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# How do legal differences and experience affect financial contracts? ☆

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**Abstract**

We analyze venture capital (VC) investments in twenty-three non-US countries and compare them to US VC investments. We describe how the contracts allocate cash flow, board, liquidation, and other control rights. In univariate analyses, contracts differ across legal regimes. However, more experienced VCs implement US style contracts regardless of legal regime. In most specifications, legal regime becomes insignificant controlling for VC experience. VC firms that do not use US style contracts fail significantly more often, even controlling for VC experience. The results are consistent with US style contracts being efficient across a wide range of legal regimes.


*JEL classification:* G24; G32

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## 1. Introduction

Financial contracting plays an important role in aligning incentives and mitigating agency conflicts between investors and entrepreneurs, thus allowing new ventures to obtain financing.[1] Studies of US venture capital (VC) investing, such as Sahlman (1990) and Kaplan and Strömberg (2003, 2004), show that investor contracts carefully allocate cash flow rights, liquidation rights, and control rights between the entrepreneur and the VC investor in order to mitigate agency conflicts. Kaplan and Strömberg (2003, 2004) also show that the characteristics of US VC contracts are consistent with the contracts predicted by financial contracting theories such as Aghion and Bolton (1992), Dessein (2005), and Dewatripont and Tirole (1994).

At the same time, the large and growing literature in law and finance finds that legal and institutional differences among countries appear to be important for the development and nature of financial markets, and also for economic growth.[2] The ability to design investments and financial contracts is potentially dependent on various elements of the institutional environment—the nature of corporate and contract law, the quality of legal enforcement, accounting systems, tax regulations, financial markets, etc. If the institutional environment affects the types of contracts that can be written, this could change the types of contracts that are used.[3]

This raises the question of whether the financial contracts observed in the US are suitable in other institutional environments. Theories of financial contracting would suggest yes (because they assume property rights are enforced and little else). Alternatively, sufficient differences in legal institutions or enforcement might lead to a negative answer. In this paper, we address this question by studying VC investments across different institutional environments—145 investments in 107 companies in 23 countries by 70 different lead VCs.

First, we describe how the contracts allocate cash flow, board, liquidation, and other control rights. In univariate analyses, the contracts differ significantly across legal regimes. VCs investing outside the US deals have weaker control, liquidation and exit rights. Non-US investments also are less likely to use contingencies—including milestones, vesting provisions and anti-dilution rights—resulting in less high-powered cash flow incentives compared to their US counterparts. These differences are manifest to some extent by the relatively greater use of ordinary common stock in Europe and less frequent use of convertible preferred.

Next, we consider how the contracts vary across legal regimes. We find that the contracts vary systematically across those regimes. In particular, investments in common law countries are more likely to look like US contracts while investments elsewhere are likely to differ. Liquidation preferences, anti-dilution protections, vesting provisions and redemption rights are more typical in common law countries while milestones are less common. These results are similar to those found in Lerner and Schoar (2005) who study private equity investments in developing countries.

In this part of the analysis, we also consider how well specific measures of the legal and institutional environment (such as creditor protection, efficiency of the legal system, tax treatment, etc.) explain the differences across legal regimes. The specific measures are not consistently related to the contractual differences (in contrast to the legal regime variables).

Given the mixed results for institutional factors, we then consider the importance of individual VC characteristics and experience. In examining the contracts, we find that some VC firms implement US contractual features across all the countries and institutional environments in which

[1] See Hart (2001).

[2] See King and Levine (1993), La Porta et al. (1997, 1998, 1999, 2000), and Rajan and Zingales (1998).

[3] E.g. Robinson and Stuart (in press) find evidence that expected litigation affect contractual completeness.