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Contract Design in Venture Capital

Incentives, Monitoring and the Allocation of Control Rights

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ABSTRACT:

Tämä kandidaatintutkielma tarkastelee venture capital sopimuksia ja sitä, miten ne muodostetaan vähentämään riskiä startup-yritysten rahoituksessa. Tutkielma on kirjallisuuskatsaus, joka perustuu teoreettiseen ja empiiriseen tutkimukseen venture capital sopimuksista. Tutkielma keskittyy siihen, miten sopimusehdot, kuten kontrollioikeudet, kassavirtaoikeudet, tappiosuoja, vaihtovelkakirjat ja vaiheittainen rahoitus vaikuttavat tehtäviin sijoituksiin. Tarkasteltu kirjallisuus osoittaa, että venture capital sopimuksia ei laadita pelkästään omistuksen ja yrityksen arvonmäärityksen perusteella. Sopimukset muodostavat myös hallinnointijärjestelmän, joka jakaa päätösvaltaa, sijoittajansuojaa ja rahoitusehtoja. Empiirinen kirjallisuus osoittaa, että sopimusten rakenne liittyy sijoittajan kontrolliin, hallitustason interventioihin, perustajan korvaamiseen ja irtautumistuloksiin. Tutkielman johtopäätös on, että venture capital sopimukset ovat dynaaminen tapa hallita informaation epäsymmetriaa, riskiä ja kontrollia sekä auttaa yritystä saamaan jatkorahoitusta ja menestymään pitkällä aikavälillä.

KEYWORDS: venture capital, finance, agreements, investments, contract law, startup companies, risk financing

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1 Introduction

Venture Capital (VC) is a form of financing for young high-risk firms. VC firms raise capital from investors and invest it into a portfolio of startups that have high growth potential. Venture Capital funds are typically organized as limited partnerships and raise capital from large financial institutions such as pension funds, insurance companies and endowments (Lerner et al., 2007; Arnold et al., 2024). Venture Capital is often linked to innovation and new technologies and it helps new ideas become real products and companies.

A key problem in VC is high uncertainty and that the companies they invest in are hard to evaluate. In early-stage startups outsiders usually know less than the founders about the true quality of the project. This creates information and incentive problems between investors and founders. VC firms try to narrow this problem by relying on financial contracting. Contracts are used to allocate cash flow rights, control rights and incentives between investors and founders (Kaplan & Strömberg, 2003)

VC contracts are applied within the startup financing cycles. Often described as Pre-seed, seed, series A, series B and later rounds. These describe the financing cycles where the company moves from an early idea into scaling and in some cases an exit through an Initial Public Offering (IPO) or an acquisition by another company. In research these stages are often used to describe how funding needs change over time (Arnold et al., 2024).

1.1 Purpose of the Study

This thesis is a literature review of venture capital financing agreements. This thesis focuses on how contract terms aim to reduce the risk of the investment. The thesis aims to answer how contract terms such as control rights and convertible securities affect risk reduction. The thesis examines how venture capitalists manage information asymmetry,

agency conflicts and changing project quality over time from a theoretical and empirical perspective. The thesis examines how control rights change depending on success. The thesis also analyzes how risk is hedged if the project no longer looks profitable in the future. It also examines how, for example, share vesting and preferred equity are used. These mechanisms show how contracts aim to reduce risk and how a flexible contract model provides different rights between investors and the entrepreneur depending on the success of the company.

1.2 Structure of the Study

Chapter 1 introduces the topic, purpose and research questions. Chapter 2 defines key concepts and describes the startup financing cycle and the main components of VC contracts. Chapter 3 reviews theoretical research on VC contract design. Staging, control rights and securities. Chapter 4 reviews empirical evidence on how these terms are used in practice and how they relate to monitoring and follow on financing. Chapter 5 discusses the limitations and the future research trajectory. Chapter 6 concludes the main findings.

2 Venture Capital and Financial Contracting

2.1 Contract Structures and Valuation Implications in Venture Capital Financing

VC financing is typically structured through equity contracts that define both payoffs and control. In a sample of 1,695 first financing rounds in the United States in the years 2002–2010, Ewens et al. (2022) focus on rounds where startups sell common or preferred equity and document the contract terms and the valuations of the deals. They report that in the median round investors invest \$7.3 million (\$5.2 million in 2012 dollars) at a post-money valuation (pre-money valuation + invested amount) of \$21.2 million (\$13 million in 2012 dollars). These numbers show that early VC rounds involve substantial capital and are priced using post-money valuations (Ewens et al., 2022).

VC contracts often use a similar set of standard terms. Fu et al. (2023) study how the contract rights evolve through funding rounds and find that many ventures go with a default contract. This contract is typically implemented in the initial funding round and is typically used in later rounds as well. Focusing on eight key terms, Fu et al. (2023) describe the default contract as convertible preferred stock with a 1x liquidation preference, one vote per share and a board-based weighted anti-dilution protection. They also note that the default contract typically does not include participating preference, contractual dividends, redemption rights at the investor's request, or IPO ratchets. In their results, over half of new ventures use the default contract for their first round of funding.

Contract terms matter not only for incentives and control but also for how valuations should be interpreted. Gornall and Strebulaev (2020) develop a valuation model and apply it to 135 United States-based unicorns (companies valued at over \$1 billion dollars). From legal filings they find that post-money valuations average 48% above fair value with 14 unicorns over 100% above fair value. They argue that reported valuations usually

assume that all shares have the same value as the most recently issued preferred shares, even though later investors usually receive strong protections. In their sample many companies gave recent investors protections such as IPO return guarantees (15%), vetoes over down-IPOs (24%), or seniority to all other investors (30%). They also find that common shares lack such protections and are 56% overvalued under the post-money logic. This supports the idea of VC contract terms affecting the economic meaning of the headline valuations.

