

BOOM, BUST, AND LITIGATION IN VENTURE CAPITAL FINANCE

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I. INTRODUCTION

Venture capital is still a comparatively young industry. While Gompers and Lerner date the first venture capital firm to 1946,¹ the industry did not really get on its feet until the late 1970s. Nonetheless, the venture capital industry has been through a sufficient number of business cycles that empiricists have mapped out a number of systematic differences in the behavior of venture capitalists (VCs) in boom and bust periods. One aim of this Article is to review this literature with a view to documenting some of these differences. Another is to draw these empirical findings together, indicating how the various strands of the empirical literature paint a remarkably consistent picture of how VCs respond to the changing economic incentives that exist in boom and bust periods. We suggest that these strands can be united by identifying three key parameters that are most responsible for prompting changes in VC behavior as between boom and bust. These are: changes in the availability and valuation of initial public offering (IPO) exits, the inelasticity of VC managerial talent in the short run, and the rapidly increasing supply of capital to venture capital funds in boom periods.

We also seek to explore how the changing availability of IPOs and greatly enhanced IPO valuations combined to produce widespread and systematic pathologies in IPO exits during the Internet

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1. PAUL GOMPERS & JOSH LERNER, *THE VENTURE CAPITAL CYCLE 4* (MIT Press 1999).

bubble (1999-2000)—pathologies that led investment bankers and VCs to change their behavior in value-destructive ways. While the evidence suggests that these pathologies did not start during the bubble, they clearly reached their apogee during that period. If there is a silver lining in all this, it is that the bubble has provided policy makers with a taxonomy of potential abuses and markers that point to the presence of such abuses, particularly extreme underpricing of new offerings. This learning will greatly lower the likelihood that these abuses will be repeated in the future.

We also discuss how a court ought to construe the VC's duties of loyalty and care in a lawsuit either by investors in a limited partnership venture capital fund, or by an investee firm whose interests were poorly served either by opportunistic or negligent VC behavior. In particular, since VC behavior differs from boom to bust, we raise the question of whether a court should look to bust period behavior in constructing a standard of care, or to boom period behavior, or some amalgam of the two. For a variety of reasons, we suggest that courts should primarily have regard to bust period behavior. We review empirical evidence that venture capitalist activities differ depending on economic conditions. We also review empirical evidence that shows venture capital fund managers tend to distort reports to institutional investors and inflate performance figures in bust periods. We begin our examination with a brief empirical review of the cyclical nature of the venture capital industry.