Relational Contracting and Business Norms in Entrepreneurial Finance

Alternate title: Relational Contracting with Strangers

Brian Broughman[1]

Indiana University

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Abstract:

Contracts between parties who have an on-going relationship often rely on informal norms, rather than formal legal rights, to resolve disputes and reduce transaction costs. Investors financing startup firms, however, may need to look outside of their existing network to find an entrepreneur with an innovative business plan. The search for innovation poses a challenge for relational models of contracting and may limit the effectiveness of social norms in entrepreneurial settings. Recognizing a tension between innovation and social embeddedness, one might expect to see greater use of arms-length contracting, especially when an investor finances an unknown entrepreneur. By contrast, I argue – using examples from angel/VC financing arrangements – that the tension between innovation and social embeddedness is resolved not through arms-length contracting, but rather by bolstering the network position of the unconnected entrepreneur through third-party intermediaries and staged financing. Third-party intermediaries – such as lawyers, board members, managers, scientists, and other entrepreneurs – are able to transform the relationship between the entrepreneur and investor by serving as 'matchmakers', 'chaperones', and 'arbitrators'. These mechanisms allow entrepreneurs and investors to commit to informal business norms, even though the parties may have no pre-existing relationship. This study extends the literature in relational contracting and in entrepreneurial finance. Furthermore, my analysis suggests that studies of financial contracts, which focus exclusively on formal terms may overstate the relevance of holdup problems in the allocation of control rights.

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[1] Professor of Law, Indiana University Maurer School of Law. For helpful conversations and comments on earlier versions of this paper, I am grateful to Ola Bengtsson, Brad Bernthal, Gordon Smith, Mark Suchman, and seminar participants at the Law and Society Association Annual Conference, the 2018 Law and Entrepreneurship Association retreat, BYU, Colorado, and San Diego University School of Law. I would also like to thank Andrew Tan for valuable research assistance.

INTRODUCTION

The literature on financial contracting highlights a risk of opportunism by whichever party controls the firm.[2] If the entrepreneur retains control of the business she may pursue private benefits (e.g. the joy of running her own business) at the expense of financial returns. To address this concern, investors may demand control rights as a condition of financing;[3] however, this merely flips the problem, since now investors may use such control to behave opportunistically towards the founders or other constituents of the firm.[4] In the context of entrepreneurial finance such problems are magnified by the fact that financing contracts are inherently incomplete and cannot specify the firm's action for every contingency that might arise.[5] While legal constraints – such as fiduciary obligations – may mitigate the risk of controlling party opportunism, the law provides an imperfect solution at best and cannot eliminate opportunistic behavior within entrepreneurial finance.[6]

Instead of formal law, the parties to a financing contract may rely on informal norms and relational modes of governance to settle their disputes and limit controlling party opportunism. Relational contracting does not require a complete contract prohibiting all instances of opportunism that might arise.[7] Instead, opportunism is constrained by informal norms backed by the implicit threat that misconduct will cause the other party to respond tit-for-tat or possibly even terminate the relationship. Relational contracting is most desirable in settings where performance

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[2] *See generally* Oliver Hart, *Financial Contracting,* 39 JOURNAL OF ECONOMIC LITERATURE 1079 (2001).

[3] Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting,* 59 REVIEW OF ECONOMIC STUDIES 473 (1992).

[4] For some background on how venture capital (VC) investors may use control opportunistically, *see* Brian Broughman, *Investor Opportunism, and Governance in Venture Capital*, *in* VENTURE CAPITAL: INVESTMENT STRATEGIES, STRUCTURES, AND POLICIES 347 (Douglas J. Cumming ed., 2010) [hereinafter Broughman *Investor Opportunism*]; Michael Klausner & Kate Litvak, *What Economists Have Taught Us About Venture Capital Contracting*, *in* BRIDGING THE ENTREPRENEURIAL FINANCING GAP: LINKING GOVERNANCE WITH REGULATORY POLICY 54 (Michael J. Whincop ed., 2001).

[5] For a general discussion of the incompleteness of financing contracts *see* Aghion & Bolton *supra* note 3; and *see* Hart *supra* note 2.

[6] See discussion in Broughman, *Investor Opportunism, supra* note 4.

[7] Not only can a relational understanding between the parties fill gaps in an otherwise incomplete contract, but also opportunistic conduct by either party will lead to sanctions within the relationship and reputational harm outside it. As noted in Stephen Carson, Anoop Madhok & Tao Wu. *Uncertainty, opportunism, and governance: The effects of volatility and ambiguity on formal and relational contracting*, 49 ACADEMY OF MANAGEMENT JOURNAL 1058 (2006): "Embeddedness creates safeguards against opportunism in the form of externalities or spillover effects from one exchange to another that disincentivise opportunism in any given relationship."

occurs over a long period of time and where the desired action is difficult to specify ex ante or may depend on non-verifiable future contingencies. While relational contracting is often studied in the context of procurement contracts between manufacturers and suppliers,[8] the concept has been extended to other settings, including relational finance between an external investor/lender and an entrepreneur.[9]

Relational governance appears particularly desirable for entrepreneurial finance. Startups firms typically face high levels of uncertainty that cannot be contracted over and often operate in rapidly evolving business environments. Furthermore, startup firms often lack collateral or cash-flows necessary to secure debt financing and instead issue equity to investors. Coupled with the uncertainty of any new business, equity financing highlights the risk exposure of both entrepreneur and investor, and particularly, the vulnerability of the non-controlling party. Relational governance may be especially valuable as a means to prevent opportunism in this setting.

Despite its potential benefits, the network structure most conducive to relational contracting may stifle innovation. Relational contracting is most effective in long-term repeat (i.e. embedded) relationships. In entrepreneurial finance this means an investor would work with a small group of entrepreneurs and return to these same entrepreneurs when financing new ventures. The problem is an investor who follows this approach may miss out on innovative projects from outside parties. To find an entrepreneur with an innovative business plan, investors may need to look outside their existing network. They may need to finance a stranger. The search for innovation poses a challenge for relational models of contracting and may limit the effectiveness of social norms in entrepreneurial settings.

How do investors navigate this tradeoff? In particular, how does the tradeoff between relational governance and the search for innovation impact the selection of which entrepreneurs receive financing, and the relative use of formal and informal modes of governance? This project

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[8] Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963); Lisa Bernstein, *Beyond Relational Contracts: Social Capital and Network Governance in Procurement Contracts.* 7 JOURNAL OF LEGAL ANALYSIS 561 (2015); Gillian Hadfield & Iva Bozovic, *Scaffolding: Using Formal Contracts to Support Informal Relations in Support of Innovation.* 2016 WIS. L. REV. 981 (2016).