The research suggests that VC contracting combines a relatively standard default structure (Fu et al., 2023), frequent use of specific downside and control related terms even in first rounds (Ewens et al., 2022) and important differences between share classes that can change the interpretation of valuations (Gornall & Strebulaev, 2020). These findings show why contract terms are a central part of how risk is managed in venture capital.

2.2 Key Contract Terms: Cash Flow Rights, Control Rights and Incentives

VC contracts consist of several key terms that allocate payoffs, decision-making power and the incentives between investors and entrepreneurs. These terms are not random. Research shows that they form a structured system that helps investors manage uncertainty and incentive problems in startups (Kaplan & strömberg, 2003; Fu et al., 2023)

2.2.1 Cash Flow Rights and Downside Protection

Cash flow rights determine how the proceeds are divided when the company is sold, does an IPO or fails. The most important cash flow term in venture capital contracts is the liquidation preference. This term gives investors priority over common shareholders

when money is distributed. Liquidation claim refers to the amount an investor is entitled to receive before common shareholders. A closely related concept is the liquidation multiple. It shows how much the investor receives relative to the amount invested before common shareholders receive anything. A 1x multiple means that the investor first gets an amount equal to the original investment.

Kaplan and Strömberg (2003) show that investors liquidation claim is typically at least as much as the invested capital. More recent evidence suggests that early-stage contracts are usually simpler. Ewens et al. (2022) document that in the first rounds the liquidation multiple is normally 1x and is more than that in only 4% of their sample. This suggests that strong downside protection exists but extreme liquidation terms are uncommon at entry.

Another important term is participation rights. Participation allows investors to receive their liquidation preference and then also share in the remaining proceeds. Ewens et al (2022) find that participation rights appear in 51% of first round contracts. Fu et al (2023) show that participation rights are not part of the default contract but is more common on the so called investor friendly deals.

2.2.2 Anti-Dilution Protection

Anti-dilution protects investors if the company raises new capital later in case of a lower valuation. Without this protection, early investors would lose value when new shares are issued on a lower valuation. Fu et al. (2023) show that broad-based weighted anti-dilution is a standard part of the default contract. Kaplan and Strömberg (2003) also report that anti-dilution clauses are very common in the VC contracts.

2.2.3 Control Rights and Governance

Control rights define who makes decisions in the company. These rights include the board seats, voting rights and veto rights over key decisions such as selling the company

or doing an IPO. Kaplan and Strömberg (2003) show that control is not determined only by ownership percentages but they are often allocated separately in the contracts. They find that the investors hold a majority of board seats in about 25% of all financing round and 36% of first financing rounds. Ewens et al. (2022) find that lead investors receive a board seat in 89% of first financing rounds.

2.2.4 Redemption Rights and Exit Related Protections

Redemption rights allow investors to require the company to purchase their shares after a certain number of years. Ewens et al. (2022) report that redemption rights appear in about 39% of first financing rounds.

Kaplan and Strömberg (2003) show that redemption rights often come with other consequences. If the company can't redeem the shares investors may gain more control or the right to sell the company. Gornall and Strebulaev (2020) find that some investors also receive IPO return guarantees, veto rights over low-priced IPOs, or priority over other investors.

2.2.5 Contract Terms as a System

Venture capital contracts can be viewed as a system of connected terms rather than as separate clauses. Fu et al. (2023) describe a widely used default contract that provides a good starting point. Kaplan and Strömberg (2003) find that rights can be made conditional on performance. These terms have a real effect on value and outcome of the investment (Ewens et al., 2022; Gornall & Strebulaev, 2020).

2.2.6 Interaction of Terms and Valuation Implications

VC-backed companies typically issue convertible preferred shares that combine downside protection and upside through conversion into common. Different financing rounds create different share classes with different cash flow and control rights. Gornall and Strebulaev (2020) describe that VC-backed companies often create a new class of

equity when they raise money. They report that the average unicorn in their sample has eight share classes. They emphasize that classes differ substantially within the same company across rounds.

Gornall and Strebulaev (2020) show that reported post-money valuations commonly assume that all shares are as valuable as the most recently issued preferred shares. They develop a valuation model and apply it to 135 US unicorns using financial terms from legal filings. They report that reported unicorn post-money valuations average 48% above fair value in their sample. They report that 14 unicorns are more than 100% above fair value.

Gornall and Strebulaev (2020) report that after adjusting for valuation-inflating terms, 65 of the 135 unicorns in their sample lose unicorn status. They argue that the difference between reported valuations and fair value is mainly caused by protections attached to preferred shares. Reported valuations often assume that all shares are valued like the latest preferred shares, even though recent investors often receive stronger protections.

Ewens et al. (2022) emphasize that observed startup contracts are complex and that contract terms can affect both startup outcomes and the split of value between entrepreneur and investor. They estimate effects of terms while accounting for endogenous selection using a dynamic search-and-matching model. They use a new data set of first financing rounds and state that they collect over 8,100 first-round VC financings between 2002 and 2015. They study both cash flow rights and control rights and focus on the investor's equity share upon conversion, participation rights, pay-to-play and investor board seats. They define participation as a cash flow right that gives the investor a preferred payout with an additional common equity claim. They define pay-to-play as taking away certain cash flow and/or voting rights if an investor does not participate in a subsequent round.

Ewens et al. (2022) report that contracts materially affect startup values with both value-increasing and value-decreasing components. They report that fixing investor and entrepreneur quality, the average startup's value increases with the investor's equity share up to an ownership stake of 15% upon conversion, and further increases decrease firm value. They also report that VCs use bargaining power to receive more investor-friendly terms compared to the contract that maximizes startup values. They state that better VCs still benefit the startup and the entrepreneur because of value creation. They state that selection of agents into deals is a first-order factor to consider in studies of contracting.

2.3 Monitoring and Value-Added Activities in Venture Capital

After making an investment VCs do not only provide money. They also monitor the company and can help in making key decisions through the governance structure.

