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ABSTRACT

This paper adresses the impact of trust on private equity contracts. Trust between investor and entrepreneur is essential to help overcome control problems, especially in an environment with severe agency risks and incomplete contracts. In this study, information about the effects of trust is collected using a simulation with 144 entrepreneurs and investors. We find that trust has an impact on the desired contracts of entrepreneurs, but not on that of investors. Our findings suggest that for parties, faced with potentially large agency problems (investors), trust and control seem to play complementary roles. On the other hand, for parties faced with smaller agency problems (entrepreneurs), trust seems to be a substitute for control.

INTRODUCTION

The venture capital industry is characterized by large information asymmetries and high levels of uncertainty on the one hand (Amit, Glosten & Muller, 1990; Chan, Siegel & Thakor, 1990) and exceptional opportunities on the other. Private equity investors, however, are faced with significant agency problems when investing in a private venture. In order to mitigate potential agency problems between entrepreneurs and outside investors, parties (investors as well as entrepreneurs) will screen one another before investing, write contracts detailing specific rights of both parties, and investors will monitor the venture after the investment (Manigart & Sapienza, 1999). The goal of the contract is to allocate cash flow rights between entrepreneurs and investors and to give control rights to both parties, such as voting rights, board rights, liquidation rights and the provision of future financing (Kaplan & Strömberg, 2000). Although the allocation of cash flow rights can be structured to provide incentives for the entrepreneur to behave optimally, the contract is especially important when business activities are not developing as favorably as expected (Kaplan & Strömberg, 2000; Sahlman, 1990).

Recent research has begun to study the content and the structure of the investment contract between venture capitalists and entrepreneurs (e.g. Gompers, 1998; Kaplan & Strömberg, 2000; Landström, Manigart, Mason & Sapienza, 1998; Sahlman, 1990) and to shed light on factors that might enhance how contracts are written. However, in a complex, long term relationship, such as that between an entrepreneur and a venture capitalist (Cable & Shane, 1997; Sapienza, Korsgaard, Folger, Sagrera & Zhang, 1999), it is impossible to negotiate and explain every single future contingency in a formal document (Landström et al., 1998): contracts are always incomplete. Moreover, imposing too many conditions and reporting requirements infringes upon managers' desire to feel in control (Sapienza, 1989) and may be interpreted by them as a signal of distrust (Kelly, 2000). Importantly, then, the pre-investment screening and negotiation process represents a critical transition from due diligence to post-investment interaction; the nature of the process by which this transition is secured may be critical to the quality of the interactions that follow (Cable & Shane, 1997; Sapienza et al., 1999). Trust helps facilitate collaboration (Mayer, Davis & Schoorman, 1995; Smith, Carrol & Ashford, 1995), reduces agency and transaction costs (Jones, 1995), and improves a firm's ability to adapt to complexity and ambiguity (Korsgaard, Schweiger & Sapienza, 1995).

In an environment with severe agency risks and incomplete contracts, trust between both parties is essential to help overcome control problems (Dasgupta, 1988). However, there is a debate in the literature on the nature of the relationship between trust and control (Das & Teng, 1998). On the one hand, it is argued that trust and control may be viewed as substitutes. Formal legal contractual agreements (control) and psychological contracts (trust) may be substitutes in interfirm cooperation (Ring & Van de Ven, 1994). On the other hand, Das and Teng (1998: 496) argue that "a higher trust level does not automatically dictate a lowering of the control level, and vice versa." There is need of a minimum level of both trust and control in order to have confidence in a partner. Both trust and control play therefore different roles in a partner relationship.

Recent studies have emphasized the importance of trust in the relationship between investors and the firms in which they invest (Harrison, Dibben & Mason, 1997; Saparito, 2000; Sapienza & Korsgaard, 1996), and some have argued that trust can have substantive direct effects on contract provisions (Sapienza et al., 1999). However, little empirical work has examined how trust develops or how it affects investor-entrepreneur exchanges and contracts. Therefore, in this paper we conduct an experiment in order to focus closely on the relationship between trust and contractual agreements.

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In the view that trust and control are substitutes, trust implies the exclusion of deliberate control over the behavior of others. When it is possible to fully trust a partner, there is no need to control the partner's behavior. Control comes into play only when adequate trust is not present. Monitoring and controlling a venture is time-consuming for the investor (Gifford, 1997), however, and therefore costly. Investors will be willing to diminish deliberate control only if they trust entrepreneurs to behave in their best interests. Therefore, in this view, it is argued that the more the investor trusts the entrepreneur, the lower will be the number of contractual clauses in the contract.

