

Entrepreneurial Financing



New Venture Deals

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Lecture 3

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Entrepreneurial Financing



- a) Identifying types of contractual relationship between the entrepreneur and the investor .
- b) Explaining Information and incentive Problems and Financial contracting along with the perfect contract.
- c) Clarifying difference between Precontractual information costs and Post contractual information costs.
- d) Identifying essentials of contract design, Discrete contracting and relational contracts.
- e) Incomplete contracts and mechanisms for resolving information and incentive Problems

Introduction

- In this Chapter we turn to the **contractual relationship** between the entrepreneur and the investor and explore how financial contracting can be used to benefit both parties.
- We emphasize the considerations that bear on the choice of contract terms, namely differences between the entrepreneur and the investor in diversification, in the information they possess, in their expectations, and in incentives.
- Although dealing with investors can be stressful, time consuming, and inconvenient for the entrepreneur, **investors can also be beneficial**. **Potential benefits derive from three sources:**
 - **Outside investment enables the entrepreneur to invest less and increase diversification.**
 - Because well-diversified investors have lower required rates of return, increasing **outside investment can increase the present value of the venture.**
 - **An investor may contribute expertise, advice, and information that enhance value.**
- In financial terms, **contracts with investors have three effects:**
 - they allocate risk,
 - they allocate expected returns, and
 - they change risk and expected returns.
- Debt financing, *for example*, allocates most of the risk to the equity investor/entrepreneur, allocates expected returns between the equity holder and creditors, and changes overall returns due to the incentive and tax effects.

1. The Economic Framework For Financial Contracting

Economics provides a useful framework for thinking about risk and return with the objective of understanding, analyzing, and designing the basic elements of venture deals.

Information and incentive Problems and Financial contracting

- **Information and incentive problems are at the core of negotiations between entrepreneurs and investors.**
- New venture markets are highly uncertain and subject to being influenced by unanticipated events.
- The parties involved may have different expectations about venture success and may have difficulty communicating their expectations.
- Outside parties often cannot know whether venture performance is due to luck or to managerial capability and effort. We refer to such problems as **Information problems**.

Information problems affect start-ups in many ways. For example, a prospective entrepreneur may have an idea with significant commercial value but be unable to protect it by patent or copyright. The entrepreneur cannot disclose the idea to prospective investors without risking its appropriation. How do entrepreneurs deal with such dilemmas? How, conversely, can investors determine the entrepreneur's true expectations?

- In addition to information problems, **Incentive Conflicts** can arise between the investors and the entrepreneur and among different investors.
- An entrepreneur with a limited equity stake may not always act in the best interest of other shareholders.
- If outside financing is in the form of debt, the entrepreneur may want to take on more risk than creditors would like.

A taxonomy of information and incentive Problems

- A useful distinction exists between costs that arise before a contract is entered and those that arise afterward.
- **Before the agreement**, the fundamental problem is information; each party is unsure about what the other knows.
- **After an agreement** is reached, the problem is incentives for performance.

A **perfect contract** anticipates and provides for every contingency. Its terms bind the parties, so that neither can try to take advantage of the other. The contract must contain sufficient detail so that a third party can fully enforce its provisions.

- **A perfect contract is efficient in the sense that**
 - (1) each risk is allocated to the party who can bear it at least cost, and
 - (2) collectively, the contract terms exhaust the possibilities for mutual gain.
- **New venture financial contracts are far from perfect.** They often include extensive lists of representations and warranties and complex contingency structures. Such provisions are designed to deal with information and incentive problems.
- They tend to be complex but incomplete in that they do not address every contingency.
- **Contractual complexity arises from efforts to address information and incentive problems through detailed contract terms.**

Precontractual information costs

- Information costs arise before any sunk (no salvageable) investment is made. They arise because:
 - future is complex and uncertain,
 - parties may have different information and expectations, and
 - each party has an incentive to distort their true information or beliefs.
- Such problems are known as “**adverse selection**” because they can cause good opportunities to be forgone.
- The choice to buy health insurance is the classic example of adverse selection. If all people are offered insurance on the same terms, those who expect to be healthy and not to use the insurance will opt not to take it, whereas the unhealthy “adverse selectors” will enroll.
- Adverse selection is driven by three major types of precontractual information costs:
 1. bounded rationality,
 2. information asymmetry, and
 3. impacted information.