Real VC contracts show that investors can separately allocate many different rights, not just cash flow rights. Kaplan and Strömberg (2003) study 213 VC investments in 119 companies from 14 VC partnerships. They show that VC contracts typically allocate board rights, voting rights, liquidation rights and other control rights. And that these rights are often contingent on observable performance measures.

Monitoring is hard in early-stage firms, where outcomes are uncertain and the information is limited. One way contracts support monitoring is by using contingencies. They are rules that change rights or funding based on performance or actions. Kaplan & Strömberg (2003) find that almost 73% of financings explicitly include some kind of contingency. They also report that VCs provide only part of the funding at closing and additional funding on a later performance or action contingency. They report that the median of committed money is \$4.5million and disburse only \$3.6million at closing.

Contracts also use incentive tools that affect founder behavior and reduce the cost of a founder leaving at the wrong time. Founder vesting is a mechanism where the founders

shares vest over a time period and unvested shares can be clawed back to the company if the founder leaves early. In their sample founder vesting appears in almost 41% of financing rounds and 48% in first VC rounds. They also report that there is also non-compete clauses in about 70% of financings (Kaplan & Strömberg, 2003). Which prevents the founder leaving and starting a rival company. Another important point is that VC contracts and rights can change over time as new rounds happen. Kaplan and Strömberg (2003) find that in about 30% of subsequent financing rounds, some contractual rights from the previous round are renegotiated.

Monitoring and the investors influence can also help the company become more professional as it grows. Hellman and Puri (2002) study 170 young high technology firms in Silicon Valley including VC and non-VC backed. They find that VC backing is related to several professionalization measures including human resource policies, the adoption of stock options and hiring of a VP. They also measure whether the investors were influential in shaping the firms HR policies. They report a marginal increase of about 48% in the likelihood that investors were influential in shaping HR in the VC backed companies. They also find that VC firms are more likely and faster to replace the founder CEO with an outside CEO and that this happens in both supportive and controlling situations.

2.4 Startup Financing Cycle

Venture Capital financing usually takes place in several stages instead of one large investment. Investors invest capital in rounds as the startup develops. This structure allows investors to update their information about the company and change terms if the venture does not perform as expected. Arnold et al. (2024) divide the startup cycle into five stages using common VC industry terms: pre seed, seed, early stage, later stage and exit. The risk of the investment is higher at the beginning and becomes lower at later stages. The scale of the investment usually increases over time (Arnold et al., (2024).

The pre seed stage is a stage where the founders work on the business plan, first product prototype and market research. At this stage the financing is usually small and comes from personal savings, friends and family, angel investors, crowdfunding, incubators and pre-seed venture funds. These investors can be helpful in giving advice on the business plan (Arnold et al., 2024).

In the seed stage the startup refines the product, hires more team members and starts marketing to attract customers and test the market. Startups at this stage actively look for professional equity investors, incubators and seed stage VC funds. At the seed stage the investments are very risky and based on European data, only around 10-15% of startups that have received seed funding in 2010-2013 later achieved a successful exit (Arnold et al., 2024).

Early stage, which covers the period after seed but while the company is still relatively young. Arnold et al. (2024) describes this as the phase where the company is generating revenue, investing in the product development and marketing, expanding their teams and entering new markets. This stage usually consists of Series A as the initial VC funding round and Series B as a second round. These rounds are usually led by VC funds and they expect the firm to grow quickly. In Europe only about one third of seed funded startups manage to raise series A round and only about half of those go on to raise series B (Arnold et al., 2024)

The later stages includes Series C, Series D and possibly further growth rounds. Startups at the later stage are more mature, usually more than 5 years old. The capital from these rounds are used to scale operations, enter new countries, launch new products and fund research and development. Later stage rounds often combine equity with debt to limit ownership dilution. They are often led by VC funds that may bring in institutional investors, banks, private equity as well as Corporate Venture Capital funds to co-invest.

Overall amounts can range from several million to hundreds of millions of euros depending on the scale of the firm (Arnold et al., 2024).

The exit stage occurs when founders and investors sell their stakes commonly through acquisition, private equity buyout or an initial public offering. Successful exits must generate high enough returns to compensate for the high risk of the VC funds investment (Arnold et al., 2024).

This multi round financing is closely related to the idea of staged investments. Dahiya and Ray (2012) show that venture capitalists usually deliver funding in stages and that this can be an efficient way to finance high risk projects. Staging allows investors to abandon ventures that show low returns while committing more capital to projects that perform well. The main implication is that it is better to invest relatively less in early rounds and more in later rounds after some uncertainty has been solved (Dahiya & Ray, 2012).

3 Theoretical Foundations of VC Contracting

3.1 Why Venture Capital Contracts Are Needed

The core theoretical problem in venture capital financing is that investment decisions must be made under extreme uncertainty where future outcomes depend on actions that cannot be fully specified. At the time of the initial investment the investor or the entrepreneur can't fully know the future state of the company making venture capital contracts inherently incomplete (Gompers, 1995; Neher, 1999).

Imperfect contracting means that simple ownership arrangements are not enough. Work, strategic choices, and adaptability are central to the value of the firm. Contracts must rely on mechanisms that allocate rights as uncertainty changes over time. Theoretical models emphasize that learning is crucial for the success of the firm. Knowledge about the quality of projects accumulates over time, and optimal contracts must allow investors to condition their actions on evolving information (Gompers, 1995; Dahiya & Ray, 2012).

This creates a trade-off between commitment and flexibility. Strong commitment supports the entrepreneur's effort, but at the same time limits the investor's ability to react to poor results. High flexibility allows the investor to stop funding weak projects. However, this can weaken the entrepreneur's performance if entrepreneurs fear premature termination of funding. VC contracts balance this trade-off by allowing decisions to continue or terminate to depend on new information that becomes available (Neher, 1999; Dahiya & Ray, 2012).

