TRAMES, 2007, **11**(**61/56**), 2, 189–205

THE ALLOCATION OF CONTROL RIGHTS IN FINANCING PRIVATE COMPANIES: VIEWS OF ESTONIAN PRIVATE EQUITY AND VENTURE CAPITALISTS

Priit Sander, Margus Kõomägi

University of Tartu

Abstract. This paper analyzes the allocation of control rights in financing private companies by private equity and venture capitalists in Estonia. Structured interviews with main providers of venture capital and private equity were conducted to collect the information about the current practice in Estonia and to highlight topical problems in this field. Due to the legal restrictions imposed on the preferred shares and convertible debt, most Estonian venture capitalists use common shares in financing high-growth firms and take similar risk position as entrepreneurs. Although, by using common shares, venture capitalists obtain voting rights, the minority ownership by itself does not provide sufficient protection of their interests. Venture capitalists increase their influence over the company through the active involvement in supervisory and management boards and detailed term-sheets which include different vetoes and additional clauses.

Keywords: venture capital, deal structuring, control rights, investor protection, entrepreneurial organizations

1. Introduction

One common feature of high-growth companies is heavy reliance on external sources of financing. In the current article, we analyze the financing of private companies by private equity and venture capital. Young companies in emerging industries are characterized by a high level of economic and technological uncertainty, the absence of credit history and collaterals and high level of information asymmetry, which prevents them of using more traditional sources of financing. Venture capital and private equity play a very important role in financing of these companies for that reason. As there is no easy way to exit the investment, venture capitalists must ensure that their interests are well protected and that the company is managed in the best possible way. Therefore the allocation of control

rights is almost as important as the allocation of cash flow rights in venture capital projects.

Control issues are especially important in countries with a low level of investor protection or in countries, where the principles of the good corporate governance are not yet fully developed. According to the empirical studies, the interests of minority shareholders are relatively well protected in Estonia (see Pistor et al. 2000). However, the enforcement of laws and regulations (effectiveness) in transition countries usually lag behind the quality of law (extensiveness) (Pajuste 2002). Previous research has suggested that control issues are far more important in Estonia than in United States (Sander 2003).

The aim of the current article is to investigate the allocation of control rights in private equity and venture capital projects in Estonia. Some organizational changes due to the venture capitalist entrance to portfolio company are also indicated. A case study method is used and interviews are conducted to collect information about the current practice of venture capital investments in Estonia. There are several similar studies conducted in developed countries (see e.g. Lehtonen 2000, Virtanen 1996). The situation in developing and transition countries has been less examined.

The paper is structured as follows. The first section gives the theoretical background. The second section describes the research methodology and gives some background information about sample companies. Next section presents the results of interviews with the representatives of sample companies. The last section includes the synthesis of theory and practice, as well as managerial implications.

2. Theoretical background

Control rights have been defined by Tirole (2001) as "the right for a player (or a group of players) to affect the course of action once the firm has gotten started" (p13). The formal distribution of control rights is determined by the nature of the claims (debt, equity, or hybrid instrument), business laws (Commercial Code, Law of Obligations Act, Bankruptcy Code, etc.), companies' bylaws, and covenants associated with the financial contracts and term sheets. However, as noted by Tirole (2001) players without formal control rights may actually enjoy substantial control over their organizations (for example large minority shareholder often decides for the majority group of smaller ones, companies with diverse ownership are controlled by managers even if the formal control belongs to the shareholders, etc.).

