

Geography and Financial Contracts

by

Ola Bengtsson* and S. Abraham Ravid**

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Abstract

This paper shows that geographical elements can form an essential component of contract design in addition to more traditional ingredients such as information problems, moral hazard and legal institutions. We analyze how investor-friendly cash flow contingencies are included in 1,804 contracts between U.S. venture capitalists (VCs) and U.S. startup companies. These contingencies affect both the pricing of the VC investment and the entrepreneur's monetary incentives. Our main finding is that contracts include considerably fewer such contingencies if the startup is located in California, and in particular in Silicon Valley. Indeed, this "California effect" has a greater impact on contract design than any other observable company, VC or founder characteristic. The effect also carries over between markets. Contracts are less investor-friendly if a VC is located in California or if a non-California VC has had large exposure to investments in California. We further show that contracts are also less investor-friendly if the startup is located in a region with a larger VC market, or if the geographical distance between the VC and the company is shorter. This latter finding supports the view that parties who are geographically close can contract more efficiently due to lower monitoring costs and better soft information. However, the "California effect" remains large and significant even after we control for these other factors. Finally, we present evidence that the effect cannot be explained by a substitution between control rights and cash flow contingencies. In fact, California contracts are less investor-friendly on both counts. We discuss how our findings are consistent with arguments on how regional culture can affect the nature of local VC markets.

*University of Illinois and **Rutgers University and the University of Chicago, Booth School of Business. Contact information: ola@illinois.edu; s.ravid@chicagobooth.edu. We are grateful to *VCExperts* and Joseph Bartlett for access to the contract data, to Sonali Das, Emily Feng, Bonny Lee, Cathy Chenxi You, Brian Steinmetz and Vikas Patel for their research assistance. We thank Brian Broughman, John Coates, Jesse Fried, William Gerken, Debarshi Nandy, Per Stromberg, and seminar participants at BIARI, Northwestern University Conference on Economics and Law of the Entrepreneur, Canadian Conference on the Economics of Innovation, Financial Management Association, NYU and NBER for valuable comments. All remaining errors are our own.

