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Two's a company, three's a crowd: Deal breaker terms in equity crowdfunding for prospective venture capital

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Michael M. Moedl [orcid.org/0000-0002-5755-2928¹](https://orcid.org/0000-0002-5755-2928)

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Abstract

Crowd-based means of funding are emerging as a valid novel way of providing scarce seed-finance for entrepreneurial ventures. In recent years, securities-based variants such as equity crowdfunding or initial coin offerings (ICOs) are increasingly attracting higher funding amounts than reward-based models, in particular for commercially oriented ventures. However, securities-based crowdfundings also come along with the more complex contracts, since they introduce a large set of new shareholders in the firm, possibly with voting, information, and cash-flow rights. This might have implications for the ownership structure and future governance of a company, and in turn influence the evaluations by prospective investors. This paper is concerned with exploring potential knockout criteria in securities-based crowdfunding contracts and to what

degree they serve as a deal breaker for the investment decision of subsequent professional venture investors. Using an explorative mixed methods approach, we find empirical evidence that, e.g., an inflated capitalization table owing to crowd investors holding direct securities in a company, redemption and voting rights by the crowd, as well as the non-existence of a drag-along clause, lead venture capitalists and business angels to refrain from an investment in an otherwise attractive but such-funded start-up firm. We conclude that contractual frictions play a decisive role in whether entrepreneurs can combine crowd-based means of funding with traditional forms of venture financing. Theoretical and managerial implications are discussed.



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Notes

1. Retrieved from MacIntosh (2013).
2. We use the term securities-based crowdfunding in favor of equity crowdfunding as equity-like or mezzanine financial instruments are also

frequently in use; see, e.g., Ahlers et al. ([2015](#)) and Hornuf and Schwienbacher ([2015](#)).

3. Source: Interviews with Steffen Reitz, CEO and founder of Smarchive/Gini (5 February, 2014), and Jakob Carstens, Head of Marketing, Seedmatch (14 February, 2014). Also see Weverbergh ([2013](#)).
4. The term crowdfunding is often used as a collective basin for all its sub-categories.
5. In fact, ICOs often use a decentralized platform, such as Ethereum or Waves.
6. Note that even though they are called “loans,” they represent a mezzanine instrument, replicating the uncertain future cash flows of a start-up firm (see, e.g., Hornuf and Schwienbacher, [2015](#)).
7. For a more detailed description of equivalent covenants in securities-based crowdfunding contracts, see section [5.1](#).
8. On the other side, Hsu ([2004](#)) have documented that entrepreneurs are more willing to accept less favorable terms when they can secure funding from more reputable VC investors.
9. For an overview of studies applying a legal lens to securities-based crowdfunding see, e.g., Mochkabadi and Volkmann ([2018](#)), section 3.4.
10. Harrison and Mason ([2000](#)) find four types of complementarities between venture capital and business angels: (1) sequential investing in start-ups at different stages, (2) co-investing in deals at the same time, (3) provision of finance to VC funds by business angels, and (4) deal referring. These types of complementarities may also be considered to exist between crowdfinancing

and venture investors. For instance, on platforms like AngelList angel investors operate as syndicate “lead” and invite the crowd to back their curated ventures, see, e.g., Agrawal et al. (2015). Also, business angels, and to a lesser extent VCs, sometimes place investments in crowdfunding campaigns. In this work, we focus on the first type of interaction, sequential investing.

11. For an overview of empirical evidence on venture capital contracts, see, e.g., Da Rin et al. (2013, 592ff.) and Denis (2004, 310ff.).
12. It deserves mentioning that even though we applied German data, the final wording of the clauses was abstracted from national particularities and formulated as universally understandable. We also cross-compared our final list with the meta-analysis of US crowd investment contract terms by Wroldsen (2017, 606ff.) and could not find any elements that could not be subsumed under one of our categories.
13. In conjunction with Likert-type ratings, the format of the scale is as follows: (1) strongly disagree, (2) disagree, (3) neither agree nor disagree, (4) agree, (5) strongly agree. For the wording of items, see Table 2. As we do not sum over items here we strictly spoken do not apply a Likert scale.
14. A crucial concern is whether self-reported survey questions can be meaningfully interpreted in terms of actual risk-taking behavior. Dohmen et al. (2011) conducted a field experiment in which participants answered the respective general risk question and additionally made choices in a paid lottery experiment. They find that responses to the general risk question are a reliable predictor of actual risky behavior and conclude that “[t]he question about risk taking in general generates the best all-round predictor of risky behavior” (Dohmen et al. 2011, p. 522).
15. See, e.g., <http://www.whiteboardmag.com/crowdfunding-seedmatch-raises->

[200-000-e-in-equity-based-funding-in-48-minutes/](http://www.faz.net/aktuell/wirtschaft/netzwirtschaft/crowdfunding-stellt-neuen-rekord-auf-13038525.html); [http://www.faz.net/aktuell/wirtschaft/netzwirtschaft/crowdfunding-stellt-neuen-rekord-auf-13038525.html; https://www.rt.com/news/163968-nsa-proof-server-crowdfunding/](https://www.rt.com/news/163968-nsa-proof-server-crowdfunding/); (accessed 19 February 2017).

16. We paid attention to the special requirements for conducting telephone interviews (e.g., Schnell et al. [2013](#), 355ff.).
17. We chose this sequence in order to ensure that conversation topics did not influence the survey experience.
18. The BVK is covering about two thirds of all German VC companies and 90% of VC investment volume in Germany according to its own statement.
19. Reliable data on business angel “population” is hard to obtain, however, according to its own statement all significant German regional business angel organizations are member of BAND, ensuring a wide coverage.
20. We extensively screened the raw dataset for answer patterns, consistency and processing time, and dropped suspicious entries.
21. Note that even though they are called “loans,” they represent a mezzanine instrument, replicating the uncertain future cash flows of a start-up firm; see Hornuf and Schwienbacher ([2015](#)).
22. A stronger prevalence of angel investors to identify previous investment contracts’ clauses as deal breakers would seem puzzling at first sight, as business angels are said to take a less formal approach to investing than venture capitalists; see, e.g., Maxwell et al. ([2011](#)), Berger and Udell ([1998](#)), Wong ([2002](#)). Potential explanations may include that angels, being more inclined to invest in earlier stages, might simply be less used to pre-

investors. In addition, in opposite to VCs, they might not have the financial and organizational means for prolonged legal disputes, and contractual complexity might thus deter them even more.

23. Additionally, we mark the weighted average of answers with a circle. The calculation of means requires the assumption of equidistant ordinal answer categories (interval scale), which might be violated in our 5-point scale. For a discussion, see, e.g., Schnell et al. ([2013](#), pp. 135–139).
24. We nonetheless include both variables in the final OLS regression. Robustness tests with excluding one or the other do not lead to significantly different results.
25. Source: Personal interview with Steffen Reitz, CEO and founder of Smarchive/Gini (5 February, 2014), and Jakob Carstens, Head of Marketing, Seedmatch (14 February, 2014). Also see Weverbergh ([2013](#)).

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Authors and Affiliations

Max Planck Institute for Innovation and Competition, Munich, Germany

Michael M. Moedl

Corresponding author

Correspondence to [Michael M. Moedl](#).

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