The choice of financing instrument is the first aspect affecting the allocation of control. Aghion and Bolton (1992) developed a theoretical model according to which the choice of financial instrument should depend on which governance structure (entrepreneur control, contingent control, and investor control) is the most effective. They suggested that control rights should belong to the entrepreneurs, if such a governance structure is feasible. In this case the company should be financed by using non-voting equity (preferred shares) (*Ibid*). In some countries

(e.g. Estonia), the owners of preferred shares are granted the voting right only if the previously agreed dividend payments are not met (unless the voting rights are given to them by the bylaw of the company). However, if such governance structure does not protect enough investors claim a contingent control structure should be used (Aghion and Bolton 1992). In that case debt or convertible instruments are the right financing instruments (lenders usually obtain the control only if the company becomes insolvent). As the formal control belongs to the shareholders (the owners of the common stock), the use of common stock gives the control to investors. But at the same time, if venture capitalists use common shares, they take similar risk position in the company as entrepreneurs. It has been argued that in the case of high risk and asymmetric information, both of which are very characteristic of the young high-growth companies, the most suitable instruments for outside investors are convertible instruments (convertible bonds or convertible preferred shares) (see Brennan and Schwartz 1993). Green (1984) points out that convertibles can be used to reduce the problem of excessive entrepreneurial risk taking arising when a straight debt is used. Cornelli and Yosha (2003) claim that the use of convertibles reduces "window dressing" activities. Empirical surveys in the United States have shown that convertible securities (especially preferred shares) are indeed the most widely used instruments in venture capital financing (Sahlman 1990, Kaplan and Strömberg 2003).

In case of equity financing, the size and variation of ownership share is the next aspect affecting the allocation of control. Traditional finance assumes that all common stock has been created equal and each shareholder receives the same pay-off per share (Dyck and Zingales 2002). In the last twenty years, however, a different view has slowly gained acceptance (Ibid). According to this new view, a controlling shareholder can obtain some benefits that are not shared by other shareholders (Ibid). Examples of such benefits are influence over who is elected to the Board of Directors, the power to build business empires, and the ability to transfer assets on non-market terms to related parties or consume perquisites at the expense of the firm (Nenova 2003). Besides extracting private benefits from the firm, a controlling shareholder can enhance its value by changing business strategy. The difference in shareholders' rights, and especially how these rights are exercised, causes a differential in the per-share value of a control ownership block and a minority ownership block (Pratt 2001). In order to protect their investments, venture capitalists should obtain the majority of shares or at least a significant minority holding in the company. This however may discourage the entrepreneur and reduce his incentives. In practice the problem can be solved either by using staged capital infusion, option contracts or by separating cash flow, voting and control rights in term-sheets. Kaplan and Strömberg (2003) found that the venture capitalist typically controlled 50% of the cash flow rights; founders, 30%; and others 20% and concluded that the founders give up a large proportion of ownership. This finding contradicts the results of Lehtonen (2000), who argued that venture capitalists usually take the minority ownership and protect their interests with extensive term sheets and shareholder agreements. Indeed, it is most common that the degree of

control acquired by venture capitalists is disproportionately large as compared to what they would get under the "one share one vote" rule (see Sahlman 1990, Kirilenko 2001).

Outside investors should also protect themselves against the dilution. Current shareholders face a problem of dilution every time new equity or convertibles (including warrants and employee stock options) are issued. Dilution as a notion is hard to understand at first because it is biunivocal in venture capital literature. First, dilution is a situation where after a financing round earnings per share (EPS) dwindle and the book value of common stock decreases. Second, the issue of new shares in the next financing round results in the original shareholders owning a smaller share of the company. The dilution of EPS and the book value of common shares is not a real economic problem in most cases (Stewart 1993). The dilution of ownership on the other hand could be dangerous, especially if the share of ownership directly affects the control rights of the investor. Venture capitalists need protection against future financing rounds having a lower valuation than the valuation of the current (protected) round (Kaplan and Strömberg 2003). Theoretical model developed by Admati and Pfleiderer (1994) shows that the only contract for the venture capitalist that induces optimal continuation is a fixed-fraction contract, in which the venture capitalist owns the same fraction of the payoff independent of the continuation decision, and also finances that same fraction of any future investment (i.e. there is no variation in venture capitalist' ownership share).

The third aspect affecting the allocation of control is the structure of the supervisory board. Supervisory board effectively controls the hiring and firing of management team and consent of the board is required for conclusion of transactions which are beyond the scope of everyday economic activities. According to Hellman (1998) venture capitalists hold effective control over the board, typically through a voting majority, and sometimes through explicit contractual agreement. According to the empirical study by Kaplan and Strömberg (2003), venture capitalist representation in board increases in later stages of financing. Baker and Gompers (1999) noted that venture capitalists have more control over the board if the risk is high and R&D costs are big (Schertler 2000).