[9] Fischer Black, *Bank Funds Management in an Efficient Market*, 2 JOURNAL OF FINANCIAL ECONOMICS 323 (1975); Ola Bengtsson, *Relational Venture Capital Financing of Serial Founders*, 22 JOURNAL OF FINANCIAL INTERMEDIATION 308 (2013) [hereinafter Bengtsson, *Serial Founders*]; Mitchell Petersen & Raghuram Rajan, *The Benefits of Lending Relationships: Evidence from Small Business Data*. 49 JOURNAL OF FINANCE 3 (1994).

uses examples from venture capital (VC) finance to investigate relational governance in entrepreneurial finance. I develop a new theory – "relational bolstering" – to explain how relational governance can function even if there is no prior relationship between an entrepreneur and investor.

I. RELATIONAL CONTRACTING AND THE PARADOX OF EMBEDDEDNESS

Stewart Macauley's groundbreaking work on procurement contracting showed that, in long-term relationships, deviation from the terms of a purchase order are rarely settled by recourse to the formal contract or remedies provided by the Uniform Commercial Code.[10] Indeed, Macauley found that lawyers are rarely consulted at all in these sorts of disputes.[11] Instead, the relevant business parties at each firm talk through the problem, rely on informal business norms regarding fair conduct to remedy the situation, and take actions to preserve the relationship. This result is contrary to both legal formalism, which implicitly assumes that contract terms are enforced[12] and incomplete contract theory which predicts opportunistic holdup in such settings.[13] The long-term repeat-play nature of the relationship between buyer and seller serves as a check on opportunism and fills gaps in an incomplete contract.

Under this account the relationship is celebrated as the glue which enables interfirm exchange. Macauley's research is followed by numerous articles,[14] including some on financial contracting,[15] emphasizing the benefits of relational ties, or as sociologists refer to it "embedded

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[10] Macauley *supra* note 8.

[11] See id.

[12] Richard Craswell. *Contract remedies, renegotiation, and the theory of efficient breach*, 61 S. CAL. L. REV 629 (1987).

[13] See Hart *supra* note 2.

[14] Ian Macneil, *Contracts-Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NORTHWESTERN UNIVERSITY LAW REVIEW. 854 (1978); Ian Macneil, *Values in contract: internal and external*, 78 NW.UL REV. 340 (1983); Ian Macneil, *Relational contract: What we do and do not know*, 4 WIS. L. REV. 483 (1985); Robert Goetz and Charles Goetz, *Principles of relational contracts*, 67 VIRGINIA LAW REVIEW 1089 (1981); David Charny, *Nonlegal sanctions in commercial relationships*, 104 HARVARD LAW REVIEW 373 (1990); Alan Schwartz, *Relational contracts in the courts: An analysis of incomplete agreements and judicial strategies*. 21 THE JOURNAL OF LEGAL STUDIES 271 (1992).

[15] These include (without limitation): See Black, *supra* note 9 and Peterson & Rajan, *supra* note 9; Christopher James, *Some evidence of the uniqueness of bank loans*, 19 J. FINAN. ECON. 217 (1987); Allen Berger and Gregory

ties". On the one hand, this body of scholarship makes a very important, yet modest, claim: contracts operate filtered through the relationship in which the parties are situated and cannot be understood purely as legal documents binding atomistic parties. At other times, however, the relational contracting literature goes further, suggesting that business parties should focus more on maintaining a strong relationship with their counterparty (& academics should focus more on studying that relationship) than on haggling over (or studying) the terms of formal contracts.[16]

In contrast to this celebration of the relationally embedded nature of market exchange, there are costs to doing business through embedded ties. Writing two decades after Macauley, sociologists study the issue not as a dyadic relationship between two counterparties, but rather as part of a broader network of interfirm relationships.[17] By widening the lens and situating the network as the unit of analysis, it is easier to see the cost of forming and maintaining embedded ties. If a business operates in a highly embedded network this implies that such firm deals with a relatively small number of counterparties – e.g. suppliers, purchasers, service providers, etc. – and returns to such parties on a repeat basis. The reliance on an embedded network limits such firm's ability to form ties with other parties.[18] By closing off such interactions the embedded firm may miss out on information and other opportunities existing outside their embedded network[19]. To illustrate with a concrete example, a supplier outside a firm's network may offer a higher quality product, better pricing, or access to new technologies. Yet, a firm operating within a highly

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Udell, *Relationship lending and lines of credit in small firm finance*. 68 J. BUSINESS 351 (1995); Rebel Cole. *The importance of relationships to the availability of credit*, 22 J. BANK. FINAN. 959 (1998); Steven Ongena and David Smith, *The duration of bank relationships*, 61 J. FINAN. ECON. 449 (2001); Sreedar Bharath, Sandeep Dahiya, Anthony Saunders, Anand Srinivasan, *So what do I get: a bank's view of lending relationships?* 85 J. FINAN. ECON. 368 (2007) Sreedar Bharath, Sandeep Dahiya, Anthony Saunders, Anand Srinivasan, *Lending relationships and loan contract terms?* 24 REV. FINAN. STUD. 1141 (2011); , Victoria Ivashina and Anna Kovner, *The private equity advantage: leveraged buyout firms and relationship banking*, 24 REV. FINAN. STUD. 2462 (2011).

[16] See *supra* note 14.

[17] *See generally* Mark Granovetter, *Economic Action and Social Structure: The Problem of Embeddedness*, 91 AMERICAN JOURNAL OF SOCIOLOGY 481 (1985). This body of research is sometimes referred to as relational network theory. In addition to the benefits outlined above, contracting through embedded ties can help improve trust between counterparties and reduce risk and uncertainty Ranjay Gulati and Martin Gargiulo, *Where do Interorganizational Networks Come From?* 104 AMERICAN JOURNAL OF SOCIOLOGY 1439 (March 1999); Joel Podolny, *Networks as Pipes and Prisms of the Market*, 107 AMERICAN JOURNAL OF SOCIOLOGY 33 (2001)).

[18] Brian Uzzi, *Social Structure And Competition in Inter-Firm Networks: The Paradox of Embeddedness*, 42 ADMINISTRATIVE SCIENCE QUARTERLY 35 (1997).

[19] Ronald Burt, *Structural Holes: The Social Structure of Competition*, CAMBRIDGE: HARVARD UNIVERSITY PRESS (1992); Ronald Burt, *Structural Holes and Good Ideas*. 110 AMERICAN JOURNAL OF SOCIOLOGY 349 (2004); see Podolny s*upra* note 17; see Uzzi, *supra* note 18.

embedded network will miss out on such opportunities, limiting the firm's ability to adapt to change.