1) Bounded rationality.

- The idea that individuals have limited capacity to deal with complexity is referred to as bounded rationality. The parties to a venture cannot anticipate every contingency the venture might face.
- To illustrate, consider an entrepreneur who is seeking funding.
- Product development time may be short or long.
- Quality of the resulting product and consumer demand may be high or low.
- Rivals may be successful or unsuccessful in their efforts to compete.
- Catastrophic events (death of the entrepreneur, war, etc.) may intervene.
- The funding needs of the venture depend on all of these factors.
- In some scenarios the investor will be eager to provide funding but not in others.
- In some, the entrepreneur would prefer to abandon the venture.
- If contracting costs were low, the parties could develop an elaborate list of contingencies and design a contract that would specify the response to each. Bounded rationality explains why entrepreneurs and investors do not try to do this.

2) Information asymmetry.

- Information asymmetry **means one party has information that the other lacks and cannot easily acquire.**
- Asymmetric information can prevent a bargain from being struck or cause risk and return to be allocated less efficiently than if information were shared.
- Information asymmetry **can be a problem for entrepreneurial ventures.**
- An entrepreneur usually cannot know why a prospective investor is interested in the venture.
- The investor may only be seeking to assess the venture as a competitive threat.
- Entrepreneurs claim that investors sometimes only get involved in a venture to keep it from reaching the market.
- This could happen if the investor was involved with another venture that targeted the same market.
- Conversely, **the investor may not be able to accurately assess the expertise and commitment of the entrepreneur.**

3) Impacted Information.

- The problem is **not** just that the information is held asymmetrically **but also** that each party has an incentive to distort what they know.
- Consequently, each fears exploitation by the other and is reluctant to commit to the venture.
- **Information is impacted** when one party is uncertain about what the other knows (information asymmetry) and the parties **cannot** easily communicate what they know to each other.
- **Impacted information** raises the cost of market exchange and contracting because prospective trading partners fear being taken advantage of.
- To complete the exchange, one or both parties must expend resources to overcome real or perceived information disadvantages. For new ventures, the expenditures often take the form of due diligence investigations in advance of contracting or negotiations of contractual contingencies that mitigate the value of information advantages.

Post contractual incentive Problems

- Once a contract has been entered or a sunk investment has been made, incentives change.
- The parties may act in ways that are not consistent with their original intentions.
- **Incentive problems arise when contracts are incomplete or when parties cannot monitor performance perfectly.**
- Such problems are known as “**moral hazard**” because behavior changes once the contract is entered.
- The classic example again comes from health insurance. A person who is fully responsible for his or her medical bills makes value-maximizing tradeoffs in deciding whether to visit a doctor. Because insured individuals are not required to pay the full cost of their medical treatments, they will tend to overuse medical services in the sense that the benefit of a specific service to the patient is less than the cost of providing it, a factor that drives up the cost of insurance for everyone.
- **Anticipating moral hazard is a first step toward finding ways to use deal structure to minimize the costs associated with moral hazard.**
- **Financial contracts also can give rise to moral hazard problems.**
- For example, once an investor commits to a venture and shares in the benefits of its success, the entrepreneur's ownership share is reduced, and the entrepreneur may devote less effort to achieving that success. It makes sense that the entrepreneur would devote less effort than if he were the exclusive beneficiary of his efforts. Replacing outside equity with debt financing changes the entrepreneur's incentives, but if the debt is risky, it does not eliminate the moral hazard.
- Moral hazard is driven by three major types of precontractual information costs:
 1. bounded rationality,
 2. specific investment, and
 3. small numbers bargaining.

1) Bounded rationality.

- Just as with adverse selection, if complete contingent claims contracting were costless, the parties could remove the potential for moral hazard by completely specifying the contingencies.
- Costless complete contracting requires both the ability to specify the full range of contingencies and the ability to costlessly monitor the performance of the entrepreneur, neither of which is even remotely feasible.

2) Specific investment.

- Specific investments are investments that support a given activity or relationship but have little value in alternative use.
- Once a specific investment is made, it is, in effect, sunk.
- An example is an entrepreneur's investment of effort and resources in developing a working prototype of a circuit board that is customized to the needs of a particular customer. Suppose, given the planned rate of production, that the amortized quarterly economic cost of effort and resources invested in developing the prototype is \$4,000 and the quarterly variable cost of circuit board production is \$2,000. The circuit board sales contract between the entrepreneur and the customer calls for the customer to pay \$7,000 quarterly. This means that the economic gain to the entrepreneur is \$1,000 per quarter. This gain is called an “**economic rent**.”

