Venture Capital Finance: A Security Design Approach Get access >

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Abstract

This paper characterizes the optimal securities for venture capital finance in an environment with multiple investment stages and double–sided moral hazard in the relationship between entrepreneurs and venture capitalists. We show that if the conditions relevant for continuation into later stages are verifiable, the optimal security gives the venture capitalist a constant share in the success return of the project over a predetermined set of continuation states. Otherwise, the parties sign an initial start-up contract that is later renegotiated. In this case, in order to minimize the incentive distortions associated with the burden of early financing stages, the optimal start-up security gives a zero payoff in low profitability states and thereafter an increasing share in the success return of the project.

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Subject: Capital Structure and Dividend Policy, Security Design

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