Sociologist Brian Uzzi refers to this problem as the paradox of embeddedness, highlighting tension between the depth and breadth of ties in a firm's network of counterparties.[20] At some point the cost of increased embeddedness in terms of lost opportunities outweighs the benefits of increased trust within embedded relations, suggesting that for each business there is an optimal level of network embeddedness.[21] For businesses in stable sectors, where innovation and major changes to the production process are less likely, the optimal level of network embeddedness may be relatively high. By contrast, firms operating in highly dynamic sectors must be able to adopt to a rapidly changing environment and consequently the optimal level of network embeddedness is considerably lower.

Figures 1 and 2 illustrate the paradox of embeddedness in the context of entrepreneurial finance. Each figure shows a hypothetical VC investor's network of startup firms ('E' for entrepreneur). The diagrams show two types of connections between the various entrepreneurs and the VC: (i) embedded ties (bold line), and (ii) arms-length ties (dashed line). Embedded ties represent an entrepreneur with whom the VC already has a strong long-term relationship. This might be thought of as serial entrepreneurs with whom the VC has a past working relationship. By contrast, entrepreneurs with whom the VC does not have a pre-existing relationship are illustrated with arms-length ties. The diagrams are most useful for understanding the set of entrepreneurs who might receive financing from a VC in the future. They are not merely a list of entrepreneurs currently financed by the VC. There is nothing unique about Figures 1 and 2; they are merely illustrative of two points along a spectrum of "embeddedness".

[20] See Uzzi, *supra* note 18.

[21] See id.

Figure 1

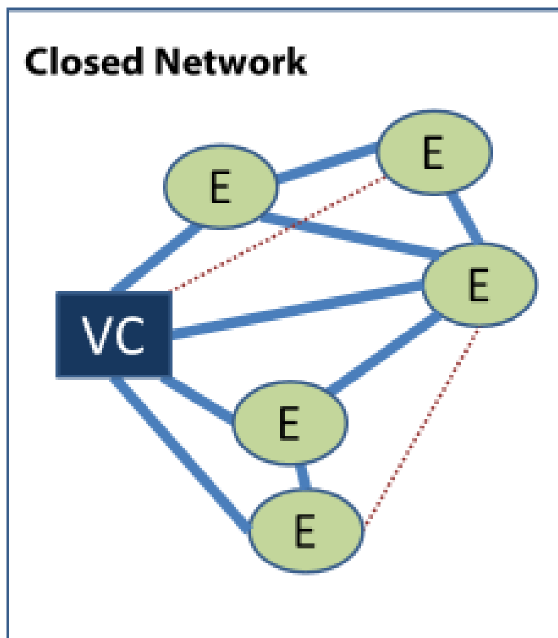

Figure 2

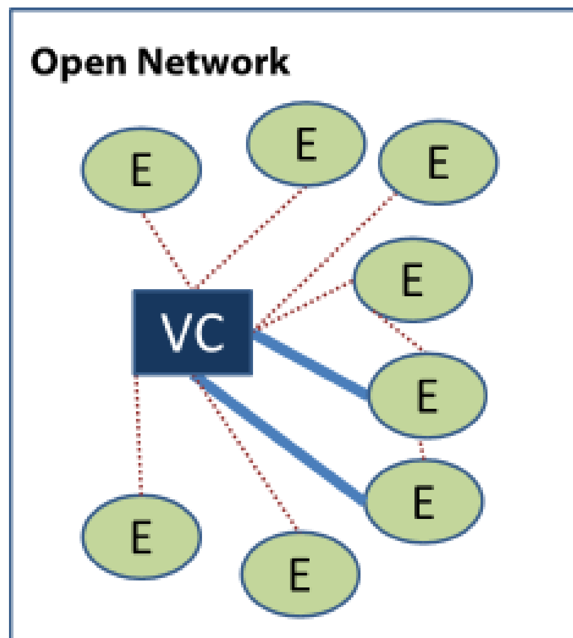

Figure 1 shows a VC operating in highly embedded (or closed) network. In this case the VC only considers financing proposals from a small group of embedded entrepreneurs. The VC in figure 1 is reluctant to provide financing to an unknown party. By contrast, figure 2 shows a VC operating in a relatively open network. Here the VC considers financing proposals from a number of unknown individuals. The choice between an open versus a closed network highlights the tension between depth (fig. 1) and breadth (fig. 2) in a VC's network. A VC operating a closed network will presumably be less exposed to opportunism, as relational contracting is more effective with embedded ties, but operating within a relatively closed network may compromise a VC's ability to find an entrepreneur with an innovative business plan. The extent to which investors operate in an open versus closed network is an empirical question, one which impacts both the selection of which entrepreneurs receive financing and how such firms are governed thereafter.

II. MYTHS AND FACTS: SERIAL ENTREPRENEURSHIP

To see the impact of relational governance on the selection of entrepreneurs for financing, I examine serial entrepreneurship. A serial entrepreneur (or serial founder) is an individual who founds multiple companies. Famous examples of serial entrepreneurs include Elon Musk, Jack Dorsey, Andreas Bechtolsheim, and Wayne Huizenga. Without serial entrepreneurs venture financing would be a game played between repeat players (the VCs) on one side and one-shot players (the entrepreneurs) on the other. If this were the case, reputational sanctions and relational governance more broadly would be much less effective. It would be difficult for unconnected one-shot entrepreneurs to sanction (or credibly communicate) opportunistic behavior by their VCs. Similarly, relational sanctions would be less effective against entrepreneur-opportunism when the entrepreneurs see themselves as one-shot players who do not need to deal with the VCs again. The presence of serial entrepreneurs is therefore important for relational governance. And, the level of serial entrepreneurship – the percentage of entrepreneurs who go on to form a second company – can be seen as a proxy for the importance of relational governance in the selection of entrepreneurs for financing.

Given this, it may be surprising to learn that less than 10% of founders of VC-backed firms become a serial entrepreneur.[22] For a large sample of venture-backed firms, Ola Bengtsson collected data on all individuals listed as a founder or co-founder in the two leading data sources for empirical research on venture capital (VentureXpert & CapitalIQ) and found a total of 9,385 distinct founders.[23] Only 637 of such individuals (approximately 7%) founded or co-founded multiple VC-backed firms. The other 8,748 individuals are one-time founders. To be sure, not all startups receive VC financing and thus it is likely that some of the 9,000+ founders in the Bengtsson study form multiple companies but only one of such companies receives VC funding.[24] Such individuals are serial entrepreneurs in a broader sense, but they are excluded from the 7%

[22] See Bengston, *supra* note 9; Paul Gompers, Anna Kovner, Josh Lerner, and David Scharfstein, *Performance Persistence in Entrepreneurship*, 96 JOURNAL OF FINANCIAL ECONOMICS 18 (2010) (finding a similar rate of serial entrepreneurship among VC-backed firms).