Control rights do not have to be directly linked to the ownership share. Gompers (1997) suggested that the use of cash flow allocation to determine control right allocation may not be optimal in a venture capital setting. Kaplan and Strömberg (2003) found that in VC financings cash flow rights, board rights, voting rights, liquidation rights, and other control rights are separately allocated and that allocation of control rights between VC and entrepreneur is a central feature of the financial contract. Although it is virtually impossible to write a complete financial contract; detailed contracts are quite common in private equity and venture capital financing. Gompers (1997) found that VCs usually have veto rights over the following decisions: asset sales, asset purchases, changes in control, and issuance of securities. The presence of these rights is unrelated to the board rights (Ibid). Many contracts also include mandatory redemption rights, which allow the investors effectively to sell their shares back to the company at

the face value (Ibid). The use of vetoes and additional clauses enables venture capitalists to obtain considerable control over the company even if minority share is taken or non-voting equity or convertibles are used.

3. Methodology, description of the cases and research questions

The case study methodology is used as the research method in this article. Case descriptions should be prepared in order to analyze case study evidence. The dominant model of the analysis is exploratory, using an explanation-building and pattern-matching technique (Yin 1989). In order to make the descriptions, some interviews are conducted, because we are searching for explanations among Estonian venture capitalists and private equity investors.

Pattern matching and explanation building is used to obtain internal validity. In order to find the casual relationships, two closely linked themes (corporate control and investor protection) are discussed in the article.

Replication is used to guarantee external validity. Although statistical generalizations cannot be made due to the research technique, analytical generalizations are still possible. Some comparisons are also made with Western-European and American venture capital investments.

The main questions posed are “how and why”, which are the most important questions in a case study research. The main questions are:

- Which financial instruments are used by Estonian venture capitalists? Why?
- What is the ownership share taken by venture capitalists in their portfolio companies and are there problems with dilution?
- How do venture capitalists protect their ownership rights in Estonia? Why?
- How are venture capitalists’ interests protected by law and/or by agreements?
- How do Estonian venture capitalists take part in the management of administrative bodies in ventures? Why?

A multiple-case study design, but a single unit of analysis is used. The holistic design is advantageous when no logical subunits can be identified. The subunits are present in this study, but cannot be revealed because of business secret. Business plans contain such information which nobody wants to publish.

Structured interviews were carried out among Estonian venture capitalists at their offices in 2004–2005. The interviews were generally arranged with CEOs, and sometimes with financial managers and accountants. Each interview took approximately one hour. The interviewees wished to remain anonymous. Although the interviews with the venture capitalists were not recorded, the authors can assure the reliability of the study. A case study protocol was used and written notes were taken. Interviews enabled the interviewer to explain and discuss the problems and questions. This ensured that the interviewee really had understood the question.

The analysis includes five venture capital cases. The description of the cases is presented as follows.

Case A is an experienced venture capital and private equity provider in Estonia. It manages two different funds. The first fund is meant for start-up investments and the second is for growth stage investments. It was one of the first venture capitalists in Estonia. It invests in different sectors in Estonia and abroad.

Case B is a small venture capital provider in Estonia, which no longer actively invests in business ventures. It has a small portfolio of Estonian and foreign ventures.

Case C is a venture capital provider in the Baltic States who has made investments in Estonia over the last decade. It has made quite large investments and has quite a large investment portfolio consisting of companies operating in different sectors.

Case D is both a venture capital and private equity provider in the Baltic States. It has made quite small investments in different sectors for less than 10 years in Estonia.

Case E is a mezzanine capital provider in the Baltic States. Its portfolio consists of quite a few enterprises operating in different sectors, but the investments have been quite large. This case differs most considerably from others, because it does not provide equity capital.

