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Abstract

Venture capitalists (VCs) have reported the use of a variety of securities, including convertible debt, and preferred equity, debt, and equity, and there is a tax bias in favor of equity. Firms that receive venture finance may be defined by a variety of characteristics, such as stage of development, type of industry, and capital requirements. Given this broad context observed in practice, previous research has not considered the extent to which different securities, among the complete class of forms of finance, attract different types of entrepreneurial firms. In this article, we investigate the empirical tractability of the adverse selection risks associated with capital structure from 4,114 first-round Canadian venture capital investments. We first characterize the nature of uncertainty (in terms of the risk of financing a *lemon* or a *nut*) facing investors for different types of entrepreneurial firms. We then show that VC syndication significantly mitigates problems of adverse selection.



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