. But working with Moritz, who is a younger guy, made things easier. We still get strange looks when we walk around Sequoia, especially from Don Valentine, who still asks, "What are you guys doing again?" My only other interaction with Don Valentine has been trying to fix his Mosaic browser and him giving me golf tips.<sup>158</sup>

"Light-hearted"? Maybe Jerry Yang is given special treatment, but this sounds hopeful. Moving beyond the personality issues, however, Kim finds more clues about how Sequoia views the world. In an interview with *The Red Herring*, Michael Moritz (Yahoo!'s venture capitalist) is asked about the perception that Sequoia is "the Los Angeles Raiders of venture capital—the tough guys who are quicker than other firms to boot the CEO or pull the financial plug."<sup>159</sup> To Kim's chagrin, Moritz seems to agree:

We are congenitally incapable of pouring good money after bad. Some people, for their own purposes, will thrust us into a position to be harbingers of bad news to management, which is all right. But we do not want to continue propping up a company if we think its chances for success have evaporated. We would be wasting our money as individuals and wasting the money of our limited partners. There have been very few instances when we decided to stop funding a company and have regretted it.<sup>160</sup>

All of this sounds perfectly rational . . . from the viewpoint of the venture capitalist. But Kim cannot help but imagine herself at the receiv-

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petitive drive, and Gordon [Russell] radiates a friendly courtliness. Contemplating those attributes is very helpful as I think about how I should conduct myself in the venture business. But I don't believe in modeling myself after one particular bronze bust.

Anthony B. Perkins, *The Young & The Restless of Technology Finance*, 6 RED HERRING ONLINE (Nov. 1993) <<http://www.herring.com/mag/issue06/young.html>>.

<sup>158</sup> *Found You on Yahoo!*, 24 RED HERRING ONLINE (Oct. 1995) <<http://www.herring.com/mag/issue24/yahoo.html>>.

<sup>159</sup> See Perkins, *supra* note 157.

<sup>160</sup> *Id.*

ing end of the message. When she learns from the interview that Sequoia looks for “[f]rugality, competitiveness, confidence, and paranoia”<sup>161</sup> in the presidents of its portfolio companies, she muses, “Three out of four ain’t bad!”<sup>162</sup>

### C. *The Future of Venture Capital Contracting*

Kim managed to gather a fair amount of information about Sequoia Capital in a very short time. The information is largely anecdotal, but it has raised her concentration level on the issue of forced exit (one of the prominent moral hazard problems) and has caused her to wonder whether she could ever get her company back after signing an agreement with Sequoia (the adverse selection problem). Even though Kim has an attorney who is experienced in venture capital transactions, her

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<sup>161</sup> *Id.*

<sup>162</sup> Anyone who finds Kim’s information gathering process fanciful should consider a recent Price Waterhouse survey of 377 CEOs from among the world’s 2000 largest companies. Among other things, the survey found that: “Sixty-four percent indicated that they use the Internet for reasons other than e-mail. Forty-six percent of the executives personally had used the Internet five or more days out of the previous month while 27 percent had logged on more than 10 days out of the previous month.” Price Waterhouse, *Global CEOs Say Electronic Commerce Will Dramatically Impact Competition* (visited Mar. 21, 1998) <<http://www.pw.com/us/304a.htm>>. It is reasonable to assume that high-tech entrepreneurs would use the Internet more often than the CEOs surveyed. In addition, entrepreneurs consider value-added services when negotiating a venture capital investment. The following story is illustrative:

[S]tartups with the right technology and team can play VC firms against each other to win ever-higher valuations. Who, for instance, will bag Tumbleweed Software, Inc.? The Redwood City-based startup, which makes software that allows companies to send documents securely over the Internet, has pitched 20-plus Silicon Valley firms to raise \$6 million. Now, 30-year-old CEO Jeffrey C. Smith gets to handpick his investors. “At this point, everyone’s money is green,” Smith says. “Now, it’s about who would be the best partner.”

On a whiteboard, he divides his suitors into five categories: in, hot, warm, cold, and out. The first cut is easy: Hambrecht & Quist, which manages a fund for Adobe Systems Inc., will win a lead position with Bessemer Venture Partners and original investor Draper Fisher Jurvetson. He dismisses the “colds” and “outs,” including Tony Mayfield Fund, which will invest only if Smith agrees to relinquish the helm, a request often made of bright but inexperienced entrepreneurs. The “warms” are largely axed, too—one simply because the partner on the deal got sick, another because of too few connections.