Venture capital industry is very knowledge intensive and dynamic. There was a professional and experienced management team in all the funds listed above. Most Estonian venture capital investments are not made in high-technology (or so-called "classic") sectors of the venture capital market, but instead in such production and service enterprises, which needed restructuring or impulse to growth. Notwithstanding the fact, they are contributing to innovation and make the organizations more dynamic and competitive.

4. Corporate control and investor protection in venture capital setting in Estonia

Deal structuring and the choice of the correct financial instrument are very important when considering corporate control issues and investment protection. Estonian venture capitalists do not use preferred shares to manage the risk. Most of the venture capital deals were made by using common shares. Syndication and staged investments are also very rarely implemented (Kõomägi, Sander 2006). This means that venture capitalists take similar risk positions as entrepreneurs unless there are some protective covenants or vetoes in the term-sheet. Sometimes their position is even worse, as they have quite often a minority ownership. The average ownership share taken by Estonian venture capitalists was 39% with a standard deviation of 21%. Venture capitalists abroad take a minority ownership on average (Lehtonen 2000).

The corporate control problems will arise when ownership share changes during the venture capital process. The share of ownership changes due to the convertible bonds in case A and B, the required ownership share depends on staged investment and business law in case A and there are two funds specialized in different sectors, which also influence ownership share.

> *The required ownership share is 51–100% for the first fund and 33.3–100% for the second fund. The reason for using a majority holding is the wish to be entrepreneurs ourselves. 33.3% of ownership is needed due to Estonian Business law: otherwise, the second party can change the articles of association in her favour and make an opportunistic decision regarding the ownership. We are also ready to take a 10% share if the entrepreneur is reliable and trustworthy.*
>
> Representative from Case A

A significant minority holding is taken also in case B (table 1). By comparison with the case A, the ownership share also changes due to the use of option contracts prepared for the managers. If the managers have a stake in the company, it enhances their motivation.

Corporate control considerations are also important when making ownership decisions. A larger share is preferred to a smaller in case C. It is not the same as a significant minority holding because sufficient control rights accompany shares of more than 50% (appendix 1). A minority holding is preferred in case D. The significant holding range is almost the same in case B (Table 1). It is common in the venture capital world that venture capitalists obtain a lower ownership share when required by accounting rules. It is also emphasized by the representative from case D.

> *We take a minority holding usually of 25–49% of equity. A significant minority holding begins at 25% of equity. The fund has not taken the objective of being a majority shareholder because it lowers the motivation of the entrepreneurs. If rapid growth is expected, we can agree on a lower ownership share. If the portfolio company cannot meet the targets, the ownership of the entrepreneur dwindles automatically in favour of the venture capitalist. Managers can use call options when the enterprise is successful and take the lost share back.*
>
> Representative from Case D

Case E is the only case where an ownership share is not taken (Table 1). Notwithstanding the ownership, a venture capitalist also gets a seat in supervisory board.

Convertible and subordinated debt are used as financing instruments in case E. Due to changes in capital structure, the share of convertible instruments also changes. This is mainly due to the option schemes for managers in Case E.

Dilution problems may arise if the shareholders' share dwindles. Dilution is not a problem if the required rate of return is realized. The ownership share is not an objective in itself. The representatives from case A and C share this view. The representative from case B adds the comments concerning option contracts to managers.

There has been dilution in our venture capital process, but we have not had any problems with it. If we get the required internal rate of return, there is no problem. Dilution is not a problem when the share dwindles due to the option contract for managers.

Representative from Case B

The representative from case D also emphasizes the ownership rules of accountancy. He connected the dilution to the accounting rules. There were no problems of dilution in Case E, because no ownership share was taken. Although the share has been diminished in the capital structure during new financing rounds, the representative from Case E did not see this as a problem.

Most Estonian venture capitalists did not consider dilution as a big problem (Table 1). This may be because staged financing was carried out in only 15% of enterprises and the variation of ownership caused by the realization of option contracts has not been great. On the other hand, this is a question of attitude. Estonian venture capitalists pointed out that it is the required rate of return that is important, not the ownership.