3.2 Control Rights as a Solution to Incomplete Contracts

Schmidt (2003) argues ownership of the firm alone cannot ensure efficient decision-making. The theory is that control rights should be given to the party that can make the best decisions in each given situation. This leads to a separation of cash flow rights and control rights.

Schmidt (2003) finds that control is most valuable when the firm is performing poorly. The entrepreneur's incentives are usually aligned with value creation, and investor intervention is less important when the firm is doing well. Investor control can prevent inefficient continuation and protect the invested capital by liquidating a weak project or replacing the entrepreneur altogether. Giving control to investors in such situations improves efficiency. Entrepreneurs often prefer to continue operations even if the expected value of the project becomes negative. Investors, on the other hand, internalize the risk of loss and are more likely to terminate inefficient projects (Schmidt, 2003).

This approach also helps to solve the hold-up problem. Because the entrepreneur's human capital is essential, giving the entrepreneur full control in all situations would expose investors to opportunistic behavior. On the other hand, giving investors full control in all situations would weaken the entrepreneur's motivation towards the project. Theory therefore supports contracts where control can shift depending on performance and outcomes (Kaplan & Strömberg, 2003).

Control rights are also closely linked to financing decision over time. Gompers (1995) and Neher (1999) find that the value of staged financing depends on the investors ability to act on new information. Without control rights investors may be forced to finance bad projects. Control complements staging by ensuring that the option to abandon bad projects can be exercised.

3.3 Staged Financing as a Dynamic Contracting Mechanism

Staged financing is one tool for managing uncertainty in VC investments. Committing capital upfront is inefficient when project quality is unknown and information arrives over time. Staging allows investors to delay part of the investment and make continuation decisions after having time to observe how the company is doing (Gompers, 1995).

Staging creates an option to continue or abandon the project. Early financing rounds generate information about the venture's prospects. Investors can stop funding and limit losses when outcomes are bad. If outcomes are favorable, investors can continue financing and increase their commitment. This structure improves efficiency because continuation occurs only when expected project value remains positive (Neher, 1999).

Staging also plays an important role in agency problems. Entrepreneurs may have incentives to continue projects even when they are no longer efficient because they value private benefits and future opportunities. By linking additional funding to interim performance staging reduces inefficient continuation and strengthens investor discipline (Neher, 1999).

Dahiya and Ray (2012) formalize staging in a dynamic model where uncertainty is highest at the beginning of the project. They find that it is optimal to invest relatively small amounts early and increase investment in later rounds as uncertainty is resolved. This allows investors to concentrate capital to the projects that show strong early signals while ending weak projects before large losses occur.

Staging is not only about timing of capital. Its effectiveness depends on the ability of investors to act on new information. Gompers (1995) finds that staging supports monitoring by creating regular checkpoints where investors evaluate progress and reassess continuation. Learning would have little value without the possibility to stop

funding. Staging improves capital allocation and reduces losses from unsuccessful companies. (Gompers, 1995; Neher, 1999 Dahiya & Ray, 2012).

3.4 Renegotiation and Control Allocation Under Incomplete Contracts

Aghion and Bolton (1992) study a long-term financial contract between a penniless entrepreneur and a wealthy investor. In their model the investor only cares about monetary returns. The entrepreneur also cares about private benefits such as reputation, effort and human capital. Because of this the two sides may prefer different actions after the project has started.

A central assumption in the paper is that the future state of nature cannot be described well enough in the initial contract. The contract is therefore incomplete. The contract can depend on a publicly verifiable signal that is imperfectly correlated with the state of nature. The signal can be interpreted as short-term performance or as a default or no default event. This matters because the contract cannot directly tell the parties what to do in every future state. Instead it must decide who gets the right to choose later actions (Aghion & Bolton, 1992).

Aghion and Bolton (1992) show that control sharing is a central feature of financial contracts. They distinguish between unilateral control, where one party has full control, and conditional control, where control depends on a signal. They also discuss joint control, where both parties must reach an agreement. In their model, joint control occurs less frequently than unilateral or conditional control. The study also shows that renegotiation cannot be ignored. Once the true state is known, parties may want to renegotiate contracts. This can improve efficiency and it can also change the distribution of future surplus. In their model the entrepreneur makes a take it or leave it offer in renegotiation. Because of this the entrepreneur may capture too much of the surplus after the state is realized. This means that a contract that looks efficient before

renegotiation may fail to protect the investor after renegotiation (Aghion & Bolton, 1992).

The main implication is that neither full entrepreneur control nor full investor control is always best. Investor control can achieve the first best when monetary benefits are in line with total revenues. Control may fail when neither condition holds. Control should move with the signal instead of staying fixed with one side (Aghion & Bolton, 1992).

Aghion and Bolton (1992) find that when full investor control is optimal the firm should issue voting equity. When full entrepreneur control is optimal the firm should issue non-voting shares such as preferred stock. When contingent control is optimal the relevant financial instruments include ordinary debt, convertible debt, warrants, and convertible preferred stock. The paper therefore treats security design as a way to implement different control allocations and not only as a way to divide cash flows. Their discussion of debt is especially relevant for venture capital. If the signal is a default or no-default event, ordinary debt can implement a contingent control rule. The entrepreneur keeps control as long as he meets the debt obligation. If he defaults the control shifts to the investor. In this interpretation debt is valuable because of the control allocation it induces. Default does not automatically mean liquidation. It can also lead to reorganization under investor control (Aghion & Bolton, 1992).

3.5 Financing and Advising as a Joint Problem

Casamatta (2003) studies venture capital as a joint financing and advisory relationship. In his model, a new project requires three different inputs. It requires an initial investment. It also requires the entrepreneur's labor input and the advisor's labor input. The entrepreneur provides an innovative input. The outside advisor provides a managerial input. Neither input can be observed so the agreement must create incentives for both parties to do their job as well as possible. In the best case, both the

entrepreneur and the advisor contribute well to the project themselves. In this case the financing structure is irrelevant and who provides the financing is irrelevant to the overall value. This changes when moral hazard is introduced into the model. The way in which cash flow rights are distributed affects how much each party contributes when the input cannot be observed (Casamatta, 2003).