[23] See id.

[24] See id.

figure reported above. This would be a problem if my goal were to measure the entrepreneurial tendencies of startup founders. For the current project, however, my goal is to measure how often founders of VC-backed firms form repeat relationships with VC investors. This type of repeat entrepreneur-VC relation is precisely what Ola Bengtsson captures with the 7% rate of serial entrepreneurship.[25]

Furthermore, limited to the group of serial founders, for each new firm that such an individual forms there is only a one-third chance (33%) that *any* of the VCs financing the new firm provided funding to one of the founder's earlier companies.[26] Most (66%) serial entrepreneurs work with a completely different group of VC investors for the entrepreneur's new company. This is important to emphasize. Even when serial entrepreneurship occurs it is seldom a repeat relationship with the same group of investors. Looking at the full population, only about 3% of founders of VC-backed firms form a repeat relationship with *any* of the VCs that financed the founder's earlier company. While Bengtsson notes that, given the large number of VC firms, this rate of repeat relationships is significantly higher than would occur through purely random sorting,[27] my guess is that it is also much lower than most observers would expect. Entrepreneurs rarely become serial entrepreneurs of VC-backed firms, and even when they do they typically work with a different group of VC firms for their new company.

These data emphasize that preserving a long-term relationship with a particular entrepreneur or group of entrepreneurs is not the main concern in determining which entrepreneurs receive financing. VCs most emphatically operate in open networks. Consistent with this evidence, VCs, angel investors, and accelerators are all open to receiving business proposals from unknown entrepreneurs. While a blind submission from an unknown entrepreneur may be less likely to receive funding, there is at least a formal avenue encouraging outsiders to enter the VC's network. Furthermore, third party intermediaries can sometimes serve as a bridge connecting an unembedded entrepreneur to an investor, a point which I address in more detail in the analysis below. Similarly, early stage investor groups hold meet & greet events where unknown entrepreneurs can give a quick pitch of their business, facilitating introductions between

[25] See id.

[26] See id, page 318.

[27] See id.

unconnected parties.[28] Given that entrepreneurial finance is inherently a disruptive sector, the relative openness of VC networks is consistent with Brian Uzzi's prediction that networks will be less embedded in settings where innovation and adaptation are more important.[29]

III. THEORY 1: CONTRACTUAL TAILORING

Though the search for innovation appears to be the primary concern of investors in choosing which startups to finance, this does not imply that relational governance is irrelevant to entrepreneurial finance. One possibility is that embedded entrepreneurs (i.e. serial entrepreneurs) are offered a different type of financing contract from the terms offered to an unconnected entrepreneur. Under this view, unknown entrepreneurs will be offered a highly formal contract arising out of arms-length bargaining, while embedded entrepreneur are offered an informal contract governed primarily by the relationship. Thus, we might expect two basic contractual forms to emerge: (i) an embedded financing contract, and (ii) an arms-length financing contract. I refer to this hypothesis as "contractual tailoring".

The terms of a formal contract may be "tailored" to fit the type of relationship that exists between an entrepreneur and VC. Under this theory, to protect themselves against opportunism, VCs will demand higher levels of control, more blocking rights, and extensive protective provisions when bargaining with an unconnected entrepreneur. Protective provisions require a startup to obtain the investor's consent before engaging in a variety of actions in which the entrepreneur could behave opportunistically. These often include a sale or liquidation of the firm; any amendment to the corporate charter; issuance of new stock; reclassification of stock; purchase, redeem, or pay dividends on any share of common stock; issue any debt; and so forth. It should be noted that the list of protective provisions used in a typical VC financing agreement is similar

[28] William Kerr, Josh Lerner, and Antoinette Schoar, *The consequences of entrepreneurial finance: Evidence from angel financings*, 27 THE REVIEW OF FINANCIAL STUDIES 20 (2011).

[29] See Uzzi, *supra* note 18.

to covenants included in many bonds or other debt agreements, and indeed VC protective provisions are sometimes referred to as covenants.[30]

Similarly, when bargaining with an unconnected entrepreneur, a VC may be more likely to demand control of the board of directors, more likely to require redemption rights (giving the VC the right to sell its stock back to the firm after some period of time), and more likely to insist on drag-along rights (forcing the entrepreneur to vote her stock in favor of a sale of the firm meeting certain conditions). All of these provisions are regularly included in at least some VC financing arrangements.[31]

For purposes of "contractual tailoring" the question is whether the likelihood of such terms depends on whether the entrepreneur and VC are in an embedded or an arms-length relationship. Since there is greater risk of opportunistic conduct from an unconnected entrepreneur, the prediction of contractual tailoring is that we will observe a more extensive use of such protections when a VC is bargaining with an unconnected entrepreneur. By contrast, when bargaining with an embedded entrepreneur, extensive negotiations over governance terms are unnecessary, since the parties can rely on relational governance to prevent opportunism.

While contractual tailoring may sound plausible, in studies of VC financing agreements there is no evidence supporting the theory. The core problem is that in today's VC market there is minimal cross-sectional variation in the use of governance terms. Indeed redemption rights and many core protective provisions – such as … [add from Ola Paper] … – are included in virtually all VC financing contracts[32]. Uniformity underscores the absence of tailoring. Thirty years ago there was more variation in VC contracting styles,[33] but in the intervening period VC financing agreements have become increasingly standardized, suggesting that most VC financing contracts are off-the-rack rather than highly tailored documents.

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[30] Ola Bengtsson, *Covenants in Venture Capital Contracts*, 57 MANAGEMENT SCIENCE 1926 (2011) [hereinafter Bengtsson *Covenants*]

[31] To be sure, the use of such provisions may expose unconnected entrepreneurs to greater risk of VC opportunism. This, however, may simply be a condition that unconnected entrepreneurs must accept in order to receive financing.

[32] See Bengtsson, *supra* note 30.

[33] Mark Suchman, *Localism and globalism in institutional analysis: The emergence of contractual norms in venture finance* 39-63 (1995).

To be sure, not all governance rights are simply boilerplate. For example, drag along rights and certain protective provisions appear in some financing contracts, but many agreements also exclude these rights. Where such variation does occur, however, it seems to be driven by considerations other than the embeddedness of the entrepreneur in the VC's network.