In the venture capital – entrepreneur relationship, both parties are vulnerable to each other in that reaching their goals requires cooperation from the other party, yet they may have goals that differ from those of the other party (Cable & Shane, 1997; Sapienza &

Korsgaard, 1996). Given this vulnerability, both entrepreneur and investor may be motivated to protect themselves by constructing more elaborate investment contracts with more protective clauses (Kelly, 2000; Manigart & Sapienza, 1999). However, given that the administration and enforcement of contract provisions is costly, both parties should be willing to have a less elaborate contract if they believe in the good will of the other party. Therefore trust should make both parties more willing to omit self-protecting and generally negotiate a less elaborate contract. The foregoing arguments lead to following hypotheses :

Hypothesis 1: A higher level of trust between entrepreneurs and investors will lead to fewer contractual clauses in the investment contract.

Hypothesis 2: A higher level of trust of one party towards the other will lead to fewer contractual clauses in the investment contract that protect that party against harmful actions of the other party.

RESEARCH METHOD AND SAMPLE

Given the proprietary nature of private equity deals, information about private equity investment contracts between entrepreneurs and venture capitalists and the preceding negotiation process is scarce (Barry, 1994; Kaplan & Stromberg, 2000). In this study, information about the effects of the negotiation process on the investment decision and on the mutual trust between entrepreneur and investor was collected using a simulation designed to manipulate the ex-ante *trust* between the two parties. We measured trust perceptions and contract term preferences at various points in the negotiation process.

The experiment was conducted with 144 entrepreneurs and investors, predominantly males, in the context of training sessions at a leading Belgian business school. Of the 68 participants who received a high trust manipulation, we obtained valid observations for 56 participants. Of the 76 participants who received a low trust manipulation, 46 observations were valid. Both in the high trust and the low trust situation, approximately half of the participants took the role of entrepreneur, the other half took the role of investor.

High versus low trust was manipulated by having participants "play" a prisoner's dilemma-type game before the negotiation session. Participants were given false feedback on the results of the game that indicated that their counterpart acted in either a trustworthy or untrustworthy manner. Participants then completed a four-item scale measuring their trust in their counterpart. A sample item is "I feel this person can be counted on to help me." Items were rated on a scale from 1, "strongly disagree", to 5, "strongly agree" and averaged to form an overall index of trust (Cronbach α= 0.84).

Participants were then randomly assigned either an "investor" scenario or an "entrepreneur" scenario. The scenario involved a case of a start-up venture, based on a real company: a young entrepreneur is looking for venture capital for his early stage internet company. He finds a venture capitalist who is willing to invest a fixed amount of money in the company in exchange for 49% of the company's shares. The participants were given a list of potential contract provisions and instructed to set their "goals" for their ideal contract. We created five measures from participants' choices: the total number of contract provisions, the absolute number of Pro-investor contract provisions, the absolute number of Pro-entrepreneur provisions, the percent of Pro-investor contract provisions, and the percentage of Pro-entrepreneur contract provisions.

Insert table 1 about here

Fourteen contract clauses, frequently used in venture capital contracts (Kaplan & Strömberg, 2000; Landström et al., 1998) were presented as possible choices to be included in the subjects' "ideal" contract. Participants were asked to decide which (if any) of these clauses they would include. Table 1 describes the 14 contract clauses. Two types of contract provisions can be included in the contract: terms that are favorable for the investor (so-called *Pro-investor clauses*) and terms that are favorable for the entrepreneur (so-called *Pro-entrepreneur clauses*). Because Pro-investor clauses are most common, we included 10 such choices; three Pro-entrepreneur choices were included; and, one clause provided protection to both investors and entrepreneurs. In recognition of the real-world costs of writing and enforcing contract provisions, we imposed a "cost" of 2,500 EURO per clause included in the contract.

After proposing an ideal contract, participants had the opportunity to go through several rounds of negotiating the contract and finalize a mutually agreed upon contract.

RESULTS

The effects of the manipulation of trust on trust perception were tested. Participants had an average trust perception of 3.45 (standard deviation=0.99). The manipulation of trust resulted in significantly different trust perceptions, with participants in the high trust condition reporting significantly greater trust in their counterpart (high trust, $\bar{x} = 3.77$; low trust, $\bar{x} = 3.06$; $p<0.01$). This finding indicates that the manipulation was successful.