The central assumption of the article is that the entrepreneur's effort is more efficient than the advisor's effort. Under this assumption Casamatta (2003) shows that the entrepreneur does not want to hire a pure consultant if the advisor does not invest money in the project. The entrepreneur would need to leave part of the project's return to the consultant in order to motivate advisory effort. This lowers the entrepreneur's own share and weakens his own incentive to work. The loss on that margin is larger than the gain from hiring the consultant.

This result is important because it explains why advising and financing often go together in venture capital. In the model a small amount of advice would increase the value of the project but the entrepreneur still does not hire a consultant. The reason is not that advice has no value. The reason is that the entrepreneur cannot recoup enough of that extra value after paying the consultant. In this setting a consultant advising is not an efficient substitute for a venture capitalist advising (Casamatta, 2003).

When all agents can invest. The result changes. Casamatta (2003) shows that it is optimal to ask for venture capital financing. The advisor should invest a strictly positive amount of money and should also exert a strictly positive amount of effort. In the model financing and advising must go hand in hand. The financial participation of the venture capitalist compensates the entrepreneur for giving up part of the project's income.

The paper also studies the role of the entrepreneur's own financial participation. Casamatta (2003) shows that there is a threshold level of initial investment. If the project requires a large initial investment the entrepreneur's financial participation increases

the net present value of the project. If the initial investment is small the entrepreneur's participation is neutral. The intuition is that there is a maximal amount of outside financing that still preserves incentives. If outside financing becomes too large the entrepreneur keeps too little of the upside and his effort falls. In that case some entrepreneurial investment helps restore incentives (Casamatta, 2003).

When the venture capitalist's financial participation is small, the optimal contract can be implemented by giving common stock to the VC and preferred stock to the entrepreneur. When the VC's financial participation is large the optimal contract can be implemented by giving preferred stock or convertible bonds to the VC and common stock to the entrepreneur. The reason is that the side with the weaker incentive needs a more high-powered claim. With small VC investment the VC needs stronger incentives. With large VC investment, the entrepreneur needs stronger incentives because less of the upside is left to him/her (Casamatta, 2003).

Casamatta (2003) also states four empirical predictions that follow from the model. Common stock should be associated with small VC financial participation, while convertible bonds should be associated with large VC financial participation. VC-backed firms should be more profitable than non-VC-backed firms in very innovative lines of business. Consultant services should be more frequent when the entrepreneur's competencies are not unique or crucial. Entrepreneurial financial investment should be positively related to start up profitability especially among less profitable startups.

3.6 Why Staged Financing and Convertible Securities Fit Together

Cornelli and Yosha (2003) study two common venture capital tools together. Stage financing and convertible securities. Their model has two investment dates. The venture capitalist invests the first amount at time 0. A second amount can be delayed until time 1 provided that the project is not liquidated. At time 1 the entrepreneur and the venture capitalist observe a signal about project quality. The signal is interpreted as short-term

performance but it is unverifiable. After observing the signal, the venture capitalist decides whether to refinance the project or liquidate it.

The paper explains why stage financing is attractive. It gives the venture capitalist an option to abandon the project when continuation is not worthwhile. This is important because an entrepreneur will almost never stop a failing project as long as somebody else keeps providing capital. Stage financing also creates incentives because the threat of abandonment can push the entrepreneur to meet goals. But the paper also shows that this same feature creates a problem. The entrepreneur may focus too much on the next financing stage and try to make interim performance look better than it really is (Cornelli & Yosha, 2003).

Cornelli and Yosha (2003) model this problem as window dressing. In their model the entrepreneur can manipulate the distribution of the interim signal so that better signal realizations become more likely even though the true quality of the project does not change. They show that manipulation that only changes the precision of the signal does not capture the relevant conflict between the entrepreneur and the venture capitalist. The important problem is a shift of probability mass from low signal realizations to higher ones because this reduces the chance of liquidation and encourages continuation of weak projects.

A main result of the paper is that standard debt equity financing does not solve this problem. Under debt, equity or a combination of the two the entrepreneur will window dress. Better-looking short-term performance lowers the probability that the project is liquidated. The venture capitalist is then forced to make the refinancing decision using worse information. In the paper's numerical example the project is worth financing without window dressing but not with window dressing. This shows that short-term manipulation can destroy the value of stage financing if the contract does not respond correctly to the signal (Cornelli & Yosha, 2003).

The key contribution of the paper is to show why convertible securities can help. Cornelli and Yosha (2003) show that an appropriately designed convertible debt contract can prevent window dressing. The logic is not that the convertible claim gives better information. The logic is that it changes the entrepreneur's payoff from a good interim signal. Window dressing does reduce the probability of liquidation but it also increases the probability that the venture capitalist will convert and become the owner of a large equity stake. If the conversion terms are favourable enough to the venture capitalist. This second effect dominates. The entrepreneur then no longer wants to manipulate the signal.

The paper also studies renegotiation. It allows spontaneous renegotiation of a debt-equity contract and asks whether renegotiation can remove the problem. The answer is generally no. In most cases spontaneous renegotiation does not give the entrepreneur the right payoff profile to prevent window dressing. Cornelli and Yosha (2003) then study designed renegotiation. They show that a certain kind of designed renegotiation can work. Convertible debt can be understood as a simple way to build a future adjustment rule into the initial contract.

The paper further shows that straight debt together with warrants can also prevent window dressing. It also considers the case where the signal is verifiable. In that case, the contract can specify liquidation and switching rules directly. A contingent debt-equity contract can mimic the logic of convertible debt while also achieving socially efficient liquidation. This is an important difference. With a verifiable signal the contract can separate the liquidation rule from the sharing rule more cleanly (Cornelli & Yosha, 2003).