Existing scholarship finds that geography, identity of the startup's law firm, and year of financing impact the use of governance rights. For example, startups on the east coast give more extensive control rights to their VC investors.[34] There is also evidence showing VC and law firm fixed effects[35], meaning the involvement of certain VCs or certain law firms in the negotiation of a financing agreement impacts choice of governance rights. Law firms become comfortable with a certain set of terms included in their standard documents and tend to reuse these familiar terms in new rounds of financing[36]. Similarly, governance rights vary over time, with certain provisions (e.g. drag-along rights & pay-to-play) occurring more in down markets.

I am not aware of any studies, however, showing that the use of such governance terms depends on whether the entrepreneur and investor had a prior relationship. Indeed, Ola Bengtsson's study of protective provisions explicitly controlled for serial entrepreneur status and found that it did not have a significant effect on the number or type of protective provisions included in the contract.[37] Bengtsson observed 182 first round financing agreements from 2005 to 2008, suggesting that a null result (while possible) is relatively unlikely to be due to a weak empirical test. Rather, everything else equal, it seems that serial entrepreneurs and one-shot entrepreneurs are both offered similar governance terms. Heightened risk of opportunism when dealing with a one-shot entrepreneur seems to have little impact on formal governance rights.

There are a couple of factors that might explain the lack of support for contractual tailoring. First, there is a strong push to reduce legal fees in early stage financing. For example, a prominent VC blog run by Fred Wilson called for legal fees to be kept under $5,000 in all seed stage financing

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[34] Ola Bengtsson and S. Abraham Ravid, *Location Specific Styles and US Venture Capital Contracting*, 5 QUARTERLY JOURNAL OF FINANCE 1550012 (2015); John Coates, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301 (2001).

[35] Ola Bengtsson and Dan Bernhardt, *Different Problem, Same Solution: Contract-Specialization in Venture Capital*, 23 JOURNAL OF ECONOMICS & MANAGEMENT STRATEGY 396 (2014).

[36] See id.

[37] See Bengtsson Covenants *supra* note 30

rounds.[38] Legal fees can sometimes eat up as much as 100 basis points of economic return in small early stage financing (e.g. $10,000 is 1% of $1,000,000), making it difficult, in Wilson's view, for an investor to get an adequate return. Thus, he encourages VCs – who are familiar with basic financing terms – to waive use of outside counsel and minimize legal due diligence in seed-stage financing. With such price pressure there is little room (or time) for lawyers to carefully design governance rights that fit the relationship between a specific entrepreneur and VC investor. Instead, each startup typically receives the standard terms from the law firm's set of model documents, which likely explains the presence of law firm fixed effects in Bengtsson and Bernhardt[39].

Second, in addition to price pressure on law firms, network and learning effects encourage use of standardized financing terms. Using standard terms lowers the cost of future financing, as other investors are familiar with these terms and can more easily price the firm and analyze the risk of a new investment[40]. Similarly, lawyers can provide future services for a firm that uses standard terms at lower cost. Indeed, the National Venture Capital Association (NVCA) even publishes a set of model legal documents, facilitating further standardization and coordinating the work of disperse parties around a standard contract (much like technology firms agree upon a standard platform). In terms of finance, this suggests that a startup firm can lower its cost of capital by agreeing to use standard (i.e. *not* tailored) governance terms. The result is that both one-shot and repeat play entrepreneurs receive similar formal contract terms.

IV. THEORY 2: RELATIONAL BOLSTERING

Instead of tailoring the formal contract, an alternative possibility is to transform the nature of the relationship between entrepreneur and investor. Even if an entrepreneur and investor did not have a prior working relationship, the financing arrangement (broadly viewed) can be

[38] See AVC blog post on March 23, 2011 "A Challenge to Startup Lawyers" available at: https://avc.com/2011/03/a-challenge-to-startup-lawyers/

[39] See Bengtsson and Bernhardt *supra* note 34.

[40] Brian Broughman, Jesse Fried, and Darian Ibrahim, *Delaware Law as Lingua Franca: Theory and Evidence*, 57 THE JOURNAL OF LAW AND ECONOMICS 865 (2014); Brian Broughman and Darian Ibrahim, *Delaware's Familiarity*, 52 SAN DIEGO LAW REVIEW 273 (2015).

structured to transform an unconnected entrepreneur into an embedded entrepreneur. Put differently, the extent to which an entrepreneur is embedded into a VC's network can be contracted over, making "embeddedness" an endogenous output of the financing arrangement rather than an exogenous (& immutable) input. This insight represents the theory of "relational bolstering" and predicts that the various strategies used to accomplish relational bolstering (explained below) will be used more often when bargaining with a previously unconnected entrepreneur.

To be clear, relational bolstering is not accomplished by adding formal language to the written agreement. There is no provision requiring that entrepreneurs and investors be friends or pledge trustworthiness. Instead investors introduce new entrepreneurs to others in their network and create repeat interactions that effectively embed the previously unconnected entrepreneur into the investor's network. While network building is probably done through a variety of mechanisms, I focus on two general strategies frequently used by VC investors: (i) third-party intermediaries and (ii) staged financing. Third-party intermediaries play various roles in the process of relational bolstering, serving as matchmakers, chaperones and arbitrators and through these various roles, as well as through staged financing, an entrepreneur and investor are able to transform their relationship to one in which relational governance may serve an important rule.

My goal in this project is theory generating. I do not explicitly test the predictions of relational bolstering, but rather I provide examples from VC financing to ground the theory in existing practices. In the following sections, I develop the theory and generate testable hypotheses.

A. Third-Party Intermediaries

To see why third parties can play an important role in relational bolstering it is important to note the obvious: entrepreneurs and investors are not the only participants in the broader ecosystem that supports new ventures and entrepreneurship more generally. There are a number of other parties – such as lawyers, board members, managers, scientists, and other entrepreneurs – that are actively involved in this space. Such third parties can serve as a bridge connecting an unknown entrepreneur to an investor, and thereby transforming the relationship between the primary parties. To illustrate this, I discuss three roles that third-parties sometimes play: matchmaker, chaperone, and arbitrator.

Matchmaker: Even if an entrepreneur does not know any angel or VC investors directly she may know (or be able to easily meet) another person – such as a lawyer,[41] another entrepreneur, etc. – who does. Such person could play the role of third-party matchmaker connecting the entrepreneur and VC. In doing so, the matchmaker does not merely introduce the parties, but also provides a reliable signal of the quality of the entrepreneur[42]. If a matchmaker were to refer a low-quality entrepreneur to a VC investor, the matchmaker would presumably suffer some reputational penalty in the VC community.