Days later, the action escalates. Venture newcomer Generation Partners raises the ante with a valuation worth \$4 million more than H&Q’s. At the same time, Microsoft Corp. board member David F. Marquardt, who runs August capital, offers \$3 million less but brings access to his blue-chip contacts. “Marquardt is right about his value,” says Smith. “But I’m not sure he’s \$3 million right.” When the dust clears, Smith snags a higher valuation than originally expected, and a total of \$7 million in capital. H&Q kicks in \$3.5 million; Bessemer puts in \$2 million, with Draper Fisher taking the remaining \$1.5 million. Generation, late to the party and lacking marquee value, loses out.

Linda Himelstein, *The Great Hunt for Hot Ideas: What starts with a bagel may end with another Yahoo!*, BUS. WK., Aug. 25, 1997, at 106.

concern with these issues will be important to the ultimate outcome of the contracting process. It is in this manner that the Web will affect future venture capital contracting.

Before attempting a more detailed discussion of how the Web might be expected to alter the venture capital contracting process, it is useful to briefly explore how venture capital contracts have changed over time. When Mark Suchman analyzed venture capital financing agreements in Silicon Valley, he observed not only that the agreements fell into several contractual archetypes, described above, but that the use of those contracts changed significantly over time.<sup>163</sup> The contracts in his sample ranged from 1976 to 1990. Over that time, venture capital contracts evolved "in rough chronological sequence . . . from Idiosyncratic contracts to Weak contracts to Pre-programmed contracts to Legalistic contracts to Close contracts to Flexible contracts."<sup>164</sup> In short, the contracts evolved from the simple to the complex. Recent contracts generally contained more detailed specification of rights and seemed to contemplate a more intimate relationship between venture capitalists and entrepreneurs than older contracts.

Suchman's data set ends in 1990, the same year Sahlman's description of venture capital contracts was published. No one has attempted to provide a more recent examination of venture capital contracts. Although all six types of financing agreements identified by Suchman survived through 1990, the popularity of each form was relatively short-lived. Suchman states, "contractual archetypes appear distinctly 'faddish,' with the popularity of specific financing models rising and then declining in a fairly consistent" manner.<sup>165</sup> It is entirely possible, therefore, that new types of venture capital financing agreements have been developed in the past seven years. This does not seem likely, however, because venture capital contracting appeared quite mature by 1990 and subsequent innovations in contract forms had long since ceased.<sup>166</sup> In addition, one would expect to see some indication of that trend in popular accounts of venture capital or in the writings of venture capital lawyers. None exist.

It is more likely, however, that there have been changes in the frequency of use of the various types over time. At the conclusion of Suchman's data set, two types of financing agreements—close contracts and

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<sup>163</sup> Suchman, *supra* note 45, at 251.

<sup>164</sup> *Id.*

<sup>165</sup> *Id.* at 253.

<sup>166</sup> *Id.* at 259. Suchman states:

By the end of [1990], the structuration process appears to be nearing completion. Most new contracts in these final years embrace one of two well-defined and highly-elaborated archetypes, and deviance/innovation remains rare. Thus, out of the complex dynamics [that characterized Silicon Valley in the late 1970s and early 1980s], the community ultimately arrives at a fairly narrow range of highly-typified and widely-diffused contractual models. In a word, venture capital financing becomes institutionalized.



flexible contracts—dominated venture capital financing. Between them, they accounted for roughly seventy-five percent of all venture capital financing agreements in 1990.<sup>167</sup> Suchman notes that these two contract types were still ascendant, while all of the other contract types were in decline.<sup>168</sup>

In speculating about the effect of the Web on venture capital contracts, one would want to have some notion of the factors that have triggered past changes in venture capital contracts. Suchman notes that venture capital contracts moved from short-term, arm's-length relationships (weak and pre-programmed contracts) prior to 1985 to long-term, hands-on partnerships (close and flexible contracts) thereafter and suggests that this move may have been prompted by a "modest retrenchment" in venture capital in Silicon Valley from 1984 through 1986. Legalistic contracts became very prominent during this period, reaching a peak in 1985.<sup>169</sup> It is possible, therefore, that the retrenchment provided the impetus for more elaborate contracts, and that the legalistic contracts acted as a transition to the permanent adoption of more elaborate contract forms.