Cornelli and Yosha (2003) make one more important point about timing. If debt conversion were delayed until time 2 after uncertainty is already resolved. The threat of conversion would disappear. Then the entrepreneur would again want to window dress in order to reduce the probability of liquidation and the project would not be financed. For this reason the deadline for conversion must be strictly before time 2. The

fundamental role of the conversion option is to adjust the debt-equity structure to new information revealed during the life of the project.

These results show that stage financing and convertible securities should not be analysed separately. Stage financing creates the continuation problem. Convertible securities are one way to control that problem. In this sense, the paper gives a clear theoretical reason for why these two features are often observed together in venture capital contracts (Cornelli & Yosha, 2003).

4 Empirical Evidence on VC Contracting

This chapter reviews empirical evidence on how VC contracts relate to investor actions and outcomes such as follow-on funding, exit and failure. It also discusses identification issues.

4.1 Investor Actions and Performance Outcomes

VC Contracts allocate cash flow rights and control rights but the real question is what investors do with these rights after investing. This section focuses on observable investor actions and what the data says about performance outcomes.

4.1.1 Board Oversight and Intervention

Board seats are a central tool for investor oversight in startup firms. Lerner (1995) studies changes in board composition between financing rounds and links them to situations where monitoring needs are likely to be high. A clear example is CEO turnover. In his sample of 220 U.S. based biotechnology firms second or later financing rounds when CEO change occurred between rounds, the mean change in the number of VC directors on the Board was +1,75. When CEO change did not happen, the mean change was +0,24. Lerner also shows that this large difference is specific to VC directors, not other outside directors.

Lerner (1995) also finds that oversight depends on monitoring costs. He shows that geographic proximity matters for board involvement. In his sample, VCs with offices within 5 miles of the company headquarters are about twice as likely to be board members as VCs whose nearest office is more than 500 miles away. Bernstein et al. (2016) find that lower travel time increases in person VC involvement. In their survey evidence, almost 90% of the 306 responders agreed that they would visit a portfolio company more frequently if there was a direct flight to the city of the company.

4.1.2 Staging as a Monitoring Technique

Staging creates checkpoints where investors can see the firms trajectory and decide whether to continue funding. Gompers (1995) tests this by using 794 firms that received their first VC investment before January 1, 1990. As of July 31, 1992, 22,5% of the firms had done an IPO, 23,8% had been acquired or merged, 15,6% had been liquidated or gone bankrupt, and 38.1% remained private.

In his duration models shorter financing durations are associated with lower asset tangibility, higher market to book ratios, and higher research and development intensity. Also there is more frequent monitoring when agency problems are likely to be larger. Firms that go public receive more financing rounds than firms that remain private. Acquired or bankrupt receive less rounds on average than firms that remain private (Gompers, 1995).

4.1.3 Professionalization and Founder Replacement

A big part of VC involvement is the professionalization of the startup. Hellman and Puri (2002) study Silicon Valley startups and link VC to the changes inside the firm. They focus on milestones like adopting a stock option plan and hiring a senior executive for sales and marketing. They use duration models with time-varying VC indicator. For stock option plans they find that obtaining VC is associated with a hazard ratio of 2.06 for adopting an option plan which shows that VC-backed firms are more than twice as likely to adopt an option plan. For hiring a VP of sales and marketing they report a hazard ratio of 1.79 implying faster professionalization after VC financing. They also report that VC financing is associated with a higher likelihood and faster timing of replacing the founder CEO with an outside CEO. They report firms being more than twice as likely to do the turnover after receiving VC money.

Kaplan et al. (2009) provide evidence on how firms evolve from business plan to IPO and then as public companies. In their sample of 50 VC-financed firms the business lines remain remarkably stable through the management turnover. They report that only 72% of CEOs at the IPO are the same CEOs as in the business plan, and only 44% of CEOs 3 years after the IPO are the same as in the business plan. They also report that the founder is CEO in only 49% of the times at the time of the IPO and that drops to 38% after 3 years.

4.2 Contract Terms and Follow-On Funding

4.2.1 Continuation as a Key Outcome

Follow-on funding is a central part of a startup firm's growth because most firms do not exit after the first round. Hochberg et al. (2007) track 16,315 companies that received their first institutional funding round between 1980 and 1999 and follow them through November 2003. They find that about 60.5% receive follow-on funding and the median company receives 2 funding rounds. Ewens et al. (2022) find that startups on a good trajectory typically need follow-on financing within a year to 18 months after their first round.

4.2.2 Terms That Share Continuation Incentives

Some contract terms are directly written to influence behavior on later rounds. Ewens et al. (2022) define pay-to-play as a provision where "certain cash flow and/or voting rights are taken away if an investor does not participate in the next round of financing. In their sample of U.S based startups from 2002-2015 pay-to-play appears in 12,3% of deals.

Contracts can also embed continuation conditions through staging inside of a round and across rounds. Kaplan and Strömberg (2004) distinguish ex ante (within round) staging and ex post (between round) staging.

4.3 Contract Terms and Exit vs Failure

4.3.1 Downside Protection and Exit Payoffs

A key reason VC contracts use preferred equity is downside protection at exit. In a liquidity event preferred shareholders are paid before common shareholders receive anything. VCs can also convert their stock into common stock at a agreed ratio. With participating preferred, investors first receive the liquidation preference and then also share pro rata in remaining value (Ewens et al. 2022).

Ewens et al. (2022) illustrate these payoffs directly. For standard convertible preferred the investor receives a liquidation preference unless they convert into common stock. In their contract sample participating preferred is in 51% of contracts while liquidation multiples above 1x are rare in only 4,3% of contracts.

Broughman and Fried (2010) show how these payoff rights matter in acquisitions. Their sample is 50 VC-backed firms sold in 2003-2004. Mean sale price is \$55 million and mean aggregate liquidation preferences are \$46,9 million. They also report that liquidation preference exceeds the sale price in 31/50 firms. This shows that as a downside protection it works in many sales and the common stock owners only get little of the sale price.

