

Investor Opportunism and Venture Financing

by Jochen Bigus

University of Hamburg

Institute of Law and Economics

Edmund-Siemers- Allee 1, 20146 Hamburg, Germany

j-bigus@jura.uni-hamburg.de

Abstract:

We look at moral hazard by an inside investor in the context of venture financing. The inside investor has experienced the entrepreneur's quality at a previous stage, an outside investor, on the other hand, cannot assess the quality. Thus, generally, an outside investor offers financial terms reflecting average entrepreneurial quality. If the entrepreneur is a "good" one the inside investor may have an incentive to appropriate rents due to his information monopoly by demanding a higher share on the venture's return before financing the next stage. If it is more costly for the entrepreneur to switch to an outside investor, she sticks with the inside investor. However, she may not choose the efficient level of effort or specific investments, rather she will underinvest. The problem becomes more severe with a so-called right of first refusal, which is widely used in the venture capital industry and often ensures that an inside (old) investor makes his offer after the outside investor does.

This problem of expropriation depends on the information structure and may be mitigated when the parties ex ante fix the financial terms of future capital infusions conditional on the performance of previous stages. These provisions are quite common (*Kaplan/Strömberg (2000)*). So far, the literature considered them as a device to mitigate moral hazard by entrepreneurs. But they can also mitigate the inside investor's incentive to negotiate opportunistically. Debt financing or mixed financing may be more favorable than equity financing since legal interest rate ceilings limit the extent to which an inside investor can hold up an entrepreneur.

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