Economic rent is an *ex-ante* concept and is measured as the excess of expected return over the opportunity cost of resources committed.

In deciding whether to make the investment to produce the circuit boards, the entrepreneur commits the resources only if the economic rent is positive. Thus, the economic rent is what makes the NPV of the investment positive.

- Now consider a scenario in which the resource commitment to manufacture the circuit boards has already been made. Economic rent is no longer relevant; instead, the concern is whether the return is sufficient to cover the alternative use value of the resources (the **variable cost**).

Suppose these resources have a salvage value of \$2,500 per quarter. The \$7,000 quarterly revenue is more than sufficient to justify continuing to make circuit boards. The \$4,500 difference between revenue and salvage value is called a “quasi rent.”

Quasi rent is an *ex-post* concept. It measures the difference between revenue received and minimum revenue necessary to justify keeping the equipment in its current use.

- **Quasi rents** exist because of sunk investments.
- **Moral hazard problems are related to the existence of quasi rents.**
- Because the entrepreneur will continue to supply circuit boards as long as the quarterly return is at least \$2,500, the customer who is paying \$7,000 has an incentive to threaten not to purchase unless the entrepreneur reduces the price.
- Such an attempt to appropriate the quasi rent is an example of moral hazard that arises after a specific investment is made.
- This example shows that the parties to a new venture must be sensitive to the presence of specific investments.
- If the investment is not specific, competition can prevent appropriation.
- If it is, then the party investing in the specific asset faces the risk of appropriation, and the contract structure may need to address the risk.

3) Small numbers bargaining. (*aggressive bargaining*)

- **Market exchange works best when large numbers of buyers and sellers compete.**
- The market for initial outside financing can be such a market.
- It is easy to see how the presence of large numbers of potential investors facilitates exchange. Any investment the entrepreneur makes at an early stage is likely to be specific to the venture and no salvageable.
- **With a large number of investors competing, the entrepreneur does not need to be concerned about making value enhancing investments before agreeing to a contract.**
- If the entrepreneur is right, competition among investors will result in terms that more than compensate for the sunk investment.
- **The difficulty arises when the number of prospective investors is small; then the entrepreneur cannot rely on competition to give him an opportunity to recover sunk investment.**
- In fact, sunk investment invites appropriation by an investor.
- Having large numbers of competitors vying in the initial stage **does not** prevent opportunism in later-stage negotiations.
- Many ventures evolve from large numbers of potential investors to small numbers as the venture progresses.
- The investor in the first round may gain a first-mover advantage that would make it difficult for rival investors to compete in later-stage negotiations.
- **It is not useful** to characterize this practice of aggressive bargaining by the investor in the second round as opportunistic particularly if the pattern is characteristic of the market so that the ability to bargain more aggressively in later rounds is reflected in the terms for the initial investment.

- Still, **in new venture financing the potential for opportunism is large.**
- To obtain initial financing, the entrepreneur may be asked to provide an abandonment option and possibly other rights, such as the right to acquire control or to terminate the entrepreneur.
- Why do venture financing contracts give so much control to investors, when it would appear that the potential for opportunism could be limited by using a more complex contract that might give similar rights but only under certain well-specified conditions?
- **Apparently, entrepreneurs in such arrangements do not fear opportunism by investors—but why not? The answer is threefold:**
 - **First**, if the venture is successful, the entrepreneur can pursue other financing, even if the investor withdraws.
 - **Second**, the investor needs to preserve a good working relationship with the entrepreneur.
 - **Third**, any investor who wishes to be involved repeatedly in new ventures must **avoid gaining a reputation for behaving opportunistically.**

2. Essentials of Contract Design

- The term “contract” spans a spectrum of agreements or understandings between parties.
- At one end, “**discrete contracts**” are:
 - those that contain very explicit provisions.
 - The transactions are impersonal, self-contained exchanges, and performance is easily observable and measurable.
 - The contracts are of short duration, and any contingencies are anticipated and provided for explicitly.
- At the other end of the spectrum are “**relational contracts.**” These are highly flexible, implicit contracts based on ongoing relationships between the parties.
- A relational contract is like a constitution that describes what the parties are trying to accomplish and how, in general terms, they aspire to share the benefits.