The exit route also matters for payoffs. Hellmann (2006) argues that convertible preferred equity allocates different cash flow rights depending on whether exit occurs through acquisition or an IPO. Convertible preferred automatically converts in case of an IPO meaning investors are treated as common in an IPO but can keep preferred terms in an acquisition. Hellmann (2006) states that this structure can make the investors payoff higher in an acquisition than in an IPO for the same underlying value realization because preferred terms apply in acquisitions but not after automatic conversion to common stock in an IPO.

Figure 1. illustrates how the investor's payoff changes with the company's exit value under two common VC securities. With convertible preferred the investor receives the liquidation preference in low exit values but switches to conversion into common once the exit value is high enough to make conversion more valuable. With participating convertible preferred the investor first receives the liquidation preference and then also participates in the remaining value on an as-converted basis. This increases the investor's payoff especially in medium exit values (Ewens et al., 2022).

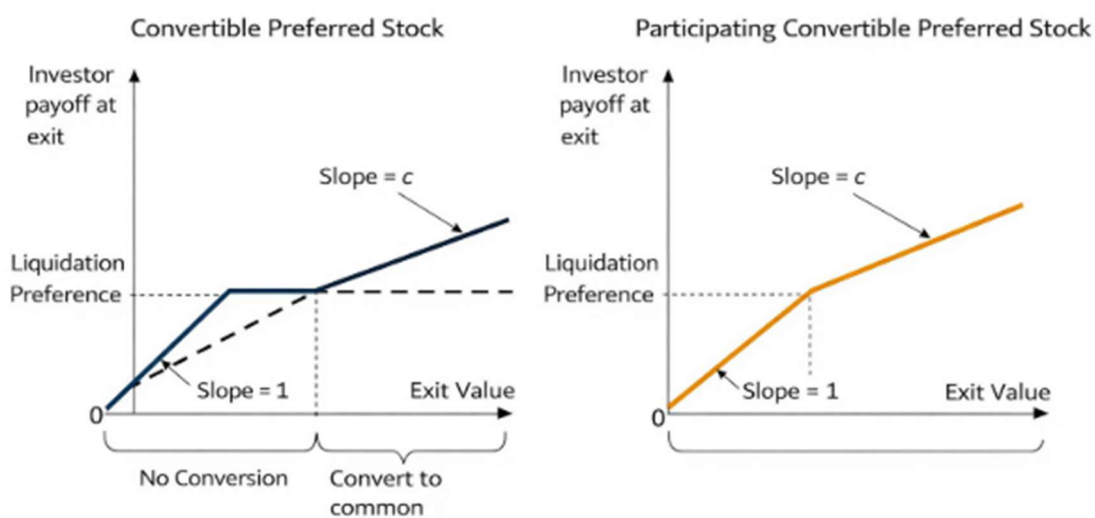


Figure 1. Exit payoff diagrams for convertible preferred stock and participating convertible preferred stock. Adapted from: Venture capital contracts, M. Ewens, A. Gorbenco, & A. Korteweg, (2022).

4.3.2 Control Rights and Exit Outcomes

Cash flow rights alone do not determine exit outcomes. Control rights shape whether a sale happens and when and who chooses whether to sell or not. Broughman and Fried (2010) describe how VC control rights works in practice. They note that VCs often have veto rights over major transactions. Board control also allows VCs to replace managers and initiate fundamental transactions such as sales and IPOs. Their data shows how much control VCs can have. In their sample of 50 sold firms 56,5% of directors are

appointed by VCs and 22.8% are appointed by common stockholders. VCs control more than half the board seats in 29/50 firms. Common stockholders only control the board in 3/50. In 21 firms the combination of outside directors and common stockholders are needed to block a sale.

4.3.3 VC Networks and Performance

Hochberg et al. (2007) study how VC networks help performance. They find that better-networked VC firms have better fund performance measured by the proportion of investments successfully exited through an IPO or acquisition. They also find that portfolio companies of better networked VCs are more likely to survive to subsequent financing and an eventual exit. In their sample of U.S based VC funds 16,315 portfolio startups 1980-1999 average exit rates are 34,2%. 20,7% being through an IPO and 13,6% through mergers and acquisitions. They find that the lead VCs network influence increases survival probability in round 1 from 66,8% to 72,4%. In round 2 from 77,7% to 82,8% and in round 3 from 79,2% to 86,6%.

4.4 Summary of Empirical Predictions Supported by the Data

This chapter supports the view that VC contracts matter. Lerner (1995) shows that VC board representation increases sharply around CEO turnover and that this change is specific to VC directors rather than other outside directors. He also shows that monitoring costs affect board involvement. Board involvement is much more likely when the VC is geographically close to the company.

More recent evidence suggests that these monitoring frictions still matter. Even with the modern communication tools. Bernstein et al. (2016) report that travel time reductions are followed by higher innovation and higher exit likelihood.

Gompers (1995) finds that shorter financing durations are associated with firm environments where monitoring and agency problems are likely to be larger. This

supports the idea of staging and how it is used to create checkpoints where investors can reassess and decide whether to continue.

Continuation is a key outcome in venture capital financing. Hochberg et al. (2007) and Ewens et al. (2022) show that continuation incentives specified in the terms of the agreement are important. Ewens et al. (2022) define a pay-to-play clause as a provision that removes certain cash flow or voting rights if the investor does not participate in the next financing round.

The evidence also supports clear predictions of downside protection in exit situations. Ewens et al. (2022) describe how liquidation preferences and participation rights change investors' returns in acquisitions and other liquidity events. They show that participating preferred stock is common in first-round financings. The exit method also affects the security structure. Hellmann (2006) explains that convertible preferred stock typically converts automatically in an initial public offering, which means that investors may be treated differently in IPOs than in acquisitions.