Matchmaking is not just concept, but occurs in practice. Mark Suchman and Mia Cahill[43], for example, describe the facilitating role that Silicon Valley lawyers play in connecting entrepreneurs to VC investors. Similarly, David Hornik, a prominent VC partner, notes the importance of a good introduction:

> *When it comes to borrowed credibility, there is perhaps no more important act than the initial introduction you are given to an investor. If you have no track record and you cold call an investor, you have huge reputational obstacles to overcome. This is particularly true because many investors will assume that you were either unable to find someone to make the introduction or too naive to realize the importance of an introduction. Either way, your likely success as an entrepreneur will be sharply discounted. On the other hand, if you are introduced to an investor by someone he or she trusts and respects, you are well on your way to a trusted relationship yourself.*[44]

Hornik goes on to note that entrepreneurs can effectively borrow the credibility and network ties of the third party making the introduction.

In terms of social embeddedness, matchmaking effectively links an unknown entrepreneur into the VC's network through the existing connections between the third party matchmaker and each of the primary parties. This is illustrated in Figure 3, showing an entrepreneur who, on a

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[41] Mark Suchman and Mia Cahill, *The Hired Gun as Facilitator: Lawyers and the Suppression of Business Disputes in Silicon Valley*, 21 LAW & SOC. INQUIRY 679 (1996).

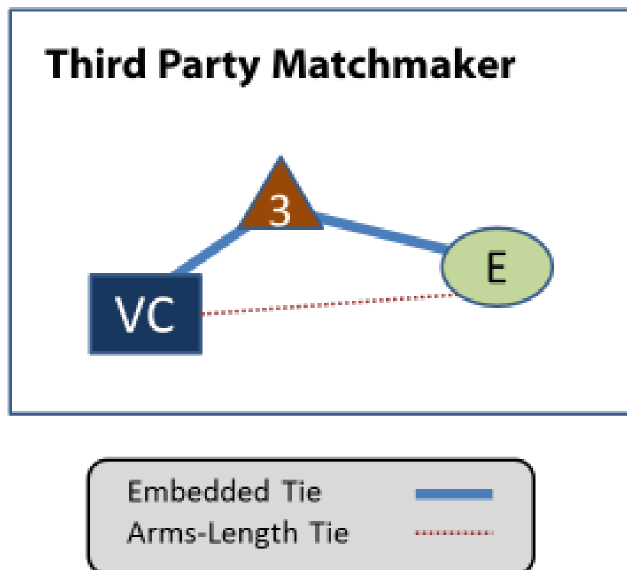
[42] See Podolny, *supra* note 17.

[43] See Suchman and Cahill, *supra* note 41.

[44] VentureBlog. Startup Advice: How Entrepreneurs Gain Credibility at http://www.ventureblog.com/2011/01/startup-advice-how-entrepeneurs-gain-credibility.html

direct basis, has only an arms-length tie to the VC, but can establish an indirect embedded tie through a 3rd party matchmaker (represented by "3").

Figure 3



To be clear, the existence of a third-party matchmaker does not suddenly transform the connection between an entrepreneur and VC into a long-term relationship. It does, however, improve the effectiveness of relational governance. If either the entrepreneur or the VC investor behaves opportunistically, such conduct may be reported to the matchmaker. Because both the entrepreneur and investor have embedded ties to the matchmaker, the matchmaker can punish the misbehaving party. For example, the matchmaker could credibly publicize the misconduct or even terminate their relationship with the opportunistic party.

One may wonder why a third party would bother to punish opportunism when they were not personally harmed. Yet, experimental research suggests that norms of cooperation and fair play are quite robust, and third parties are willing to punish norm violations even when this requires the third-party to exert some effort (cost) and the third party will receive no benefit from enforcing

the norm.[45] Through their shared connection to the third party, the relationship between the entrepreneur and investor becomes less of an arms-length bargain and takes on features of a relational contract.

Chaperone: Perhaps the biggest limitation of matchmaking, however, is that it primarily operates at the time the relationship if formed. Thus, opportunism which occurs years later may not be easily observed by (or credibly communicated to) the matchmaker. One way to address this problem is to extend the matchmaker's role by adding a socially embedded third-party to the startup's management team. I refer to such individuals as "chaperones", because they are in a position to observe and monitor the primary parties. Regardless of the actual work done by a chaperone, she is present at the startup firm and can observe the behavior of the entrepreneur and the VC investor. The ideal chaperone is embedded in both the entrepreneur's network and the VC's network, thus providing a relational bridge between the entrepreneur and investor.

The Chaperone's relational ties are effectively borrowed by the primary contract parties, letting them form something akin to an embedded relationship with each other, even absent a prior relationship. Because the chaperone can observe later occurring opportunism, the decision to hire a chaperone is effectively an *ex ante* pledge to refrain from certain forms of opportunistic conduct and can be viewed as a term of the broader financing arrangement.

VCs often help startups find skilled managers and directors,[46] and sometimes even insist on certain personal changes as a condition of financing.[47] VC's active involvement in governance is celebrated as an added benefit that VC investors (unlike passive investors) can provide. A VC firm's extensive network is a valuable asset that helps the startup find the most qualified person

[45]Ernst Fehr and Simon Gächter, *Cooperation and Punishment in Public Goods Experiments*, 90(4) AMERICAN ECONOMIC REVIEW 980 (September 2000); Hoffman, McCabe, & Smith (1998); Ernst Fehr and Urs Fischbacher, *Third Party Punishment and Social Norms*, 25 EVOLUTION AND HUMAN BEHAVIOR 63 (2004); Ernst Fehr, Urs Fischbacher, and Simon Gächter, *Strong reciprocity, human cooperation, and the enforcement of social norms*, 13 HUMAN NATURE 1-25 (2002).

[46] *See e.g.* Michael Gorman, and William Sahlman. *What do venture capitalists do?*. 4 JOURNAL OF BUSINESS VENTURING 231 (1989).

[47] For example, VCs will sometimes insist that the firm hire an outside CEO in connection with a new round of financing. *See* Broughman INVESTOR OPPORTUNISM *supra* note 4.

for the work. Indeed, there is evidence that founders will take worse economic terms to be associated with a highly reputable VC who can add value through such connections.[48]

My focus is different. Rather than using a VC's network to find the best employee, relational bolstering predicts that an arms-length entrepreneur and VC will look to hire new employees with whom they have shared connections, possibly even at the expense of finding the most qualified person for the job. This emphasizes that there are costs to using third-parties for relational bolstering. The ideal chaperone may significantly improve relational governance, but possibly be a less efficient employee or a less informed director.