Insert table 2 about here

Consistent with our hypotheses, the manipulation of trust resulted in significantly different contract preferences for entrepreneurs, as shown in Table 2. However, contrary to our expectations, trust leads entrepreneurs to include significantly more clauses in their ideal contract. This difference is largely explained by entrepreneurs' preferences regarding Pro-investor clauses: entrepreneurs in the high trust condition specified significantly more Pro-investor clauses than did entrepreneurs in the low trust condition. This finding, while not explicitly hypothesized, is consistent with our thinking, for it suggests that entrepreneurs who trust the investor are more willing to allow for contract provisions that are advantageous to the investor. Trust did not have a significant impact on entrepreneurs' preferences for Pro Entrepreneur clauses. For the investors the effects of the trust manipulation on the contract measures were not significant.

Insert table 3 about here

To further explore these hypotheses, we examined the relationship between trust perceptions and contract terms. The correlations between trust perceptions and contract measures are reported separately for each party in Table 3. Trust perceptions were not related to the total number of clauses proposed by either party. However, there is some evidence that trust is related to the percentage of proposed provisions that are protective. Specifically, for entrepreneurs, trust was positively associated with percentage of proposed provisions that were favorable to the investor, and negatively associated with proposed provisions that were favorable to the entrepreneur. These findings provide limited support for Hypothesis 2. However, investors' trust was not associated with their choice of contract provisions.

Insert table 4 about here

In supplemental analyses, we examined the relationship between trust perceptions and the clauses in the mutually agreed upon final contract, the results of which are reported in Table 4. For investors the effects of the trust perception on the contract measures in the final contract were not significant, consistent with the findings of the initial contracts. Also consistent with previous findings is that the trust perception of entrepreneurs was negatively related with the % of Pro-Investor clauses. The relationship between Trust Perception and the % of Pro-Investor clauses in the final contract, however, was negative, contrary to the findings in the initial contract.

DISCUSSION AND CONCLUSIONS

We have found in this experimental setting that trust has an impact on the desired contracts of entrepreneurs, but not on that of investors. The number of contractual clauses that investors wanted to include in their ideal contract appeared to be independent of their level of trust or distrust of the entrepreneur. Trusting the entrepreneur did not appeart to influence their desire for legal protection. Thus, the findings suggests that trust may not be a substitute for legal contracts and monitoring options, but trust and control play rather complementary roles, supporting Das and Teng (1998).

In contrast, trust signficantly affected entrepreneurs' contract preferences. Entrepreneurs in the high trust condition appeared to prefer a more elaborate contract. However, the findings regarding Pro-investor clauses explains this surprising result: entrepreneurs were willing to give up control over investors when the trust was high, supporting the view that trust and control are substitutes (Ring & Van de Ven, 1994). Moreover, a higher level of trust induced entrepreneurs to accept higher level of control of the investor.

In including more favorable terms for the investors, entrepreneurs may moreover send a strong signal to investors that they accept outside control, and thus that the potential moral hazard problem is small. This, in turn, is likely to increase the trust that investors have in the entrepreneurs. One aspect of this phenomenon, however, that we are unable to examine is the long-term effect on entrepreneurs' attitudes that such contractual "sacrifices" might have. In agency theory terms, this giving up of rights/ protection could be seen as a bonding or signaling cost that entrepreneurs are willing to submit to in order to secure the investment. Equity theory, however, suggests that such actions, if not reciprocated in some observable ways by investors later on, may lead to a deterioration of the exchange relationship. That is, if entrepreneurs knowingly sacrifice some benefits to themselves for the sake of the relationship, they will expect to be treated in kind at some point. They may later on believe that they have given too much and gotten too little in return for their gestures of trust, especially if they are not treated in like manner by their investors when the opportunities arise. If this were to happen, then they would likely retaliate by withholding effort or information, exactly the opposite effects of what investors want (Sapienza & Korsgaard, 1996).

The relationship between trust and control is clearly a complex relationship. For parties, faced with potentially large agency problems (investors), trust and control seem to play complementary roles. On the other hand, for parties faced with smaller agency problems (entrepreneurs), trust seems to be a substitute for control.