Research evidence suggests that investor characteristics can influence outcomes beyond the written terms of the deal. Hochberg et al. (2007) show that more networked VC investors are associated with better survival of portfolio companies in early rounds of financing and better exit success of funds. This supports the prediction that deal outcomes reflect not only the deal itself but also the investor's capabilities and networks.

5 Discussion

5.1 Limitations

This thesis has several limitations. It does not test the theories examined with new data or build a new empirical model. Therefore, the conclusions depend on the data and findings of the selected studies.

The theoretical literature is based on simplified models. This is useful because the models make the key contractual mechanisms clear. However these models simplify the real financing rounds of a startup company. In a startups lifetime contracts often involve multiple investors, multiple financing rounds, multiple share classes, renegotiation, and legal details.

The empirical literature reviewed in this study also focuses on limited samples. Many important studies focus on the United States, and several of them also examine limited sectors and companies, such as biotech companies, Silicon Valley startups, unicorns, or companies that have already been sold. Also many VC contracts never get published as many startup companies stay private throughout their whole lifetime. This means that the findings cannot automatically be considered generalizable across countries, industries, or sectors.

It is also important to note that better startups may end up with better investors. Better investors may receive different rights. Stronger rights may simultaneously reflect bargaining power, project risk, or investor quality. The reviewed literature acknowledges this problem. Ewens et al. (2022) emphasize that selection is a key problem in the study of VC agreements.

This study examines many different terms of venture capital contracting, but some contract terms are discussed in more depth than others. Control rights, staged financing, and downside protection are discussed in more detail than some other topics, such as anti-dilution clauses in later financing rounds or the role of multiple investors in deal design.

It is also important to remember that the venture capital market itself changes over time. Some of the studies reviewed use older data that may already be irrelevant due to the rapid development of the VC field. Others use newer data and more detailed agreements. This means that the paper combines observations from different venture capital environments. For this reason, the paper should be read as an overview of the key mechanisms of venture capital contracting.

5.2 Suggestions for Future Research

The literature reviewed in this thesis suggests several useful and interesting directions for future research. This thesis shows that the different contract terms are closely linked to each other. Future research would therefore benefit from analyzing how these terms operate as a whole within the same financing round or agreement, rather than just the impact of one contract term at a time.

The existing empirical literature would also benefit from broader international research. Many of the studies reviewed in this paper are based on US data. It would be useful to conduct research in other major VC markets such as Europe and Asia. This would be particularly useful as markets vary greatly across countries due to different laws and business sectors.

Many of the studies used in this thesis are based on rather old data. Since technology and the sectors being financed have developed very rapidly, it would be important to examine whether this has changed the contract structure and whether some terms no

longer have such a high weight. More recent data could show whether the key findings of previous studies still apply in today's markets or whether technological and market developments have changed how venture capitalists formulate investment contracts.

Further research could also be conducted on follow-on financing decisions. The literature reviewed here strongly suggests that raising follow-on financing is very important. Future research could examine more directly how contract terms affect obtaining follow-on financing rounds.

The impact of investor involvement and internal changes within the company could also be studied in more depth. For example, how the replacement of a founder-CEO has affected the long-term success of companies.

Future research would be good to pay more attention to the complexity of real venture capital deals. The life cycle of many startups involves multiple investors, renegotiations, and deals. It would be good to build a dataset that tracks deals, investors, and companies together across different funding rounds, providing better data on the long-term effects on the success of the company.

6 Conclusions

This thesis examined the design of venture capital contracts as a way of managing uncertainty in startup financing. The key conclusion is that venture capital contracts are not simply just valuation or ownership agreements. They are also instruments for allocating cash flow rights, control rights, incentives, and continuation decisions to lower the risk of the investment.

The literature shows that VC agreements often contain so-called standard terms. These include liquidation preferences, anti-dilution clauses, board seats, voting rights, redemption rights, and conversion features. The literature suggests that these contract terms should not be looked at one at a time but rather as part of a functional whole. The economic significance of an agreement is not determined solely by its headline level valuation. It also depends on the protections and rights attached to the security (Kaplan & Strömberg, 2003; Fu et al., 2023; Gornall & Strebulaev, 2020; Ewens et al., 2022).

Downside protection is also a key element of VC contracts. Investors often gain a preferential position in poor outcomes through liquidation preferences and related protection mechanisms. At the same time, they retain the opportunity to benefit from positive developments by converting their shares into common stock. This combination helps explain why convertible preferred stock is so common in venture capital financing. It provides investors with protection in poor outcomes while allowing them to participate in good outcomes. A review of corporate acquisitions, IPOs, and valuations shows that different classes of shares can have very different economic values, even within the same company (Hellmann, 2006; Gornall & Strebulaev, 2020; Ewens et al., 2022).

Control rights are a core element of venture capital contracts. When the outcomes are not good, ownership alone is not enough to determine control. Venture capital agreements must also specify who has decision-making power as the company develops and new information comes in. The literature explains why control can shift in different

situations and why the security structure and governance structure are closely related (Aghion & Bolton, 1992; Schmidt, 2003).

We can also see that staged financing is one of the ways venture capitalists manage uncertainty over time. Investors do not usually commit to investing all their capital at once. Instead, funding is released in stages. This allows investors to learn, monitor, and close weak projects before large losses occur. Staged financing also creates its own incentive problems. Cornelli and Yosha (2003) show that staged financing can create incentives to embellish results and that convertible securities can help reduce this problem.

Venture capitalists do more than provide capital. Empirical research shows that venture capital contracts support monitoring and intervention after the initial investment. Venture capitalists also help with the professionalization of the firm when necessary, such as in recruitment practices, stock option planning, and founder-CEO replacement. These findings support the idea that venture capital agreements are not only designed to finance startups but also to guide their internal decisions (Kaplan & Strömberg, 2003; Kaplan & Strömberg, 2004; Lerner, 1995; Hellmann & Puri, 2002; Kaplan et al., 2009).

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