Table 1. General overview of venture capital investment in Estonia

	A	B	C	D	E
Financial instruments	Common stock, Convertible bonds	Common stock, Convertible debt	Common stock, Convertible debt, Preferred shares	Common stock, Subordinated debt	Convertible debt, Subordinated debt
Share (%)	51–100; 33.3–100; 10[1]	20–50; 100[2]	15–100	25–49	0
Variation of share	Often	Often	Rarely	Rarely	Rarely
Dilution	Yes	Yes	Yes	Yes	No
Dilution as a problem	No	No	No	No	No

In order to protect themselves, they set vetoes and additional clauses in the term-sheet. These are as follows:

- vetoes on equity transactions
- a fixed capital structure
- fixed capital costs
- fixed board members
- option contracts
- fixed control variables

The representative from case A highlighted some corporate control problems concerning the Estonian Commercial Code. These problems arise because venture

[1] If entrepreneur is trustworthy

[2] Restructuring deal

capitalists are outside investors and therefore do not have much information and power to influence decisions.

> *Problems exist at the board level. The management board has a representation right and the relationship with the supervisory board is quite fuzzy in Estonian law. Investor protection is also a problem in Estonia according to venture capital (as outside equity) providers. Venture capitalists should get more rights than ordinary minority shareholders.*
>
> Representative from case A

On the other hand, there were no problems concerning corporate control and investor protection in case B. It is a question of attitude.

> *Investor protection is well guaranteed in Estonian business law. There have been no serious problems so far. The taxation of option contracts is the only problem we have faced. This is due to the income tax on fringe benefits. We also set vetoes in the term-sheet to protect ourselves.*
>
> Representative from Case B

The attitude towards corporate control problems depends on previous experiences with portfolio companies. Problems have mostly arisen when the venture capitalist has less than 33.3% ownership. Shareholders can block all those resolutions at a general meeting that require a supermajority, if share ownership is above 33.3% (Appendix 1).

Corporate control problems also arose concerning minority investor status in case C. Venture capitalists should not be treated as ordinary outside minority shareholders. The representative from case A also pointed out this problem. This leads to the determination of sufficient share of ownership according the Estonian Commercial law (Appendix 1). Although vetoes can be stated in advance, the regulations by law also have to be considered.

> *The management and the supervisory board members are indicated in the term-sheet in advance. Although we usually take the minority share, we want more rights than an ordinary minority shareholder. The problem is in using preferred shares as instruments that should guarantee greater investor protection.*
>
> Representative from Case C

Another problem concerning the Estonian Commercial Code is the regulation of preferred shares. As the representative from case E pointed out, preferred shares are allowed for use in no more than 1/3 of share capital. It is especially a problem for case E, because of mezzanine financing.

The representative from case D pointed out the very intriguing problems of outside investor protection concerning minority shareholding. This problem also stems from the Estonian Commercial Code, but from a different viewpoint.

> *We set vetoes of equity transactions in the term-sheet even if we have a very low ownership share. The implementation of some paragraphs is a problem in the Estonian Commercial Code. If a venture capital fund liquidates its holding and*

a new holder sells its holding within 6 months at the higher price, the venture capital fund will have no opportunity to obtain any profit. It is obvious that the entrepreneurs beguiled the venture capital fund due to the existence of asymmetric information. There is no such common law practice (solution) in Estonia. Another problem arises due to the minority holding: a minority share-holder cannot for example influence the dividend decision. We do not under-stand the advantages given by a preferred share. A private limited company may not use preferred shares.

Representative from Case D

What could be the solution to this intriguing problem? This is actually a question of asymmetric information. Although venture capitalists are considered the best investors to deal with asymmetric information (Amit et al. 1998), some problems will remain.

There are many problems concerning mezzanine financing protection in Estonia. There is a gap in the Estonian Commercial Code concerning convertible instruments. Two problems exist: the restrictions on the use of preferred stock and the missing regulations on mezzanine financing.

