1 Introduction

1.1 Motivation

During its comparably short 40-year history, the German venture capital market has developed into one of the largest and most important national venture capital markets in Europe. Smaller only than the British (EUR 3.958 bn), French (EUR 1.689 bn), and Spanish (EUR 1.295 bn) venture capital markets, it ranks fourth in terms of new investments with EUR 1.079 bn invested in 2004. As a result of this significant investment activity, venture capital is one of the fastest growing and most visible segments of the German economy, with new investments growing at an annual growth rate of 10.6% over the past ten years and representing 0.50‰ of the German gross domestic product (GDP) in 2004.[1] Venture capital investments are believed to substantially contribute to the German economy's structural change because they are systematically employed to support "creative destruction" through innovation and growth.[2]

Venture capital investments fill in the financing gap faced mainly by those German small and medium-sized enterprises (SMEs) which are active in high-technology and innovation-intensive industries and engage mainly in research and development or product development. This financing gap results from the fact that their revenues and the founders' private resources are not sufficient to cover expenses. Furthermore, debt financing through banks and other credit institutions is not available to them due to the high risks associated with their business model and a lack of collateral. Thus faced with special investment characteristics, venture capital companies attach great importance to the contracts governing their financing relationships.

Such contractual relations and underlying contracts are the subject of contract theory. From a theoretical perspective, they even constitute the essence of the

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1 See BVK (2005a), p. 27, and BVK (2005d), pp. 21–23, 28.
2 See Frommann and Dahmann (2003), pp. 16–19, and Schefczyk (2000), p. 23.

firm.[3] Furthermore, venture capital companies are considered to most closely approximate the investor of theory. The venture capital financing relationship is almost fully described by focusing on a few key aspects discussed in the following.

Due to diverging interests, asymmetric and imperfect information, and multiple incentive problems between the venture capital company and its portfolio company, a transfer of capital in a complex and highly unpredictable world and under significant business risk leads to (double-sided) opportunistic and aberrant activities, observable and hence controllable by neither party.[4] From these activities result (agency) costs which can be minimized by implementing incentive-compatible contracts. The complexity of venture capital investments, however, makes the ex-ante specification of the contracting parties' actions and obligations in all future states of the world infinitely costly and thus impossible. Therefore, the parties resort to incomplete contracts which automatically realign incentives and define governance structures for the contracting parties, and thus adapt more effectively to the ex-post realized states of the world.[5] These incentive and governance mechanisms are modeled by allocating cash flow and control rights which are specified by the two distinct contract components: financial instruments and contractual covenants.

The financial instrument most commonly employed in the German venture capital market is straight equity.[6] In the US venture capital market, convertible securities are the predominant financial instrument.[7] Venture capital practices, such as the use of financial instruments, are usually benchmarked against the US venture capital market because it is the oldest worldwide, with 60 years of investment experience, and the largest in terms of new investments

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3 "[M]ost organizations are simply legal fictions which serve as a nexus for a set of contracting relationships among individuals." Jensen and Meckling (1976), p. 310. Legal fiction, in this citation, circumscribes the fact that an organization is, by law, treated as an individual. See Jensen and Meckling (1976), p. 310. See also Hart and Holmström (1987), p. 73.

4 See Holmström (1979), pp. 74–75.

5 See Williamson (1988), p. 570.

6 See Bascha and Walz (2002), p. 13, and Hommel et al. (2003), p. 328.

7 See, for example, Kaplan and Strömberg (2000b), p. 284, and Sahlman (1990), pp. 480–481.