Such a progression seems quite plausible. More elaborate contracts may have been an inevitable part of the maturation of venture capital contracting. Certainly, the subsequent boom in venture capital has not resulted in a revival of simple venture capital contracts, so it would be wrong to attribute too much of the elaboration of venture capital contracts to the short retrenchment.

Suchman also analyzes the influence of informational intermediaries, such as law firms and venture capital funds, arguing that these groups have a profound impact on choice of contract form.<sup>170</sup> In the end, Suchman concludes that the evolution of contractual forms is caused by many factors: "Temporal, institutional and economic factors all exert significant influences on the selection of contractual models."<sup>171</sup>

Changes in venture capital contracts will be further encouraged by the increasing bargaining power of entrepreneurs. For most would-be entrepreneurs, venture capital financing is notoriously difficult to obtain. Then again, most would-be entrepreneurs have terrible business ideas. Anecdotal evidence suggests that the venture capital industry is highly competitive on the supply side, especially when a "hot" company is involved.<sup>172</sup> In addition, venture capital is attracting record amounts of

<sup>167</sup> *Id.* at 257.

<sup>168</sup> *Id.*

<sup>169</sup> *Id.*

<sup>170</sup> *Id.*

<sup>171</sup> *Id.* at 285.

<sup>172</sup> Steve Kaufman, *The Red Carpet Treatment: Venture Capitalists, Fresh With Cash, Compete Harder to Attract the Best and Savviest Entrepreneurs*, SAN JOSE MERCURY NEWS, Nov. 18, 1996, at 1E; REID, *supra* note 93, at 144 (describing the financing of Marimba, Inc., stating, "[t]he company had its pick among some of the Valley's finest

money, and venture capital firms compete not only among themselves, but with other providers of private equity, including “angels”<sup>173</sup> and corporations, such as Adobe Systems, Intel, Cisco Systems, Informix, and Netscape. Venture capitalists also compete with other forms of start-up financing, including “bootstrapping,”<sup>174</sup> commercial lending,<sup>175</sup> and, increasingly, public equity markets.<sup>176</sup> Moreover, businesses that ultimately are funded through venture capital usually are financed by a syndication of venture capital firms. Syndication implies that the entrepreneur could have selected financing from any one of multiple venture capitalists. Indeed, the industry seems to recognize that entrepreneurs have choices.<sup>177</sup> Finally, an entrepreneur may decide that the costs associated with venture capital are simply not worth the effort. The ability of the entrepreneur to exit provides a check on venture capitalist opportunism.

The future of venture capital contracts is impossible to predict with any degree of certainty. Nevertheless, the foregoing analysis suggests some possibilities. For example, the shift in bargaining power in favor of entrepreneurs, combined with the improved market for venture capitalist reputation, should allow entrepreneurs to make better choices prior to entering into a venture capital relationship, thus addressing the adverse selection problem *ex ante*. Increased bargaining power also may enable entrepreneurs to bargain more frequently for the ability to address adverse selection *ex post*, through discretionary redemption provisions. With respect to the moral hazard problem, the improved market

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funds, and in the end went with Netscape’s elite backer Kleiner Perkins”). In a recent novel set in Silicon Valley, Po Bronson describes a venture capitalist contemplating an investment in an Internet company:

Eighteen months ago, a startup that designed Internet routers had come to Marquee looking for a million bucks, and Marquee had done the usual venture capital games—stalled, checked around for competition, tried to negotiate more shares for their money. In the meantime, the Internet router market had boomed, and the company funded its own growth through profits. They stopped returning Travis’s phone calls. Now it was about time to go public. If Marquee hadn’t diddled around and just given them the money, that million would soon be worth twenty. Travis Grissom wouldn’t make the same mistake twice.

PO BRONSON, *THE FIRST \$20 MILLION IS ALWAYS THE HARDEST* 184 (1997).

<sup>173</sup> Little is written about angel investors. For an anecdotal account of angel investing, see Michael S. Malone, *Angels in the Valley* (last modified Apr. 1997) <<http://www.upside.com/texis/mvm/story?id=34712c19f>>.