Discrete contracting

- An example of a discrete financial contract is one between an entrepreneur and a bank.
- If the loan is collateralized, the contract is **discrete**.
- The bank **does not** need to accept the entrepreneur's sales projections or verify the venture's financial performance.
- The entrepreneur is not concerned that the lender will act opportunistically as long as it is clear that the venture can meet its debt obligations.
- If the lender does not renew the loan in spite of the entrepreneur's adequate collateral, the entrepreneur can turn to another lender.
- **Discrete contracting** works best for simple exchanges, where the parties have similar expectations, objectives are easy to specify, and performance is easy to verify.
- If the parties have materially different expectations, it may be possible to design a more complex contract that is still discrete but circumvents the need to have similar expectations.

- If expectations are held symmetrically and incentives are not a concern, then the better-diversified party should bear most of the risk of a new venture.
- For entrepreneurial ventures, this implies that the investor (who is likely to be well diversified) would bear most of the risk and the entrepreneur would have a relatively low-risk claim on the venture's cash flows.
- However, **both information asymmetry and incentive considerations are central to contracts involving investment in entrepreneurial ventures.**
- The contractual solution will be different if beliefs are asymmetrically held; in such cases, deal terms may shift risk toward the better-informed or more optimistic party.
- Suppose, *for example*, that the entrepreneur is confident he can achieve \$200,000 in monthly sales within 18 months.
- The investor is less optimistic and projects monthly sales of \$100,000.
- A deal that provides for equity sharing can be based on the investor's projections **but** include a provision that if the entrepreneur's revenue expectation is met, he will receive a specified percentage increase in equity.

Discrete contracting can also address incentive problems.

- Suppose an entrepreneur is concerned that a first-round investor may attempt to hold up the entrepreneur when second-round funding is needed.
- In the first round, the entrepreneur can rely on competition among investors, but afterward the selected investor may gain an information advantage over rivals and could exploit that position.
- Consistent with earlier discussion, the incentive problem arises because the entrepreneur will have made a specific investment in the venture that is appropriable by the investor.
- The concern can be addressed by discrete contracting: **the parties can agree in advance on the terms and conditions under which the investor will provide second-round financing.**

Discrete contracting, however, can also create incentive problems.

- **It is usually difficult to state explicit conditions that do not distort incentives.**
- If, for example, the entrepreneur's equity share is tied to sales in month 18, then the entrepreneur may devote too much attention to sales and not enough to profitability.
- On balance, it is sometimes better to leave certain provisions general or unstated and to rely more on reputation and the relationship.

Relational Contracting and Flexibility

- Relational contracts rely on implicit mechanisms such as damage to reputation for enforcement of an understanding.
- **The virtue of a relational contract is flexibility.**
- Consider the alternatives of seeking financing from either a passive investor who has limited familiarity with the market or from a VC who is involved in the industry and would be an active participant in the venture's management.
- **The passive investor is more likely to seek a discrete contract.**
- Because of bounded rationality, the contract is likely to be designed around crude proxies, such as revenue or profit targets that are only rough indicators of the success of the venture.
- Conditions for later-stage investment, allocation of ownership, and other factors may hinge on whether the venture meets those targets.
- Many unforeseen conditions could result in failure to meet the targets even if the venture is worth pursuing.
- The problem is exacerbated if the investor is passive and has no firsthand knowledge of why a performance target was or was not met.

Relational Contracting and Flexibility (Cont.)

- VC financing is likely to be more flexible.
- Essentially, the VC offers a relational contract that generally does not tie funding to specific performance but rather provides continued support (and possibly funding) as long as doing so is in its interest.
- Deal terms enable the VC to monitor the entrepreneur and even to restrict the entrepreneur's ability to act without VC consent.
- The net effect is that if additional funds are needed, the VC is in a good position to evaluate whether to advance the funds.
- The entrepreneur typically does not have previous experience or reputation for a managing business.
- One of the potential benefits for associating with a reputable VC is that they have extensive networks they can rely on to provide expertise when needed.
- The VC cannot know with certainty how much direct involvement will be required.
- The result is that the contracts are not explicit about the amount of oversight or monitoring the VC will provide.
- Such contracts expose entrepreneurs to the risk of opportunism, but that risk is mitigated by the reputation of the VC.
- **Discrete contracts and flexible relational contracts are different responses to bounded rationality.**
- Which response is better in any particular setting depends on the identities of the parties, the costs and benefits of flexibility, and the ability of the parties to agree on explicit terms.

