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Legality and venture capital governance around the world

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ABSTRACT

We analyze governance with a new dataset on investments of venture capitalists in 3848 portfolio firms in 39 countries from North and South America, Europe and Asia spanning 1971–2003. We provide evidence that cross-country differences in legality, including legal origin and accounting standards, have a significant impact on the governance structure of investments in the VC industry: better laws facilitate faster deal screening and deal origination, a higher probability of syndication and a lower probability of potentially harmful co-investment, and facilitate investor board representation of the investor. We also show that country-specific differences exist apart from legal and economic development.

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1. Executive summary

Venture capital is distinct from other forms of financial intermediation primarily through the governance and value-added that the investor provides to the investee. While the oldest and most successful venture capital market has been in the U.S., venture capital activities have spread across the globe with increasing vigour in the latter part of the 20th century. Nevertheless, massive differences remain in the size and success of venture capital markets around the world. The defining characteristic of venture capital as a form of financial intermediation is the governance provided to their entrepreneurial investees. As such, the source of international differences in venture capital markets is most likely attributable to the impact of laws and institutions on venture capital governance structures.

In this paper, we focus on international differences in governance structures and investment patterns in venture capital in three related and equally important categories: (1) time from fundraising to deal origination (which reflects screening and due diligence), (2) syndication and co-investment, and (3) board seats and security choice. To fully understand the structure and governance of venture capitalists vis-à-vis their entrepreneurial investees, it is useful to examine each of these complementary and interrelated aspects in unison. Further, a joint analysis of each of these governance mechanisms which address the various stages throughout the investment cycle of the venture capitalist facilitates a fairly comprehensive picture of the source of international differences in venture capital markets. We thereby add to the literature and build on prior work on international differences in VC markets based on aggregate industry data.

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The first main pillar of our analysis focuses on the screening process, which is of vital importance to venture capitalists. For instance, venture capitalists in the U.S. receive more than 1000 requests for financing each year, but complete at most only a couple of deals in a typical year. In terms of cross-country differences in venture capital finance, where the legal and institutional framework impedes the due diligence and investment process (e.g., through slow bureaucracies, risk of contract repudiation etc.) this slows down the rate of investment and ability of a fund to properly manage deal flow and the financing of meritorious entrepreneurial firms.

The screening and due diligence process is in turn closely connected to syndication and co-investment, or the interaction among different investors within any investment. This is the second main pillar of our analysis. Prior research has established the notion that syndication enhances venture capitalist screening, monitoring and value-added. By contrast, co-investment (i.e., the investment of different funds of the same VC firm into the same entrepreneurial firm) does not facilitate these governance mechanisms and may reflect an agency problem vis-à-vis the institutional investors if one VC fund is using capital to bail out the bad investments of another VC fund within the same VC organizational structure. We extend the literature by exploring the issue of whether successful legal and institutional structures facilitate syndication relations and inhibit co-investment by VCs in a very broad international context.

Our third and final pillar invokes an analysis of the interaction between venture capitalists and their investees. We study cash flow and control rights that focus on the substantive aspect of governance as opposed to the form of governance. In regard to the control rights, we investigate the question of whether the venture capitalist has a seat on the board of directors of the entrepreneurial firm. We are able to add to prior research by studying a broader array of data and countries than that which has previously been possible with prior datasets. In regard to cash flow rights, we extend prior work by examining whether the financial contract between the VC and entrepreneur involves just upside potential for the investor, or whether there is both period cash flows provided to the investor prior to exit, as well as upside potential. That is, we have specific details on the contract that get beyond the form of the contract and go more closely at the substantive structure of the contract. In view of the fact that contracts of different forms may be functionally equivalent, and specific contractual forms that are immaterial to their substantive content may be attributable to hidden practice level concerns that are of first order importance; this is an important new dimension of our analysis.

In each of the three main areas of our analysis we analyze the impact of different legal systems and thereby consider the Legality index. We also consider the robustness of the legality results to legal origin variables (English, French, German and Scandinavian) as prior work is consistent with the view that English legal origin facilitates capital raising through stronger legal protections afforded to investors. We further consider accounting standards, as they directly relate to information asymmetries faced by investors, which are particularly pronounced for early stage investments in high-tech companies. The effect of laws is considered while controlling for economic conditions (GNP per capita, MSCI index performance, etc.).

A key component of our analysis rests with the introduction of a very large international dataset of 3828 venture capitalist investments from 39 countries (from North and South America, Europe and Asia) and 33 years (1971–2003). We show that the legal framework has a strong impact on each of these closely related areas of governance, and significantly build on and extend the literature on international differences of venture capital. The new data introduced herein reveal a number of key results with respect to international differences in time to investment and deal origination, syndication, co-investment, board seats, and the functional form of the financing instrument chosen. Our first central result indicates that better laws facilitate faster deal screening and origination. Second, we show that better laws lead to a higher probability of syndication and a lower probability of potentially harmful co-investment. Third, we show that better laws also facilitate board representation of the investor. We also find evidence that law matters in terms of influencing the probability of using securities which involve periodic cashflows prior to exit, albeit this latter finding is not as statistically robust. Overall, however, we do note that law plays an important role in the extensive venture capital data introduced herein for a wide variety of robustness checks, such as inclusion or exclusion of the US from the dataset. Legal conditions are an important condition for enabling venture capitalist governance structures that facilitate the financing of high-tech entrepreneurial ventures, and the success of a country's venture capital market.

2. Introduction

Venture capital is distinct from other forms of financial intermediation primarily through the governance and value-added that the investor provides to the investee (see e.g., Sapienza, 1992; Manigart et al., 1996, 2002; Gompers and Lerner, 1999; Kanniainen and Keuschnigg, 2003, 2004). While the oldest and most successful venture capital market has been in the U.S., venture capital activities have spread across the globe with increasing vigour in the latter part of the 20th century (see e.g., Lerner, 2000; Hege et al., 2003; Mayer et al., 2005; Lerner and Schoar, 2005). Nevertheless, massive differences remain in the size and success of venture capital markets around the world. The defining characteristic of venture capital as a form of financial intermediation is in the governance provided to their entrepreneurial investees. As such, the source of international differences in venture capital markets is most likely attributable to the impact of laws and institutions on venture capital governance structures.

In this paper, we focus on international differences in governance structures and investment patterns in venture capital in three related and equally important categories: (1) time from fundraising to deal origination (which reflects screening and due diligence), (2) syndication and co-investment, and (3) board seats and security choice. To fully understand the structure and governance of venture capitalists vis-à-vis their entrepreneurial investees, it is useful to examine each of these complementary and interrelated aspects in unison. Further, a joint analysis of each of these governance mechanisms which address the various stages throughout the investment cycle of the venture capitalist facilitates a fairly comprehensive picture of the source of international

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