<sup>174</sup> “Bootstrapping” is the process of financing a business from the business’ own revenues. Obviously, bootstrapping is unfeasible for many entrepreneurs, who are unable to provide the initial capital necessary to get a product to market.

<sup>175</sup> Commercial lending has traditionally been inaccessible to high technology companies, whose only assets tend to be intangible.

<sup>176</sup> Christopher B. Barry & Adel M. Turki, *Initial Public Offerings by Development Stage Companies*, 2 J. SMALL & EMERGING BUS. L. 101 (1998).

<sup>177</sup> See, e.g., Case & O’Grady, *supra* note 21, at 6-13 (“An entrepreneur will encounter only the disadvantages of venture capital if he does not exercise the same diligence and judgment in carefully choosing venture capital partners as they use in deciding where to invest their capital.”).

for venture capitalist reputation will increase the incentives of venture capitalists to resist opportunistic behavior. A heightened sense of the risks of accepting venture capital may cause entrepreneurs to demand more explicit protections against opportunism, although it seems unlikely that venture capitalists would forego their most powerful weapon, staged financing. Finally, an improved market for reputation should affect the pricing of venture capital investments.

## V. CONCLUSION

The market for venture capitalist reputation is the glue that holds the venture capital process together. Entrepreneurs face substantial agency costs in "hiring" venture capitalists to perform value-added services, and the explicit terms of venture capital contracts do not adequately protect entrepreneurs against opportunism and incompetence. Without the checks provided by the market for venture capitalist reputation, therefore, entrepreneurs would be virtually powerless to enforce the promises of venture capitalists to provide value-added services.

Although the importance of the market for venture capitalist reputation is often noted, it is rarely analyzed. This Article suggests that the market for venture capitalist reputation is both informationally and fundamentally inefficient. Although mechanisms exist to convey information about reputation to entrepreneurs, those mechanisms probably do not result in an efficient market because of the absence of a centralized location—like a stock exchange—where various assessments of venture capitalist reputation can be "traded." The Web performs two functions that improve the efficiency of the market for venture capitalist reputation: (1) it serves to centralize some reputational information and (2) it lowers the cost of distributing information, thus expanding the scope of its distribution.

**APPENDIX**  
**Venture Capitalist Survey**

Surveys were sent by electronic mail to over 100 venture capital firms, and 41 firms responded.

Why did your firm construct a Web page? (Check all that apply.)

80.5% a. We expect entrepreneurs to locate our firm through the Web page.

90.2% b. We expect entrepreneurs who have contacted our firm through other means to use the Web page as a source of additional information about our firm.

31.7% c. We expect the Web page to improve networking among our portfolio companies.

39.0% d. We expect the Web page to increase our name recognition among other venture capitalists.

34.2% e. We expect the Web page to increase our name recognition among lawyers, accountants, and others who make referrals to venture capital firms.

24.4% f. We expect investors to locate our firm through the Web page.

19.5% g. We expect to communicate with our investors through the Web page.

22.0% h. Other. Please explain: [Common answers: entrepreneurs expect it, it provides an information source to the entrepreneurial community, and it provides up-to-date information about the firm.]

Which of the following have contacted your firm after accessing your Web page? (Check all that apply.)

97.6% a. Entrepreneurs.

26.8% b. Investors.

22.0% c. Lawyers.

19.5% d. Accountants.

24.4% e. Venture capitalists.

36.6% f. Others. Please specify: [Common answers: prospective employees, investment bankers, journalists, and professors.]

Has your firm funded any entrepreneurs who contacted your firm after accessing your Web page?

14.6% Yes.

85.4% No.

What effect, if any, will the Internet have on venture capital financing?

[Answers to this question ranged from "None" or "Unknown" to extensive speculations about the future of venture capital financing. Several respondents expressed their hope that the Web site would allow entrepreneurs to target their funding requests to venture capi-

talists with the proper specialization, but many noted that most business plans submitted via the Web site were of inferior quality. Some respondents thought that the Web would assist entrepreneurs by providing easier access to information about venture capital financing, perhaps even reducing the need for intermediaries. Many respondents suggested that the Web would affect supply-side competition, either by providing better access to alternative forms of startup financing, including angel investors or by extending the reach of venture capitalists who are located outside of Silicon Valley.]