Incomplete contracts and mechanisms for resolving information and incentive Problems

- **Relational contracts do not “solve” information and incentive problems.**
- **Because the contracts are incomplete,** other mechanisms that address informational asymmetry and opportunism often accompany relational contract.
- The mechanisms that are adopted to complement relational contracts involve **signaling, screening, bonding, and monitoring.**
- Technically, the terms **“signaling” and “screening”** apply to mechanisms that address adverse selection (**informational asymmetry**), **whereas “bonding” and “monitoring”** apply to mechanisms that address moral hazard (**opportunism**).

1) Signaling.

- It can be difficult for an investor to distinguish high-quality ventures from the “lemons.”
- Part of the problem is that the entrepreneur’s claims of success potential are costly or impossible to verify.
- Sometimes an entrepreneur can convey positive private information simply by showing the information to investors and leaving them to draw their own conclusions. But this is risky if an investor could decide to appropriate the opportunity.
- Sometimes, providing the information is not feasible for the entrepreneur.
- How, for example, without elaborate documentation, can an entrepreneur establish that efforts to develop new voice-recognition software have progressed much more rapidly than expected? Conversely, how can a VC firm show that it is not involved with or considering any competing products that could influence its attitude toward the entrepreneur’s product? The challenge is to do so in a way that is convincing, yet still preserves the value of the information.
- **One solution is for the holder of the information to use a signal.**
- A **signal** is a credible demonstration that obviates the need to convey the information.
- Sometimes, **deal terms can serve as signals.**
- Suppose an investor is concerned that an entrepreneur’s financial projections are overly optimistic.
- **By proposing a contract that ties his return to performance targets, the entrepreneur “signals” his positive beliefs.**

Signaling. (cont.)

- Consider the following terms for a contract between an entrepreneur, Miles Stone, and a VC firm, Limited Deals, Ltd., concerning financing for a virtual amusement park venture. Upon signing the agreement, Limited is committed to finance the venture up to \$4.0 million for one year, by which time specific benchmarks are to be met. If the benchmarks are met, Limited will invest an additional \$2.0 million; if the venture fails to meet one or more benchmarks, Limited can decide not to invest in the second round. If Limited does not invest, then Miles has 60 days to find a new investor; if he is unable to do so, then Limited has the right to force liquidation. Miles retains ownership of the amusement park idea and the related copyrights and trademarks. If the other assets are sold, the proceeds are to be distributed in proportion to shares of invested capital. Finally, if Limited invests the second-round \$2.0 million even though the venture does not meet the benchmarks, then Limited gains managerial control.
- Willingness to abide by these terms signals several things about Miles.
- **First**, the benchmarks are based on his projections. By structuring the deal around them, Miles signals confidence that the projections are reasonable.
- **Second**, his willingness to relinquish control if performance expectations are not met signals confidence in his managerial skills. The arrangement also affects Miles's incentives to devote effort to the venture. By working harder, he helps assure that the benchmarks are met and that he maintains control.
- Thus, **signaling also addresses moral hazard.**

2) Screening.

- Screening is much like signaling, except that the party without the private information offers a menu of alternative terms so that the party with information reveals the information through the act of choosing.
- In a new venture setting, the investors can offer entrepreneurs alternative types of financing.
- Given the choice, entrepreneurs with low expectations, for example, are likely to prefer financing that does not include liquidation preference for the entrepreneur or terms that reduce the entrepreneur's own risk exposure.
- In contrast, entrepreneurs who are confident in their expectations are more likely to accept favorable liquidation preferences and more of the risk exposure, believing that the venture will succeed and everyone will do well at exit.
- **The screening contract in effect elicits information about the entrepreneur's beliefs and expectations.**

3) Bonding.