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TABLES

TABLE 1

Description of contract provisions

Nr	Description	Pro …
1	Ratchet down agreement. Failure to meet performance targets within a specified period results in a pre-agreed reduction in the entrepreneur’s equity share.	Investor
2	Ratchet up agreement. Meeting certain performance targets within a specified period results in a pre-agreed increase in the entrepreneur’s equity share of the venture.	Entrep.
3	Board Control over Hiring of Senior Personnel. Provides investors with the right to oversee and approve hiring of senior management personnel.	Investor
4	Investor veto rights over acquisition and divestiture. Provides investors with the right to prevent undesired changes in the business structure of the venture.	Investor
5	Agreement on frequency of board meetings. Specifies the number of board meetings to be held and requires investor attendance as board member.	Entrep.
6	Agreement on completeness, timeliness, and accuracy of information provided to board. Provides investors with guarantee of complete financial and market reports in a complete, timely manner prior to board meetings.	Investor
7	Board approval of budgets and plans. Provides investors with say in setting strategic direction of venture.	Investor
8	Secrecy agreement. Entrepreneur agrees not to reveal identity of potential investor or potential terms of offer to any outside parties.	Investor
9	Pre-agreed valuation formula. A pre-specified formula for calculating the value of the venture.	Investor Entrep.
10	Patent rights ownership. This term protects the entrepreneur from loss of value of proprietary patent.	Entrep.
11	Stock vesting agreement. This term requires that significant portions of the entrepreneur’s equity does not vest or “kick in” until the entrepreneur has remained with the venture for a significant period of time.	Investor
12	Investor control of the board. This term structures the board so that the investors control the chair and the majority of the board seats.	Investor
13	Board right of managerial dismissal. This term gives the board the right to fire the lead entrepreneur or other member of the entrepreneurial team for violations of ethics and honesty.	Investor
14	Non-compete clause. This term provides sanctions against top managers who leave the venture and attempt to compete directly against the venture, whether unethically using contacts/ knowledge/ or resources obtained from the venture or not.	Investor

TABLE 2

Effects of trust manipulation ("ideal contract")

Variable		Entrepreneur (N=49)		Investor (N=53)	
		High Trust (N=27)	Low Trust (N=22)	High Trust (N=29)	Low Trust (N=24)
Trust Perception	Mean	3.81	3.05**	3.73	3.07**
	S.D.	(0.92)	(1.19)	(0.62)	(1.00)
Total # of Clauses	Mean	5.74	4.59*	6.86	6.42
	S.D.	(2.44)	(2.13)	(2.55)	(1.93)
# Pro-entrepreneur Clauses	Mean	2.07	1.82	1.03	0.96
	S.D.	(0.92)	(0.66)	(0.87)	(0.81)
# Pro-investor Clauses	Mean	2.89	2.05 †	5.21	4.79
	S.D.	(2.03)	(1.79)	(2.09)	(1.77)
% Pro-entrepreneur Clauses	Mean	0.38	0.45	0.15	0.16
	S.D.	(0.19)	(0.22)	(0.14)	(0.13)
% Pro-investor Clauses	Mean	0.45	0.37 [(a)]	0.75	0.74
	S.D.	(0.24)	(0.24)	(0.15)	(0.17)

S.D.: standard deviation

Significance level of t-test for independent samples

(a) p=0.10;

† p<0.1

* p<.05

** p<0.01

(1-sided)

TABLE 3

Correlation between Trust Perception and dependent variables (“ideal” contract)

Dependent Variable	Entrepreneur (N=49) Correlation	Investor (N=53) Correlation
Total # of Clauses	0.15	0.12
# Pro-entrepreneur Clauses	0.06	0.07
# Pro-investor Clauses	0.17	0.09
% Pro-entrepreneur Clauses	-0.22 †	0.02
% Pro-investor Clauses	0.31*	-0.03

† p<0.1

* p<.05

TABLE 4

Correlation between Trust Perception and dependent variables (mutually agreed upon final contract)

Dependent Variable	Entrepreneur (N=42) [a] Correlation	Investor (N=46) [a] Correlation
Total # of Clauses	-0.06	0.15
# Pro-entrepreneur Clauses	-0.11	0.02
# Pro-investor Clauses	-0.02	0.15
% Pro-entrepreneur Clauses	-0.24*	-0.06
% Pro-investor Clauses	-0.22 †	0.05

[a] A few participants did not come to an agreement.

† p<0.1

* p<.05

(1-sided)