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Venture capital and the incorporation decisions of IPO firms

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ABSTRACT

This paper investigates whether IPO firms backed by venture capital investors are more likely to incorporate in states that are takeover friendly. Venture capital firms benefit when their portfolio companies are subject to the discipline of the corporate control market. State-level antitakeover statutes diminish the effectiveness of the corporate control market by making firm acquisition more costly. I find that venture capital-backed IPO firms are more likely to incorporate in a takeover-friendly state, such as Delaware. State-level antitakeover statutes are effective takeover deterrents, as my results show that firms incorporated in takeover-friendly states are more likely to be acquired in the five years following their IPO. I also find that firms incorporated in takeover-friendly states have higher Tobin's *Q* values than firms incorporated in takeover-unfriendly states, suggesting that state-level antitakeover statutes negatively impact firm value.

1. Introduction

In the United States, firms are free to incorporate in any state, and many change their state of incorporation around the time of their initial public offering (IPO). Because state-level antitakeover provisions make takeovers more costly for potential bidders, firms that incorporate in a state with such provisions in place are less vulnerable to takeover. Some investors, however, such as venture capital firms, may benefit from a corporate control market that is uninhibited by antitakeover provisions that make firm acquisition more difficult. As venture capital is a significant source of early funding for

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firms, this paper examines whether state-level antitakeover provisions play a meaningful role in the state-of-incorporation decisions of venture capital-backed IPOs.

Venture capital investors generally acquire the control and influence necessary to impact the decisions of the companies in which they invest, and thus are likely to have an impact on the state-of-incorporation decision.[1] Venture capital investors should prefer incorporations in states with fewer and less-onerous antitakeover statutes for two reasons. First, strong governance mechanisms—in this case, an active market for corporate control—are known to have a positive impact on firm value.[2] The presence of antitakeover provisions reduces the disciplinary effect of the market for corporate control, which has the potential to impact negatively the value of the venture capital investors' stake in the firm. Second, as Cumming, Fleming, and Schwienbacher (2005) demonstrate, liquidity is important to venture capital investors. While venture capital investors' generate their greatest returns by taking their portfolio companies public (Gompers & Lerner, 1999), lock-up provisions often prevent them from liquidating their stake at the IPO. The corporate control market represents an alternative liquidation option. State-level antitakeover provisions, however, reduce liquidity by making firm acquisition more costly.[3] Given that venture capital firms stand to benefit when their portfolio companies are exposed to the corporate control market, I hypothesize that venture capital firms favor incorporations in takeover-friendly states.

Employing econometric techniques that control for the endogeneity of venture capital backing, this paper examines the relation between venture capital backing and the state-of-incorporation decision for a large sample of IPO firms. Consistent with my hypothesis, this study indicates that venture capital-backed IPOs are less likely to incorporate in states with state-level antitakeover provisions in place. These results are robust to the exclusion of all firms incorporated in Delaware, which Daines (2001) finds are more likely to be the target of a takeover than firms incorporated elsewhere. In addition, firms incorporated in Delaware and firms incorporated outside of their home state are more likely to be venture capital backed, suggesting that venture capital-backed firms actively seek incorporations in takeover-friendly states.

Bebchuk and Cohen (2003) identify five state-level antitakeover provisions that impact firms' exposure to the corporate control market: (a) a control share acquisition statute, which effectively forces a shareholder vote to proceed with a hostile bid; (b) a fair price statute, which requires bidders to pay all shareholders the same price for their shares regardless of whether the shareholders tender at the initial offer; (c) a business combination statute, which imposes a waiting period before the assets of a bidder and target firm may be combined following a takeover; (d) a poison pill statute, which dilutes a bidder's position by allowing target firm stockholders to purchase more shares at a discount when triggered; and (e) a constituencies statute, which allows management to consider other constituencies (e.g., employees, creditors) when evaluating a takeover proposal. Bebchuk and Cohen aggregate these five provisions into a state antitakeover index, based on the assumption that a firm's exposure to the corporate control market is limited by incorporating in a state in which these provisions are in place.

Consistent with this premise, I find that firms that incorporate in states with control share, fair price, constituencies provisions, and high state antitakeover index values are less likely to be acquired in the five years following their IPO. In line with Field and Karpoff (2002), however, there appears to be no relation between the presence of state-level antitakeover provisions and takeover premiums for firms that are acquired. In addition, I find that firms incorporated in takeover-unfriendly states trade at lower Tobin's *Q* values than firms incorporated in takeover-friendly states, suggesting that state-level antitakeover provisions negatively impact firm value.

The remainder of this paper proceeds as follows. Section 2 reviews the literature on antitakeover provisions. Section 3 describes the data and method at the center of this study. Section 4 reports empirical results consistent with an association between venture capital backing and IPO firms' state

[1] For evidence, see Black and Gilson (1998), Gompers (1999), Lerner (1995), and Sahlman (1990).

[2] A few recent examples include Gompers et al. (2003), who find that portfolios of firms with strong shareholder rights outperform portfolios of firms with weak shareholder rights; Cremers and Nair (2005), who report a positive relation between institutional ownership and performance; and Bebchuk and Cohen (2005), who report that firms with classified boards trade at lower valuations.

[3] I thank an anonymous referee for suggesting the liquidity motivation.