- In contract terms, posting a bond is one way to give credibility to a commitment not to engage in opportunistic behavior.
- A **bond** is a penalty that will be paid by the party who makes a promise in the event that the promise is broken.
- The **fundamental element of a bond** is that the party who posts it is made worse off if the commitment is violated.
- Thus, a bond provides an incentive to fulfill a commitment.
- **The commitment** can be **explicit and specific** (like agreeing to resign if the investor is not satisfied with the entrepreneur's effort) or **implicit** (like tying compensation to the attained level of sales).
- Investors may be concerned that an entrepreneur will not focus on the right activities and problems.
- For example, the entrepreneur may be more interested in working on technical problems than in managing a rapidly growing organization, or he may not recognize failure or may not be open to refocusing the venture.
- **A bond can be provided in several different ways.**
- Sometimes a set of specific contract provisions can function as a bond, such as giving up equity if certain conditions are not met: for example, signing a sales contract with a major customer that the entrepreneur promised he can deliver.
- Other means of implementing a performance bond would be to give the investor the right to terminate the entrepreneur as CEO if the targets are not met, with the warning that reliance on specific conditions is not always ideal **because random aspects of new venture development may be beyond the control of the entrepreneur and unrelated to his abilities.**
- Moreover, explicit conditions are subject to manipulation in ways that are not in the parties' interests

4) Monitoring.

- The other way opportunistic behavior is controlled is by **monitoring**.
- In lieu of bonding, the parties can rely on observation.
- **Monitoring** can be direct, as in the case of an investor who serves on the venture's board, or indirect, as in the case of requiring financial statements to be periodically audited by a reputable accounting firm.
- The **relationships between VC firms and their portfolio companies** involve elements of both bonding and monitoring.
- The deal structures frequently involve bonding arrangements such as termination rights or warrants, but the investors also closely monitor performance.
- Some monitoring involves formal triggers; for example, hypothesis testing and staging give the investor specific, periodic opportunities to evaluate whether to continue investing.

Monitoring. (Cont.)

- For ventures where borrowing is possible, the use of debt covenants is an example of monitoring that employs a trigger.
- Debt covenants are contractual terms used by lenders to place restrictions on borrowers.
- Debt covenants may restrict the borrower from taking on additional debt or making capital investments beyond what originally was contemplated.
- They may also require the borrower to adhere to certain constraints with respect to various financial ratios and may limit the ability of the borrower to make distributions to other investors.
- Use of convertible debt can be a way to allay the lender's concern that the entrepreneur may take on risks that do not benefit the lender.
- The debt is convertible at the lender's option (or triggers specified in the contract) to a predetermined number of shares of common stock. In that way the lender is positioned to benefit from the firm's performance if it is especially strong and the entrepreneur or firm manager has less incentive to take unwarranted risk.
- The conversion option thus aligns the interests of the entrepreneur more closely with those of the lender.
- **It is common for high-risk new ventures to borrow using convertible debt or to issue convertible preferred stock.**

Summary

- The chapter develops a conceptual framework for evaluating contractual features of new venture financing. Differences in attitudes toward risk and differences in expectations about value and potential success give rise to a significant opportunity for an entrepreneur to contract with outside investors in ways that both parties perceive to be beneficial. The chapter demonstrates that thoughtful design of contracts between entrepreneurs and outside investors can enhance the value of projects and turn unacceptable projects into attractive ones.
- Adverse selection arises when the parties enter a negotiation with asymmetric information and expectations. Informational asymmetry is an impediment to effective contracting between entrepreneurs and prospective investors, since each may be concerned that the other knows more and is trying to take advantage. Solutions to adverse selection include signaling and screening. A signal is a mechanism that a party with positive information can use to distinguish herself from those with negative information. A screen is a mechanism that a party without information can use to compel the party with information to reveal whether the information is positive or negative. Screening and signaling are similar in that parties with negative information find that it is not economical to imitate those with positive information.
- Moral hazard arises after an agreement is entered. If a sunk investment has been made and is specific to a relationship, a party to the agreement can attempt to appropriate the value of the investment. Techniques for controlling moral hazard problems include bonding and monitoring. Bonding involves making a commitment or investment such that the party who has the opportunity to appropriate would be worse off by exploiting the sunk investment than by not doing so. Monitoring can be used by one party to limit the ability of the other party to act opportunistically.
- Given the venture and the entrepreneurial team, the financial contract emerges as a potentially important determinant of success or failure. A well-designed contract can contribute dramatically to the value of an idea and help allay the concerns of investors about the capabilities and commitment of an untested entrepreneur. A poorly designed contract, however, can just as easily prevent a good idea or product from reaching the market. Information and incentive problems arising from adverse selection and moral hazard are important determinants of financial contract terms and organizational structures.



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