Arbitrator: Neither the chaperone nor the matchmaker changes formal decision-making rights within the startup firm. If an entrepreneur holds a majority of a startup's outstanding equity and controls the board of directors, the entrepreneur can use such power to push through various actions and opportunistically benefit the entrepreneur at the expense of the VC's financial interest. Matchmakers and chaperones do not formally change this, but merely add an informal reputational penalty to an entrepreneur who abuses her control over the firm. This added reputational penalty may be sufficient to deter most instances of opportunism, but the formal power is still held by the controlling party.

An alternative use of third-party intermediaries, however, offers the promise that it can formally change control rights, by vesting a tiebreaking vote in a trusted third party. A startup's board of directors can be structured so that neither the entrepreneur nor VCs control the board[49]. For example, on a 5-member board, the entrepreneur and VC may each be entitled to appoint 2 directors, and the final board seat may be given to a mutually appointed third-party. Since most board action requires a simple majority, under this arrangement neither the entrepreneur nor the VC has unilateral power to direct the firm. Instead, the entrepreneur and investor need the support of at least one other director to push through an action. When the entrepreneur and investor disagree, their dispute is resolved by the judgment (i.e. vote) of the neutral third-party director (the

[48] David Hsu, *What do Entrepreneurs Pay for Venture Capital Affiliation*?, 59 JOURNAL OF FINANCE 1805 (2004).

[49] See Broughman, *supra* note 4; Brian Broughman, *Independent Directors and Board Control in Venture Finance*, 9 REVIEW OF LAW & ECONOMICS 41 (2013).

"arbitrator").[50] Broughman[51] notes that this board configuration can limit the risk of opportunism by forcing the entrepreneur and VC to give up their narrow self-interest and commit to informal norms and strategies favored by a socially embedded third party.

In practice, startups firms often share control of the board with a third-party holding the tie-breaking seat. For example, in a study of approximately 200 VC financing agreements, Kaplan and Strömberg find a 25% likelihood that VCs control the board, a 14% likelihood that entrepreneurs control the board, and a 61% likelihood that control of the board control is shared with a mutually appointed independent director holding the tie-breaking vote.[52] Broughman and Fried find similar results – approximately 64% of firms share control with a third party independent director holding the tie-breaking board seat – using data from a sample of Silicon Valley startups.[53]

Furthermore, evidence from the appointment process suggests that both entrepreneurs and investors have a voice in the selection of these so-called "independent" directors, and often select an individual with prior ties to both the entrepreneurs and the VC investors. One may worry that because VCs have more extensive networks, they may have an undue influence in the selection of an "independent" director. In contrast, more than 70% of the entrepreneurs surveyed in Broughman[54] report that the firm's entrepreneurs and VCs each had a prior relationship with the independent director(s).[55] In VC backed firms independent directors are not simply *independent*, but rather they are a *mutual connection* that can help bridge the relational gap between entrepreneur and investor.

In selecting this board arrangement, the parties have effectively ensured that important disagreements – at least ones that require board action – will be decided by a mutually embedded

[50] In separate studies Gordon Smith and Bill Bratton also analyze the use of third-party independent directors in VC backed firms, and highlighting various benefits that this arrangement allows. *See* D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA LAW REVIEW 315 (2005); William Bratton, Venture capital on the downside: preferred stock and corporate control, 100 Michigan Law Review 891 (2002)

[51] See Broughman, *supra* note 49.

[52] Steven Kaplan and Per Stromberg, *Financial contracting theory meets the real world: an empirical analysis of venture capital contracts*, 70 REVIEW OF ECONOMIC STUDIES 281 (2003).

[53] Brian Broughman and Jesse Fried, *Renegotiation of Cash Flow Rights in the Sale of VC-Backed Firms*, 95 JOURNAL OF FINANCIAL ECONOMICS 384 (2010).

[54] Brian Broughman, *The Role of Independent Directors in Startup Firms*, 2010 UTAH L. REV. 461 (2010)

[55] See id at page 495.

party. Even though an entrepreneur and investor may not have a pre-existing relationship, they can commit to have their disputes decided by someone that they both trust. Note, this does not require a particularly complex, or highly tailored, formal contract. Rather, the complexity is in finding overlapping connections that can be used to bolster the nascent relationship between an unknown entrepreneur and an investor.

B. Staged Financing

VC investments are typically staged over multiple rounds of financing. Each round is separately negotiated, and the identity of the investors may change from one round to the next. Under the conventional interpretation, staged financing protects VCs against asymmetric information[56] and helps VCs monitor entrepreneur performance[57].

The VC may be unable to observe whether an entrepreneur has a high quality or low quality project. By contrast the entrepreneur knows the true value of her project, but cannot provide verifiable information demonstrating such value at the time of financing. In this case, all entrepreneurs have an incentive to claim they have a high value project, and the VC is stuck in a variation of the classic market for lemons[58].

To illustrate, assume a VC knows the expected value of a startup firm and knows the distribution of possible values, while the entrepreneur knows the true value of the firm. The firm needs a total of $X million in financing. Financing can be provided in one round or split over multiple rounds. If the VC were to provide the full amount of financing upfront (i.e. no staging), it runs into an adverse selection problem. An Entrepreneur with a low quality project is more likely

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[56] Dirk Bergemann and Ulrich Hege, *Venture capital financing, moral hazard, and learning*, 22 JOURNAL OF BANKING AND FINANCE 703 (1998); Eike Houben, *Venture capital, double-sided adverse selection, and double-sided moral hazard*, SSRN Working Paper Series, No. 365841; Klaus Schmidt, *Convertible securities and venture capital finance*, 58 JOURNAL OF FINANCE 1139 (2003).

[57] Paul Gompers, *Optimal Investment, Monitoring, and the Staging of Venture Capital,* 50 JOURNAL OF FINANCE 1461 (1995).

[58] George Akerlof, *The market for "lemons": Qualitative uncertainty and the market mechanism*, 84 QUARTERLY JOURNAL OF ECONOMICS 488 (1970).

to accept the VC's offer. The VC cannot solve this problem by setting valuation lower because that will just drive away more of the high quality entrepreneurs.

Instead, the VC could split financing into multiple rounds (or stages), providing a small amount now and then negotiating later rounds when better information is available. While staged financing is typically thought of as a protection for investors, it is also desired by entrepreneurs with high quality projects[59]. Without staged financing an entrepreneur with a high-quality project would be offered a valuation below the true value of the firm and would receive the full $X million at this low valuation, significantly diluting the entrepreneur's ownership. With staged financing, the entrepreneur only needs to accept a small amount of funds at the low valuation and can expect to receive a higher valuation in the subsequent rounds, when more information about the quality of her firm is revealed to the VC.