The seat on the supervisory board is required despite no ownership. There have been no problems getting it so far. The legislation concerning mezzanine financ-ing is missing in Estonia. The Estonian Commercial Code does not allow the use of preferred shares to the value of more than 1/3 of share capital, but these are the main instruments in mezzanine financing. The solution is to use sub-ordinated debt[3], but it also has shortages due to the law of Obligations Act.

Representative from Case E

Estonian venture capitalists highlighted that the Estonian Commercial Code does not regulate the usage of mezzanine financing and convertible instruments (Table 2). Preferred shares are not allowed if more than 1/3 of share capital.

Table 2. Corporate control and investor protection problems

Problem	A	B	C	D	E
Control problems	Rights between supervisory and management board	No	No	Supervisory board authority	No
Problems with legal protection	Minority holding	No	Too many restrictions in commercial code	Implementation of commercial code; minority interests	Missing regu-lations for mezzanine financing
Problems with financial instru-ments	No	Taxation of option contracts	Preferred shares	Preferred shares	Convertible instruments

[3] Subordinated debt has no inferior features in Estonia since 2004 (Bankruptcy Act 2003)

Private limited companies are not allowed to use preferred shares at all. It restricts mezzanine financing in Estonia and financing entrepreneurs.

Even if a minority holding is taken, significant control rights are required and fortunately often achieved. The venture capitalist will get a board seat notwithstanding ownership. How big should the holding be to guarantee investor protection for Estonian venture capitalists? There are different views as pointed out during the interviews.

There are also some problems at the board level (Table 2). The rights between the supervisory and the management board are quite fuzzy. Venture capitalists always get a seat on the supervisory board, but some important decisions and everyday decisions are made by the management board. Some venture capitalists have a seat on the management board as well. This issue necessitates active involvement and majority ownership, leading us to the fact that venture capital is more than just money.

5. Synthesis of the research results and managerial implications

Several surveys in different countries (see e.g. Pinegar and Wilbricht (1989), Kester et al. (1998), Kjellman and Hansen (1995) etc.) have shown that the most preferred source of financing is internal equity capital and if external financing is needed, companies prefer straight debt (either in the form of bank loans or bonds). The same holds for Estonia (Sander 2003). However, these surveys concentrate on large, mature and in most cases listed companies.

It should be noted that even though the venture capitalists in Estonia used some debt instruments (convertible or subordinated debt) to reduce the risk, most of venture capital deals were made using common shares. The research conducted among venture capital backed entrepreneurs showed that 85% of deals were financed by common stock, 5% by convertible debt and 10% by ordinary debt. Preferred stock was not used at all (Kõomägi 2005). The picture is thus clearly different from what is observed in the United States (see Gompers (1997), Kaplan and Strömberg (2003)). This difference can be partly explained by the fact that Estonian venture capitalists rarely financed companies in their seed or start-up phase. The financing of expansion stage is less risky and therefore the use of common stock does not lead to the excessive risk taking by venture capitalist. But the main reason, why Estonian venture capitalists use common stock probably lies in our law system. Lerner and Shcoar (2005) argue that private equity groups in civil law countries tend to use common stock and rely on equity and board control. Estonia is a civil law country and our civil law originates form the German Civil Law. Venture capitalists indicated several legal problems that prevent the use of preferred shares and convertibles. First, private limited companies cannot use preferred shares. According to the data from the Centre of Registers and Infosystems, there are more than 70 000 private limited companies and less than 6000 public limited companies in Estonia. Although the reorganization of private

limited company into a public limited company is possible, the requirements that a public limited company must fulfil are stricter. Second, Estonian Commercial Come stipulates that the sum of the face values of preferred share shall not exceed 1/3 of the share capital (§ 237). Similar restriction refers to the convertible debt (§ 241). As it is possible to issue preferred share or convertible debt *above the par*, these articles do not limit the actual amount obtained by using these instruments, however some problems will arise if the owners of these instrument want to convert their bonds or preferred shares into the common shares.