Under the conventional interpretation, the extent of staging will depend on the severity of the asymmetric information problem. Staged financing forces a firm to spend time negotiating with investors adding significant transaction costs to the business. Thus, without asymmetric information under the conventional view, there would be no need for staged financing.

Relational bolstering suggests an alternative reason for staged financing. Existing scholarship overlooks the relational elements created by staged financing. Even if an entrepreneur and an investor have access to the same information, staging may still be desirable as it transforms the entrepreneur into a repeat player. The entrepreneur expects to have to raise future rounds of financing from the same group of VC investors, making reputation and relational modes of governance more relevant. If either party behaves opportunistically between rounds of financing they can be punished in the follow-on round. An existing VC, for example, could refuse to participate in a follow-on round, sending a strong negative signal to the market, and making it difficult for the entrepreneur to raise needed funds. Similarly, staged financing helps build trust, by creating repeat interactions between parties formerly operating at arms-length

[59] D. Gordon Smith, *Team Production in Venture Capital Investing*, 24 JOURNAL OF CORPORATION LAW 949 (1999).

C. Predictions of Relational Bolstering

Both staged financing and use of third-party intermediaries introduce some cost. For staged financing this is easy to see. Each new round of financing creates additional transaction costs. Because of staging, a startup's management team is forced to spend time pitching their business to investors for follow-on financing rather than building their product. Entrepreneurs view this as a significant cost and distraction and one that could be avoided by obtaining more money up front.

Less obvious, third party intermediaries can also add cost. For example, absent relational governance concerns the optimal management team for a given startup may not include any embedded third-parties. Thus, when a firm hires an embedded third-party to serve as a chaperone, this may represent a departure from the optimal arrangement and may introduce cost in terms of lost productivity. Similarly, sharing board control with an embedded third-party may also depart from the optimal board structure in terms of strategic advice.

I point this out to emphasize that we should only expect to see increased use of staged financing and third-party intermediaries when the benefit exceeds the cost. In terms of relational bolstering, this suggests that, everything else equal, the extent of staged financing and use of third-party intermediaries will be higher when contracting with an unconnected entrepreneur. The benefit of these arrangements increase when a VC is contracting with an unconnected entrepreneur, as they can improve the functioning of relational governance. Thus, the theory of relational bolstering predicts that *when a VC contracts with an unconnected entrepreneur (i.e. one outside the VC's network) the degree of financial staging will be higher and the parties are more likely to make use of embedded third-parties as matchmakers, chaperones, and arbitrators.*

V. IMPLICATIONS

The theory of relational bolstering makes several contributions to existing scholarship and has practical implications for our understanding of venture capital financing arrangements.

First, my analysis extends the existing literature on relational contracting. While the degree of network embeddedness in venture capital may be considerably less than in a typical

procurement contract setting, this does not mean that relational modes of governance are ineffective. Instead, the theory of relational bolstering suggests that a previously unconnected entrepreneur and investor can use third party intermediaries and staged financing to bolster the network position of the entrepreneur, making the relationship itself an endogenous output of how the financing arrangement is structured. Furthermore, this allows the parties to commit to informal business norms, even though the entrepreneur may be new to the system, suggesting a similar dynamic to Kreps explanation of how reputation can develop even when many participants in a market are one-shot players.[60] The theory of relational bolstering paints a very different picture of how relational governance operates than the traditional version in which two-parties are locked in a long-term bilateral relationship.

In particular, relational bolstering requires dense networks of intermediaries to connect an unknown entrepreneur to an investor. This is different from the traditional view of relational governance which only requires a long-term bilateral relationship between the primary parties. My analysis above implicitly assumes that an entrepreneur and investor can always find intermediaries with whom they each have a shared connection. In a dense entrepreneurial enclave, like Silicon Valley, this may be easier to satisfy, as the large number of industry connections in the area increases the likelihood of a shared contact. By contrast, in an area with few startup firms or few businesses in the startup industry, the likelihood of a shared intermediary contact between an arms-length entrepreneur and investor may be much lower. This suggests that relational bolstering will be more effective within entrepreneurial enclaves, and indeed may even contribute to the persistence of such enclaves despite the high cost of doing business in locations like San Francisco and Boston, and the difficulty exporting the VC contracting model to new locations.

Second, the theory of relational bolstering highlights the endogeneity of embeddedness and network structure more broadly. Endogeneity is not surprising as networks are not randomly structured and change over time. Endogeneity does, however, present a big challenge to the existing scholarship in sociology and related fields on network structure. Current empirical scholarship typically treats the existence or type of network connection between two parties as an explanatory variable used to predict some outcome (e.g. success in college, obtaining financing,

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[60] David Kreps, *Corporate Culture and Economic Theory*, in FIRMS, ORGANIZATIONS AND CONTRACTS , at pages 221 - 275 (Oxford Press, 1996).

etc.). The theory of relational bolstering challenges scholars to come up with more dynamic models in which the network structure is itself an endogenous feature of the model. For empirical work it also encourages longitudinal analysis of network ties.

Third, relational bolstering suggests that financial contract theory overstates the importance of holdup problems in incomplete contracts because of its exclusive focus on formal governance rights. The existing literature on financial contracting emphasizes agency conflict and holdup problems[61], and considers various mechanisms – alignment of cash-flow incentives[62]; state-contingent control[63]; and renegotiation[64] – that each address risk of opportunism. Existing scholarship on financial contract design, however, generally overlooks use of relational governance as a possible solution to the holdup problem. My analysis suggests that even if there is no prior relationship between an entrepreneur and investor, relational governance can be an important constraint limiting opportunistic holdup. Though an entrepreneur or investor may have the formal power to behave opportunistically, relational bolstering increases the reputational penalty she is likely to suffer from such conduct.

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[61] See Hart, *supra* note 2.

[62] Michael Jensen and William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 JOURNAL OF FINANCIAL ECONOMICS (1976); Paul Gompers, Joy Ishii, and Andrew Metrick, *Incentives vs. Control: An Analysis of U.S. Dual-Class Companies*, NBER Working Paper No. w10240. Available at SSRN: http://ssrn.com/abstract=492353

[63] See Aghion and Bolton, *supra* note 3.

[64] Sanford Grossman and Oliver Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral integration*, 94 JOURNAL OF POLITICAL ECONOMY 691 (1986).