The minimal ownership share required by different venture capitalists is different. Most of them are satisfied with significant minority holding, although the definition of this term varies. This is probably the right strategy because if the majority ownership belongs to the entrepreneur, the moral hazard problems are smaller and the overall performance of the company is better (Amit et al. 1998). But there are also some funds that require a majority ownership (especially in financing of start-up companies). This indicates that venture capitalists also pursue different strategies. Some of them are essentially willing to become entrepreneurs and take very actively part in the management of the portfolio company, while the others provide mostly just the money. The analysis carried out by Kõomägi (2006) showed that the non-financial assistance is not big, but exists. It is connected to strategic planning in supervisory board, development of different functional systems in enterprise and corporate governance (*Ibid*).

Although all venture capitalists who provide equity financing have experienced the dilution of their holdings, none of them claimed this was a problem. This may stem from the fact that staged financing has been used relatively rarely in Estonia (Kõomägi, Sander 2006) and therefore dilution does not happen very often. Although the staged financing is a very potent mechanism of the control (see Sahlman 1990), it may require complex contract to handle the possible dilution problems associated with it. The use of employee stock options may lead to the dilution of ownership too. Due to the taxation problems associated with option contracts, these instruments are not very widely used in Estonia.

There is no cumulative voting rule according to the Estonian Commercial Code, which means that the majority shareholder could easily select all the members of the supervisory board by himself. Therefore it is essential for venture capitalist with minority shareholding that the board seats are agreed in term-sheets, which is indeed also the current practice in Estonia. Similar behaviour has been observed also in the United States (see Kaplan and Strömberg 2003). Seats on the board are required even in case of non-equity financing. Control over the supervisory board is important as it enables to dismiss managers in case of poor performance or agency conflict between outside investors and managers. There have been cases when managers were actually fired in venture capital backed companies, even though venture capitalists had minority holdings in the company. On some occasions, venture capitalists were not content with representation only on supervisory board level and have taken seats in management board of the company as well, which allowed them to actively take part in the daily management of the company.

As mentioned already in the introduction, minority shareholders' rights are protected relatively well in Estonia, especially for a country whose legal system has civil law origin. Pistor et al. (2000) underlined that there are two alternative strategies shareholders may invoke to assert their control over the management – "voice" or "exit". The "voice" refers to an internal control mechanism executed by voting at the general meeting. However, investors can also sell their shares if they are not satisfied with the way the company is managed. While Estonian Commercial Code follows the "one share, one vote" rule and there are super-majority requirement for most important decisions (see Appendix 1), the exit is difficult if the company is not listed. In some countries investors have a right to sell their share back to the company at a fair price, if they are not satisfied with the way the company is managed. The Estonian Commercial Code does not provide such an option. As there are also no mandatory dividends, selling minority shares of a company at a fair price may be rather difficult. The absence of mandatory dividends as a problem was pointed out also by one of the venture capitalists. There was a proposal to introduce mandatory dividends in 2004, but entrepreneurs opposed it very actively and the legislation was never passed. Although the introduction of mandatory dividends would help to protect minority shareholders' rights, it also would force companies to rely more on outside capital and create additional tax burden due to the specific nature on Estonian Income Tax Law.

Previous analysis has highlighted some problems with the legal protection of minority shareholders rights. Most of these problems can be overcome by writing a rather detailed financing contract, which determines the allocation of cash flow, voting and board rights, as well as includes different vetoes. The use of additional clauses and vetoes allows venture capitalists to remain minority shareholders and still have a considerable control over the company and influence the management decisions. This illustrates clearly the difference in governance of public and private companies.

6. Conclusion

The current research confirmed that the allocation of control rights is a central feature of financial contract between venture capitalist and entrepreneur in Estonia. Quite similarly to other civil law countries, common stock was the most often used financial instrument in venture capital investments in Estonia. Non-voting equity was used very rarely which is in deep contrast to the current practice in the United States. The preference of common equity stems from the legal grounds. The Estonian Commercial Code includes several articles that hinder the use of convertibles or preferred shares.

Most venture capitalists preferred the status of minority shareholder. Therefore their position in the company would be relatively weak unless they protect themselves through explicit allocation of control rights in financial contract. The

current research indicated that Estonian venture capitalists got seats in supervisory board despite their minority shareholder status. Venture capitalists were represented in the board even if they act as lenders and not as shareholders. In addition to the distribution of the board seats, the financial contracts included several special clauses and vetoes. In that respect the situation is thus quite similar to what is observed in countries with more experienced venture capital market.

The allocation of control rights in venture capital financing is not static. Due to the dynamic nature of venture capital backed companies, additional capital infusions, exercising conversion rights and employee stock options, there might be frequent changes in ownership and board structure. This in turn may lead to other organizational changes.

Acknowledgements

The authors are grateful to Professor Maaja Vadi for helpful comments and encouragement and to the two anonymous reviewers for their useful suggestions. The usual disclaimer applies. This article was prepared on the Estonian Science Foundation Grant 6630.

Addresses:
Priit Sander
Faculty of Economics and Business Administration
University of Tartu
Narva mnt 4
51009 Tartu, Estonia
Tel.: +372 7376 336
E-mail: Priit.Sander@ut.ee
Margus Kõomägi
Department of Entrepreneurship
Pärnu College
University of Tartu
Ringi 35
80010 Pärnu, Estonia
Tel.: +372 4450 541
E-mail: Margus.Koomagi@ut.ee

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Appendix 1

Shareholders' rights in Estonia

Ownership	Shareholders' rights
> 0 %	The shareholder has the right to participate in the general meeting of shareholders and in the distribution of profits and, upon dissolution, of the remaining assets of the public limited company, as well as other rights provided by law or prescribed by the articles of association (§ 226). If new shares are paid for in money, a shareholder has a pre-emptive right to subscribe to the new shares in proportion to the sum of the nominal value of the shareholder's shares (unless these rights are barred by a resolution of the general meeting).
> 10 %	At the general meeting of shareholders, shareholders whose shares represent at least one-tenth of the share capital may demand a resolution on conduct of a special audit on matters regarding the management or financial situation of the public limited company, and the appointment of an auditor for the special audit (§ 330). In case of the liquidation of the company, shareholders whose shares represent at least one-tenth of the share capital can request a court to appoint the liquidators (§ 369). The court shall also specify the procedure for and amount of remuneration for the liquidators. Shareholders whose shares represent at least one-tenth of the share capital may demand the calling of a special general meeting (§ 292)
> 25 %	Shareholders whose shares represent at least one-quarter of the share capital can block the resolution of the general meeting by which the pre-emptive rights of shareholders are barred (§ 345).
> 33.333…%	Shareholders can block all those resolutions of the general meeting, which require a supermajority (at least 2/3 of the votes represented at the general meeting.) including the resolution on the amendment of the articles of association (§ 300), decisions to increase and reduce share capital (§ 341, § 356), decisions on dissolution (§ 365), merger (§412), division (§ 456) or transformation of the public limited company (§ 498, § 504).
> 50 %	Shareholders can make all decisions that require a simple majority including elect and remove members to the supervisory board, elect an auditor, approve the annual report and distribute profit, issue convertible bonds, decide whether the company should buy back its own shares, etc. (§ 298).
> 66.666…%	Shareholders can make the resolution on the amendment of articles of association (§ 300), decisions to increase and reduce share capital (§ 341, § 356), decisions on dissolution (§ 365), merger (§ 412), division (§ 456) or transformation of the public limited company (§ 498, § 504).
> 75%	The pre-emptive right of the shareholders may be barred by a resolution of the general meeting, which receives at least three-quarters of the votes represented at the general meeting (§ 345).
> 90 %	On the application of a shareholder whose shares represent at least 9/10 of the share capital of a public limited company (majority shareholder), the general meeting of shareholders may decide in favour of the shares belonging to the remaining shareholders of the public limited company (minority shareholders) being taken over by the majority shareholder in return for fair monetary compensation (§ 363^1).
> 95 %	A resolution on the takeover of shares belonging to minority shareholders shall be adopted if at least 95/100 of the votes represented by shares are in favour (§ 363^7).

Source: Estonian Commercial Code